DOWNEY FINANCIAL CORP
Form 10-K
March 01, 2005

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**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.

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# 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

Page 1 **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.

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**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.

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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



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

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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;

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- 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.

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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.

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***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.

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## 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.

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# 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.*



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 | - | - | - | - |
| Change in interest expense | 96,842 | (45,884 ) | (34,972 ) | 15,986 | (12,343 ) | (71,066 ) | (766 ) | (84,175 ) |
| Change in net interest income | $ 21,173 | $ (13,657 ) | $ 21,758 | $ 29,274 | $ 22,683 | $ (47,660 ) | $ (1,436 ) | $ (26,413 ) |

**Provision for Loan Losses**

During 2004, provision for loan losses totaled $2.9 million, compared to a $3.7 million reversal in 2003 and an expense of $0.9 million in 2002. The current year provision for loan losses was due to growth in our loan portfolio.

For further information, see Allowance for Losses on Loans and Real Estate on page 55.

**Other Income**

Our total other income was $91.4 million in 2004, up from $90.9 million in 2003 and $67.1 million in 2002. The $0.4 million increase from 2003 primarily reflected:

- 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 items were partially offset by:

- 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 $5.7 million unfavorable change associated with securities gains/losses, virtually all of which related to a partial economic hedge against value changes of MSRs;
- 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; and
- a $2.9 million decline in income from a litigation award recorded in 2003.

Total other income increased $23.9 million during 2003 due primarily to a $15.6 million increase from gains on sales of loans, a $12.6 million improvement in loan servicing activities, a $5.9 million increase in loan and deposit related fees and a $2.9 million litigation award. These favorable items were partially offset by a $10.4 million loss from trading securities and a $1.6 million decline in our other income category.

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

***Loan and Deposit Related Fees***

Loan and deposit related fees totaled $60.5 million in 2004, up $7.5 million from 2003 and $13.3 million from 2002. During 2004, our loan related fees increased $4.9 million due to higher loan prepayment fees and our deposit related fees increased $2.6 million, due primarily to higher fees from our checking accounts.

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

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| Loan related fees: | | | |
| Prepayment fees | $ 23,608 | $ 16,780 | $ 15,999 |
| Other fees | 8,542 | 10,479 | 9,258 |
| Deposit related fees: | | | |
| Automated teller machine fees | 9,503 | 8,925 | 7,328 |
| Other fees | 18,886 | 16,892 | 14,635 |
| Total loan and deposit related fees | $ 60,539 | $ 53,076 | $ 47,220 |

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

Income from our real estate and joint ventures held for investment totaled $13.9 million in 2004, up $4.1 million from 2003 and $3.7 million from 2002. The current year increase was primarily attributed to a $4.0 million increase in gains from sales to $11.2 million (a $2.3 million increase in gains from sales of wholly owned real estate and a $1.7 million increase in gains related to joint venture projects reported within 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 years indicated.

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Rental operations, net of expenses | $ 1,014 | $ 1,213 | $ 2,102 |
| Net gains on sales of wholly owned real estate | 5,657 | 3,317 | 1,200 |
| Equity in net income from joint ventures | 5,655 | 4,379 | 5,476 |
| Interest from joint venture advances | 1,576 | 1,454 | 1,024 |
| (Provision for) reduction of losses on real estate and joint ventures | - | (528 ) | 448 |
| Total income from real estate and joint ventures held for investment, net | $ 13,902 | $ 9,835 | $ 10,250 |

For additional information, see Investments in Real Estate and Joint Ventures on page 40, Allowance for Losses on Loans and Real Estate on page 55 and Note 6 of Notes to Consolidated Financial Statements on page 87.

 **Navigation Links**

***Secondary Marketing Activities***

We recorded a loss of $19.2 million in loan servicing from our portfolio of loans serviced for others during 2004, which was an improvement of $7.8 million from 2003 and $20.4 from 2002. Contributing to the improvement in 2004 were declines of $7.0 million in the amortization of MSRs and $6.0 million in payoff and curtailment interest cost, both of which were impacted by lower prepayments. Most of our loan servicing agreements require us to pay interest to the investor for an entire month, even if the loan we service for others prepays prior to the end of a month. That additional interest cost is what we call payoff and curtailment interest cost. However, we benefit from the use of those proceeds from the time of repayment until we are required to remit the funds to the investor. That benefit results in an increase to our net interest income. In each of the three years, the fair value of our MSRs declined due to the drop in long-term interest rates that resulted in an increase in the actual and projected rate loans we service for others prepay, thereby shortening their expected average life. Those declines in the fair value required us to record a provision for impairment in each year. In 2004, the addition totaled $16.8 million, up $4.9 million from 2003, partially offsetting the improvement in other components of our loan servicing activities. During the fourth quarter of 2004, we sold approximately 80% of our MSRs. We believe those sales should reduce our earnings volatility, since the amount of MSRs we now own is significantly lower. At December 31, 2004, loans we service with capitalized MSRs totaled $2.1 billion, down from $9.3 billion at December 31, 2003 and $8.1 billion at December 31, 2002. In addition to the $2.1 billion of loans we serviced for others with capitalized MSRs at December 31, 2004, we serviced $4.5 billion of loans on a sub-servicing basis for which we have no risk associated with changing MSR values. On loans we sub-service, we receive a fixed fee per loan each month from the owner of the MSRs.

The following table presents a breakdown of the components of our loan servicing loss for the years indicated.

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| Net cash servicing fees | $ 20,945 | $ 21,215 | $ 16,536 |
| Payoff and curtailment interest cost [(a)] | (5,631 ) | (11,611 ) | (5,117 ) |
| Amortization of mortgage servicing rights | (17,789 ) | (24,774 ) | (14,435 ) |
| Provision for impairment of mortgage servicing rights | (16,750 ) | (11,890 ) | (36,613 ) |
| Total loan servicing loss, net | $ (19,225 ) | $ (27,060 ) | $ (39,629 ) |

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

Sales of loans and mortgage-backed securities we originated increased in 2004 to a record $6.9 billion, up from $6.6 billion in 2003 and $6.0 billion in 2002. Net gains associated with these sales totaled $54.4 million in 2004, down from $61.4 million in

2003, but up from $45.9 million in 2002. Included in these gains was the SFAS 133 impact of valuing derivatives associated with the sale of loans, for which we recorded a loss of $2.4 million in 2004 and $0.9 million in 2003, compared to income of $6.1 million in 2002. Excluding the SFAS 133 impact, a gain of $56.8 million or 0.82% of loans sold was realized in 2004, down from 0.95% in 2003, but up from 0.66% in 2002. Net gains included capitalized MSRs of $32.0 million in 2004, compared to $61.1 million in 2003 and $53.2 million in 2002.

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

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| Mortgage servicing rights | $ 31,991 | $ 61,110 | $ 53,236 |
| All other components excluding SFAS 133 [a] | 24,817 | 1,264 | (13,474 ) |
| SFAS 133 | (2,365 ) | (938 ) | 6,098 |
| Total net gains on sales of loans and mortgage-backed securities | $ 54,443 | $ 61,436 | $ 45,860 |
| Secondary marketing gain excluding SFAS 133 as a percentage of associated sales | 0.82 % | 0.95 % | 0.66 % |

[a] *Included a $0.3 million gain in 2002 associated with the treasury operation s sale of $1.0 billion of mortgage-backed securities.*

For additional information concerning MSRs, see Note 11 of Notes to Consolidated Financial Statements on page 91.



***Securities Available for Sale and Trading Securities***

In both 2004 and 2003, we purchased and sold securities as a partial economic hedge against value changes in our MSRs. In 2004, the securities were classified as available for sale, while in 2003 they were classified as trading securities. Losses from the sales in 2004 totaled $16.1 million, a $5.7 million unfavorable change from the loss in 2003. No securities were held as a partial economic hedge at year-end 2004 due to the sale of approximately 80% of our MSRs.

**Operating Expense**

Our operating expense totaled $229.5 million in 2004, up from $207.1 million in 2003 and $186.7 million in 2002. The current year increase was due to higher general and administrative expense, which increased by $21.8 million or 10.5%. That increase was primarily associated with a rise of $13.6 million or 10.1% in salaries and related costs and a $5.2 million increase in our other general and administrative expense category, which included an accrual for pending litigation. For further information, see Item 3. Legal Proceedings on page 20.

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

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| Salaries and related costs | $ 148,221 | $ 134,610 | $ 119,514 |
| Premises and equipment costs | 33,980 | 32,261 | 30,694 |
| Advertising expense | 5,525 | 3,712 | 4,418 |
| SAIF insurance premiums and regulatory assessments | 3,151 | 3,205 | 3,078 |
| Professional fees | 1,828 | 2,383 | 1,435 |

| | | | |
|---|---|---|---|
| Other general and administrative expense | 37,061 | 31,828 | 27,505 |
| Total general and administrative expense | 229,766 | 207,999 | 186,644 |
| Net operation of real estate acquired in settlement of loans | (256 ) | (929 ) | 11 |
| Total operating expense | $ 229,510 | $ 207,070 | $ 186,655 |

**Provision for Income Taxes**

Our effective tax rate was 39.1% for 2004, down from 42.3% for both 2003 and 2002. The decline in the effective tax rate reflects a reduction to federal tax expense of $5.6 million during the year from the settlement of prior year tax return issues. See Note 1 on page 75 and Note 19 on page 96 of Notes to the Consolidated Financial Statements for a further discussion of income taxes and an explanation of the factors which impact our effective tax rate.

**Business Segment Reporting**

The previous discussion and analysis of the Results of Operations pertained to our consolidated results. This section discusses and analyzes the results of operations of our two business segments  banking and real estate investment. For a description of these business segments and the accounting policies used, see Business on page 1 and Note 1 on page 75 and Note 25 on page 109 of Notes to Consolidated Financial Statements.

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

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| Banking net income | $ 99,478 | $ 95,459 | $ 106,074 |
| Real estate investment net income | 8,184 | 6,282 | 6,219 |
| Total net income | $ 107,662 | $ 101,741 | $ 112,293 |

 **Navigation Links**

***Banking***

Net income from our banking operations totaled $99.5 million in 2004, up from $95.5 million in 2003, but down from $106.1 million in 2002. Contributing to the increase between 2004 and 2003 was a lower effective tax rate, due to a $5.6 million reduction in the current year federal income tax expense associated with the settlement of prior-year tax returns. Pre-tax income declined $2.6 million in 2004 primarily due to the following:

- a $22.1 million increase in operating 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 MSRs;
- 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 the redemption of the related capital securities. This debt was replaced with lower cost senior debt; and

- a $2.9 million decline in income from a litigation award recorded in 2003.

Those unfavorable items were partially offset by the following:

- a $29.4 million increase in net interest income reflecting growth in average interest-earning assets;
- a $8.1 million increase in loan and deposit related fees; and
- a $7.8 million improvement in loan servicing activities.

During 2003, net income from our banking operations declined $10.6 million. The decrease was primarily due to a $26.2 million decline in net interest income, a $20.3 million increase in operating expense and a $10.4 million loss from trading securities. These unfavorable items were partially offset by a $15.6 million increase in net gains on sales of loans, a $12.6 million improvement in loan servicing activities, a $5.2 million increase in loan and deposit related fees, a $4.7 million improvement in provision for loan losses and a $2.9 million litigation award.

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

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| Net interest income | $ 318,178 | $ 288,740 | $ 314,981 |
| Provision for (reduction of) loan losses | 2,895 | (3,718 ) | 939 |
| Other income | 76,144 | 79,084 | 55,423 |
| Operating expense | 228,280 | 206,142 | 185,859 |
| Net intercompany income (expense) | (148 ) | 169 | 343 |
| Income before income taxes | 162,999 | 165,569 | 183,949 |
| Income taxes | 63,521 | 70,110 | 77,875 |
| Net income | $ 99,478 | $ 95,459 | $ 106,074 |
| **At period end** | | | |
| Assets: | | | |
| Loans and mortgage-backed securities | $ 14,542,778 | $ 10,396,510 | $ 10,976,942 |
| Other | 1,097,534 | 1,237,858 | 999,197 |
| Total assets | 15,640,312 | 11,634,368 | 11,976,139 |
| Equity | $ 1,007,651 | $ 917,018 | $ 823,104 |



***Real Estate Investment***

Net income from our real estate investment operations totaled $8.2 million in 2004, up from $6.3 million in 2003 and $6.2 million in 2002. The increase during 2004 was primarily due to a $4.0 million increase from gains on sales.

During 2003, net income from our real estate investment operations was virtually unchanged from 2002 primarily due to higher gains from sales and interest from joint ventures being offset by an unfavorable change in provision for losses on real estate and joint ventures and lower net rental income.

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

| *(In Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| Net interest income (expense) | $ (291 ) | $ (127 ) | $ 45 |
| Other income | 15,241 | 11,858 | 11,631 |
| Operating expense | 1,230 | 928 | 796 |
| Net intercompany income (expense) | 148 | (169 ) | (343 ) |
| Income before income taxes | 13,868 | 10,634 | 10,537 |
| Income taxes | 5,684 | 4,352 | 4,318 |
| Net income | $ 8,184 | $ 6,282 | $ 6,219 |
| **At period end** | | | |
| Assets: | | | |
| Investments in real estate and joint ventures | $ 55,411 | $ 35,716 | $ 33,890 |
| Other | 18,776 | 3,503 | 14,174 |
| Total assets | 74,187 | 39,219 | 48,064 |
| Equity | $ 65,691 | $ 27,607 | $ 42,325 |

For a further discussion regarding income from real estate investment, see Real Estate and Joint Ventures Held For Investment on page 30, and for information regarding related assets, see Investments in Real Estate and Joint Ventures on page 40.



**FINANCIAL CONDITION**

**Loans and Mortgage-Backed Securities**

Total loans and mortgage-backed securities, including those we hold for sale, increased $4.1 billion or 39.9% from year-end 2003 to a total of $14.5 billion or 92.9% of total assets at December 31, 2004. The increase occurred in both loans held for investment and loans held for sale. Loans held for investment increased $3.3 billion, as portfolio originations exceeded repayments and a reduction due to a sale, and loans held for sale increased $839 million.

Our loan originations, including loans purchased, totaled a record $15.7 billion in 2004, up from $11.3 billion in 2003 and $10.9 billion in 2002. This current year increase primarily reflected record originations of one-to-four unit residential loans of $15.1 billion, of which $8.3 billion or 55% were for portfolio, with the balance for sale in the secondary market. Our origination of subprime loans totaled $828 million in 2004, up from $318 million in 2003. Our prepayment speed, which measures the annualized percentage of loans repaid, for one-to-four unit residential loans held for investment was 39% during 2004, compared to 51% during 2003 and 39% during 2002. Refinancing activities related to residential one-to-four unit loans, including new loans to refinance existing loans which we or other lenders originated, constituted 78% of originations during 2004 compared to 83% during 2003 and 78% during 2002. Refinancing activities increased from $9.1 billion in 2003 to $11.7 billion in 2004, as a lower interest

rate environment existed throughout most of the year.

We originate one-to-four unit residential adjustable rate mortgages both with and without loan origination fees. In adjustable rate mortgage transactions for which we charge no origination fees, we receive a larger interest margin over the rate index to which the loan pricing is tied than in those for which we charge fees. In addition, a prepayment fee on loans with no origination fees is generally required if prepaid within the first three years. These loans generally result in deferrable loan origination costs exceeding loan origination fees.

Originations of adjustable rate residential one-to-four unit loans for portfolio, including loans purchased, totaled $8.3 billion in 2004, up from $4.6 billion in 2003 and $4.4 billion in 2002. Of the 2004 total:

- 90% were monthly adjustable loans tied to either the COFI or MTA index and generally provide for negative amortization. Loans tied to COFI represented 80% of monthly adjustable originations, while MTA-related loans represented the difference. This is in contrast to 2003 when MTA-related loans represented 62% and COFI-related represented 38%; and
- 8% were adjustable loans tied to London Inter-Bank Offered Rate ("LIBOR") that typically adjust every six months.

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

| *(In Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
|---|---|---|---|---|---|
| **Loans originated and purchased** | | | | | |
| Investment portfolio: | | | | | |
| Residential one-to-four units: | | | | | |
| Adjustable by index: | | | | | |
| COFI | $ 5,995,317 | $ 1,077,726 | $ 2,264,065 | $ 2,041,962 | $ 3,179,126 |
| MTA | 1,505,413 | 1,795,628 | 890,814 | 169,909 | 17,040 |
| LIBOR | 667,227 | 405,080 | 3,903 | 12,683 | 6,254 |
| Adjustable fixed for 3-5 years | 124,008 | 1,353,320 | 1,288,389 | 978,713 | 37,366 |
| Fixed | 482 | 22,647 | 40,375 | 21,199 | 14,661 |
| Total residential one-to-four units | 8,292,447 | 4,654,401 | 4,487,546 | 3,224,466 | 3,254,447 |
| Other | 628,715 | 377,355 | 269,407 | 180,498 | 253,529 |
| Total for investment portfolio | 8,921,162 | 5,031,756 | 4,756,953 | 3,404,964 | 3,507,976 |
| Sale portfolio[(a)] | 6,783,718 | 6,223,868 | 6,172,572 | 4,823,938 | 1,729,220 |
| Total for investment and sale portfolios | $ 15,704,880 | $ 11,255,624 | $ 10,929,525 | $ 8,228,902 | $ 5,237,196 |

[(a)] *Primarily residential one-to-four unit loans.*

At December 31, 2004, $11.3 billion of our one-to-four unit adjustable rate mortgages were subject to negative amortization, of which $37 million represented the amount of negative amortization included in the loan

balance. The amount of negative amortization declined $11 million during 2004 as borrowers paid off loans or repaid previously capitalized interest. For further information, see Residential Real Estate Lending on page 3.

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

| | *December 31,* | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *2004* | | *2003* | | *2002* | | *2001* | | *2000* | |
| *(Dollars in Thousands)* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* |
| **Investment Portfolio** | | | | | | | | | | |
| Residential one-to-four units: | | | | | | | | | | |
| Adjustable by index: | | | | | | | | | | |
| COFI | $ 8,461,835 | 72 % | $ 4,819,852 | 61 % | $ 6,831,649 | 85 % | $ 7,244,336 | 92 % | $ 8,096,156 | 92 % |
| MTA | 2,224,130 | 19 | 2,503,336 | 32 | 1,090,646 | 13 | 612,867 | 8 | 635,503 | 7 |
| LIBOR | 908,596 | 8 | 403,450 | 5 | 25,296 | - | 37,254 | - | 50,126 | 1 |
| Other, primarily CMT | 119,475 | 1 | 185,437 | 2 | 136,230 | 2 | 4,248 | - | 5,734 | - |
| Total adjustable loans [(a)] | $ 11,714,036 | 100 % | $ 7,912,075 | 100 % | $ 8,083,821 | 100 % | $ 7,898,705 | 100 % | $ 8,787,519 | 100 % |

[(a)] *Excludes residential one-to-four unit adjustable fixed for 3-5 year loans still in their initial fixed rate period.*

Origination of loans secured by multi-family properties, including loans purchased, totaled $22 million in 2004, down from $85 million in 2003, but up from $3 million in 2002. Our origination of commercial real estate loans, including loans purchased, totaled $10 million in 2004, up from $4 million in 2003 and $1 million in 2002.

During 2004, we originated $37 million of construction loans, principally for entry level and first time move-up residential tracts. This compares to $80 million in 2003 and $124 million in 2002. Our origination of land development loans totaled $28 million in 2004, compared to $20 million in 2003 and $56 million in 2002.

Origination of non-mortgage commercial loans totaled $1 million in 2004, down from $3 million in 2003 and $14 million in 2002.

As we entered the fourth quarter of 2004, we decided to slow our asset growth to maintain a strong capital position and to manage asset growth more in line with the growth in our retained earnings. In November, we sold approximately $1 billion of our residential one-to-four unit loans on a servicing released basis leaving $12.8 billion in our portfolio held for investment. The loans sold were seasoned adjustable rate mortgages tied to MTA that we expect to replace with higher yielding adjustable rate product. While this sale temporarily resulted in assets growing more slowly than the growth of our retained earnings, we expect to replace the MTA loans sold and to achieve more comparable growth in assets and retained earnings before the end of first quarter 2005. Initially, the sale will result in a reduction of net interest income until the loans are replaced. However, we expect a breakeven point for the lost net interest income to occur within approximately six months following the sale date, when considering the 2004 fourth quarter gain from this loan sale. After the initial approximate six month period, overall profits should be enhanced from the higher yielding loans. We will continue to originate significant volumes of adjustable rate mortgages to the extent we can profitably sell the amount in excess of our balance sheet needs in the secondary market.

At December 31, 2004, our unfunded loan application pipeline totaled $3.0 billion. Within that pipeline, we had commitments to borrowers for short-term interest rate locks, excluding expected fallout, of $1.2 billion, of which $476 million were related to

residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, we had commitments for undrawn lines of credit of $412 million and loans in process of $46 million. We believe our current sources of funds will enable us to meet these obligations.

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

| *(In Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
|---|---|---|---|---|---|
| **Investment Portfolio** | | | | | |
| Loans originated: | | | | | |
| Loans secured by real estate: | | | | | |
| Residential one-to-four units: | | | | | |
| Adjustable | $ 7,125,626 | $ 2,958,976 | $ 2,648,302 | $ 1,800,777 | $ 2,798,592 |
| Adjustable subprime | 805,138 | 301,938 | 466,086 | 423,777 | 392,794 |
| Adjustable fixed for 3-5 years | 124,008 | 692,635 | 818,417 | 890,704 | 33,004 |
| Adjustable fixed for 3-5 years subprime | - | 11,683 | 47,794 | - | 3,117 |
| Total adjustable residential one-to-four units | 8,054,772 | 3,965,232 | 3,980,599 | 3,115,258 | 3,227,507 |
| Fixed | 284 | 20,447 | 40,245 | 16,443 | 9,167 |
| Fixed subprime | - | 1,468 | - | 4,708 | - |
| Residential five or more units: | | | | | |
| Adjustable | 20,801 | 46,774 | 2,806 | - | - |
| Fixed | - | - | - | 125 | 678 |
| Total residential | 8,075,857 | 4,033,921 | 4,023,650 | 3,136,534 | 3,237,352 |
| Commercial real estate | 10,039 | 3,847 | 1,157 | 133 | 23,720 |
| Construction | 36,817 | 80,201 | 124,168 | 101,716 | 98,330 |
| Land | 28,053 | 19,589 | 56,362 | 16,242 | 16,530 |
| Non-mortgage: | | | | | |
| Commercial | 1,375 | 2,585 | 13,671 | 17,581 | 18,504 |
| Automobile | - | 118 | 855 | 4,825 | 56,576 |
| Other consumer | 530,577 | 185,608 | 70,388 | 32,953 | 38,136 |
| Total loans originated | 8,682,718 | 4,325,869 | 4,290,251 | 3,309,984 | 3,489,148 |
| Real estate loans purchased: | | | | | |
| One-to-four units | 215,012 | 664,363 | 460,263 | 88,057 | 9,178 |
| One-to-four units subprime | 22,379 | 2,891 | 6,439 | - | 8,595 |
| Other [(a)] | 1,053 | 38,633 | - | 6,923 | 1,055 |
| Total real estate loans purchased | 238,444 | 705,887 | 466,702 | 94,980 | 18,828 |
| Total loans originated and purchased | 8,921,162 | 5,031,756 | 4,756,953 | 3,404,964 | 3,507,976 |
| Loan repayments | (4,570,630 ) | (5,212,106 ) | (3,911,209 ) | (3,715,163 ) | (1,981,802 ) |
| Other net changes [(b)] | (1,043,052 ) | (25,768 ) | (37,515 ) | 2,029 | (291,935 ) |
| Net increase (decrease) in loans held for investment | 3,307,480 | (206,118 ) | 808,229 | (308,170 ) | 1,234,239 |

| | | | | | |
|---|---|---|---|---|---|
| **Sale Portfolio** | | | | | |
| Originated whole loans: | | | | | |
| Residential one-to-four units | 6,715,955 | 6,219,652 | 6,155,727 | 4,818,301 | 1,641,099 |
| Residential one-to-four units subprime | - | - | - | - | 87,174 |
| Non-mortgage loans | 730 | 3,154 | - | - | - |
| Loans purchased | 67,033 | 1,062 | 16,845 | 5,637 | 947 |
| Loans transferred from (to) the investment portfolio [(b)] | 977,625 | (7,274 ) | (2,928 ) | (7,454 ) | 54,993 |
| Originated whole loans sold | (5,090,301 ) | (939,373 ) | (919,211 ) | (737,773 ) | (687,512 ) |
| Loans exchanged for mortgage-backed securities | (1,796,201 ) | (5,642,483 ) | (5,104,433 ) | (3,816,171 ) | (970,319 ) |
| Capitalized basis adjustment [(c)] | (4,331 ) | (1,816 ) | 12,414 | (10,326 ) | - |
| Other net changes | (31,692 ) | (5,317 ) | (5,386 ) | (4,762 ) | (10,815 ) |
| Net increase (decrease) in loans held for sale | 838,818 | (372,395 ) | 153,028 | 247,452 | 115,567 |
| Mortgage-backed securities, net: | | | | | |
| Received in exchange for loans | 1,796,201 | 5,642,483 | 5,104,433 | 3,816,171 | 970,319 |
| Sold | (1,796,201 ) | (5,642,483 ) | (6,184,650 ) | (3,816,171 ) | (975,088 ) |
| Purchased | - | - | 1,014,098 | 115,597 | - |
| Repayments | (24 ) | (1,882 ) | (51,956 ) | (6,523 ) | (7,031 ) |
| Other net changes | (6 ) | (37 ) | 1,347 | (296 ) | 284 |
| Net increase (decrease) in mortgage-backed securities available for sale | (30 ) | (1,919 ) | (116,728 ) | 108,778 | (11,516 ) |
| Net increase (decrease) in loans held for sale and mortgage-backed securities available for sale | 838,788 | (374,314 ) | 36,300 | 356,230 | 104,051 |
| Total net increase (decrease) in loans and mortgage-backed securities | $ 4,146,268 | $ (580,432 ) | $ 844,529 | $ 48,060 | $ 1,338,290 |

*[(a)] Primarily five or more unit residential loans except for $6.7 million of commercial real estate loans in 2001 and $1.1 million of construction loans in 2000.*
*[(b)] Primarily included changes in undisbursed funds for lines of credit and construction loans, changes in loss allowances, loans transferred to real estate acquired in settlement of loans or from (to) the held for sale portfolio, and the change in interest capitalized on loans (negative amortization). During the fourth quarter of 2004, we transferred to our sale portfolio and sold approximately $1 billion of our loans held for investment. Also included in 2000 was $367 million of net automobile loans sold as part of the sale of subsidiary.*
*[(c)] Reflected the change in fair value of the rate lock derivative from the date of commitment to the date of funding.*

 **Navigation Links**

At December 31, 2004, approximately 90% of our real estate loans were secured by properties located in California, principally in Los Angeles, San Diego, Orange, Santa Clara and Riverside counties. This compares to 95% at year-end 2003. Also, approximately 63% of our residential one-to-four unit loans held for investment were originated in 2004, with an additional 18% originated in 2003.

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

| | December 31, | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
| **Investment Portfolio** | | | | | |
| Loans secured by real estate: | | | | | |
| Residential one-to-four units: | | | | | |
| Adjustable | $ 10,425,738 | $ 6,945,106 | $ 6,739,243 | $ 6,365,149 | $ 7,098,689 |
| Adjustable subprime | 1,231,911 | 940,655 | 1,297,280 | 1,424,656 | 1,633,917 |
| Adjustable fixed for 3-5 years | 1,017,958 | 1,687,323 | 1,697,953 | 999,528 | 101,711 |
| Adjustable fixed for 3-5 years subprime | 19,415 | 42,952 | 81,421 | 66,760 | 92,609 |
| Fixed | 65,371 | 105,042 | 210,001 | 334,384 | 454,838 |
| Fixed subprime | 3,126 | 4,432 | 7,412 | 15,303 | 17,388 |
| Total residential one-to-four units | 12,763,519 | 9,725,510 | 10,033,310 | 9,205,780 | 9,399,152 |
| Residential five or more units: | | | | | |
| Adjustable | 95,163 | 91,024 | 6,964 | 6,055 | 14,203 |
| Fixed | 1,424 | 1,904 | 3,676 | 5,124 | 5,257 |
| Commercial real estate: | | | | | |
| Adjustable | 28,384 | 36,142 | 40,373 | 40,900 | 37,374 |
| Fixed | 4,294 | 13,144 | 31,042 | 71,609 | 127,230 |
| Construction | 67,519 | 105,706 | 103,547 | 84,942 | 118,165 |
| Land | 25,569 | 16,855 | 53,538 | 22,028 | 26,880 |
| Non-mortgage: | | | | | |
| Commercial | 4,997 | 4,975 | 15,021 | 22,017 | 21,721 |
| Automobile | 858 | 3,823 | 11,641 | 24,529 | 39,614 |
| Other consumer | 283,798 | 95,319 | 56,782 | 50,908 | 60,653 |
| Total loans held for investment | 13,275,525 | 10,094,402 | 10,355,894 | 9,533,892 | 9,850,249 |
| Increase (decrease) for: | | | | | |
| Undisbursed loan funds | (49,089 ) | (56,543 ) | (95,002 ) | (61,280 ) | (72,328 ) |
| Net deferred costs and premiums | 232,277 | 108,990 | 96,744 | 77,916 | 79,109 |
| Allowance for losses | (34,714 ) | (30,330 ) | (34,999 ) | (36,120 ) | (34,452 ) |
| Total loans held for investment, net | 13,423,999 | 10,116,519 | 10,322,637 | 9,514,408 | 9,822,578 |
| **Sale Portfolio, Net** | | | | | |
| Loans held for sale: | | | | | |
| Residential one-to-four units | 1,122,534 | 276,295 | 649,964 | 509,350 | 251,572 |
| Non-mortgage | - | 3,090 | - | - | - |
| Capitalized basis adjustment [a] | (4,059 ) | 272 | 2,088 | (10,326 ) | - |
| Total loans held for sale | 1,118,475 | 279,657 | 652,052 | 499,024 | 251,572 |
| Mortgage-backed securities available for sale: | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Adjustable | 304 | 334 | 2,253 | 101,562 | 6,050 |
| Fixed | - | - | - | 17,419 | 4,153 |
| Total mortgage-backed securities available for sale | 304 | 334 | 2,253 | 118,981 | 10,203 |
| Total loans held for sale and mortgage-backed securities available for sale | 1,118,779 | 279,991 | 654,305 | 618,005 | 261,775 |
| Total loans and mortgage-backed securities | $ 14,542,778 | $ 10,396,510 | $ 10,976,942 | $ 10,132,413 | $ 10,084,353 |

[a] *Reflected the change in fair value of the rate lock derivative from the date of commitment to the date of funding.*

We carry loans for sale at the lower of cost or fair value. At December 31, 2004, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

At December 31, 2004, our residential one-to-four units subprime portfolio consisted of approximately 95% "Alt. A and A-" credit, 4% "B" credit and 1% "C" credit loans. The average loan-to-value ratio at origination for these loans was 71%.



We carry mortgage-backed securities available for sale at fair value which, at December 31, 2004, was essentially equal to our cost basis.

The table below sets forth the scheduled contractual maturities, including principal amortization, of our loan and mortgage-backed securities portfolio at December 31, 2004.

| *(In Thousands)* | *Within 1 Year* | *1-2 Years* | *2-3 Years* | *3-5 Years* | *5-10 Years* | *10-15 Years* | *Beyond 15 Years* | *Total* |
|---|---|---|---|---|---|---|---|---|
| Loans secured by real estate: | | | | | | | | |
| Residential: | | | | | | | | |
| One-to-four units: | | | | | | | | |
| Adjustable by index: | | | | | | | | |
| COFI | $ 120,734 | $ 126,671 | $ 132,900 | $ 285,725 | $ 846,709 | $ 1,076,395 | $ 5,872,701 | $ 8,461,835 |
| MTA | 50,362 | 52,364 | 54,448 | 115,479 | 331,369 | 402,731 | 2,067,245 | 3,073,998 |
| 6-Month LIBOR [a] | 28,399 | 29,781 | 31,232 | 67,103 | 198,534 | 251,825 | 1,153,409 | 1,760,283 |
| Other, primarily CMT [b] | 7,553 | 7,908 | 8,276 | 17,733 | 52,118 | 65,503 | 223,772 | 382,863 |
| Fixed | 3,412 | 3,631 | 3,862 | 8,478 | 26,877 | 35,907 | 124,907 | 207,074 |
| Five or more units: | | | | | | | | |
| Adjustable | 1,552 | 1,635 | 1,721 | 3,716 | 11,135 | 66,178 | 9,226 | 95,163 |
| Fixed | 48 | 48 | 53 | 391 | 315 | 480 | 89 | 1,424 |
| Commercial real estate: | | | | | | | | |
| Adjustable | 1,560 | 1,672 | 1,793 | 3,454 | 3,031 | 16,874 | - | 28,384 |
| Fixed | 188 | 208 | 221 | 3,247 | 430 | - | - | 4,294 |
| Construction | 67,519 | - | - | - | - | - | - | 67,519 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Land | 25,025 | 131 | 143 | 270 | - | - | - | 25,569 |
| Non-mortgage: | | | | | | | | |
| Commercial | 4,455 | 60 | 69 | 150 | 263 | - | - | 4,997 |
| Automobile | 664 | 182 | 10 | 2 | - | - | - | 858 |
| Other consumer [(c)] | 1,667 | 1,830 | 2,009 | 1,637 | 276,655 | - | - | 283,798 |
| Total loans | 313,138 | 226,121 | 236,737 | 507,385 | 1,747,436 | 1,915,893 | 9,451,349 | 14,398,059 |
| Mortgage-backed securities, net | 15 | 15 | 15 | 32 | 91 | 108 | 28 | 304 |
| Total loans and mortgage-backed securities | $ 313,153 | $ 226,136 | $ 236,752 | $ 507,417 | $ 1,747,527 | $ 1,916,001 | $ 9,451,377 | $ 14,398,363 |

*[(a)] Included $718 million of residential one-to-four unit adjustable fixed for 3-5 year loans still in their initial fixed rate period.*
*[(b)] Included $263 million of residential one-to-four unit adjustable fixed for 3-5 year loans still in their initial fixed rate period.*
*[(c)] Included home equity loans, which are interest only, with balances due at the end of the term. All or part of the outstanding balances may be paid off at any time during the term without penalty.*

At December 31, 2004, the maximum amount the Bank could have loaned to any one borrower, and related entities, under regulatory limits was $181 million or $301 million for loans secured by readily marketable collateral, compared to $147 million or $245 million for loans secured by readily marketable collateral at year-end 2003. We do not expect that these regulatory limitations will adversely impact our proposed lending activities during 2005.

**Investment Securities**

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

| | | | *December 31,* | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
| Federal funds | $ - | $ 1,500 | $ 2,555 | $ 37,001 | $ 19,601 |
| U.S. Treasury and agency securities available for sale | 496,944 | 690,281 | 457,797 | 356,910 | 284,102 |
| Corporate bonds available for sale | - | - | - | 45,445 | 21,513 |
| Other investment securities available for sale | 65 | 66 | 67 | 68 | 69 |
| Municipal securities held to maturity | - | - | 6,149 | 6,320 | 6,481 |
| Total investment securities | $ 497,009 | $ 691,847 | $ 466,568 | $ 445,744 | $ 331,766 |



The fair value of temporarily impaired securities, the amount of unrealized losses and the length of time these unrealized losses existed as of December 31, 2004 are presented in the following table. The $79,000 unrealized loss on the security that has been in a loss position for less than 12 months is due to changes in market interest rates. We have the intent and ability to hold the

security until that temporary impairment is eliminated.

| | *Less than 12 months* | | *12 months or longer* | | *Total* | |
|---|---|---|---|---|---|---|
| *(In Thousands)* | *Fair Value* | *Unrealized Losses* | *Fair Value* | *Unrealized Losses* | *Fair Value* | *Unrealized Losses* |
| U.S. Treasury and agency securities | $ 231,262 | $ 79 | $ - | $ - | $ 231,262 | $ 79 |
| Other investment securities | - | - | - | - | - | - |
| Total temporarily impaired securities | $ 231,262 | $ 79 | $ - | $ - | $ 231,262 | $ 79 |

The following table sets forth the maturities of our investment securities and their weighted average yields at December 31, 2004.

| | *As of December 31, 2004 Amount Due* | | | | |
|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *In 1 Year or Less* | *After 1 Year Through 5 Years* | *After 5 Years Through 10 Years* | *After 10 Years* | *Total* |
| Federal funds | $ - | $ - | $ - | $ - | $ - |
| Weighted average yield | - % | - % | - % | - % | - % |
| U.S. Treasury and agency securities | | | | | |
| available for sale [(a)] | - | 61,137 | 427,167 | 8,640 | 496,944 |
| Weighted average yield | - % | 2.95 % | 4.01 % | 3.98 % | 3.88 % |
| Other investment securities | - | - | - | 65 | 65 |
| Weighted average yield | - % | - % | - % | 6.25 % | 6.25 % |
| Total investment securities | $ - | $ 61,137 | $ 427,167 | $ 8,705 | $ 497,009 |
| Weighted average yield | - % | 2.95 % | 4.01 % | 4.00 % | 3.88 % |

*[(a)] At December 31, 2004, virtually all of our securities had step-up provisions that stipulate increases in the coupon rate ranging from 0.25% to 4.00% at various specified times over a range from February 2005 to September 2014. 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.*

**Investments in Real Estate and Joint Ventures**

DSL Service Company participates as an owner of, or a partner in, a variety of real estate development projects, principally retail neighborhood shopping centers and residential developments, most of which are located in California. For additional information regarding these real estate investments, see Note 6 of Notes to the Consolidated Financial Statements on page 87. We

have substantially completed and leased most of the neighborhood shopping center projects with a weighted average occupancy rate of 89% at December 31, 2004. At December 31, 2004, the Bank had no loan commitments to the joint ventures.

DSL Service Company is entitled to interest on its equity invested in its joint venture projects on a priority basis after third-party debt and shares profits and losses with the developer partner, generally on an equal basis. DSL Service Company has obtained guarantees from the principals of the developer partners. Partnership equity or deficit accounts are affected by current period results of operations, additional partner advances, partnership distributions and partnership liquidations. We have analyzed our variable interests in these joint venture projects and we have determined based on the dispersal of risks among the parties involved that we are not the primary beneficiary of any of these variable interest entities. Therefore, the joint venture projects are not consolidated into our financial results, but rather are accounted for under the equity method.

As of December 31, 2004, DSL Service Company was involved with one joint venture partner. This partner was the operator of four residential housing development projects. DSL Service Company had four wholly owned retail neighborhood shopping centers located in California and Arizona.

Our investment in real estate and joint ventures amounted to $55 million at December 31, 2004, compared to $36 million at December 31, 2003 and $34 million at December 31, 2002. The increase during 2004 was primarily attributed to new investments of $22 million in joint venture projects and $14 million in wholly owned projects, our share of joint venture profits of $6 million, investments of $3 million in affordable housing funds and



investments of $2 million in existing wholly owned projects. Those increases were partially offset by a $21 million return of capital from two of our existing joint ventures and the sale of one wholly owned project with a carrying value of $7 million. The increase during 2003 was primarily attributed to a $6 million investment in existing shopping centers, a $5 million investment in a new joint venture and our share of joint venture profits of $3 million. Those increases were partially offset by a $7 million return of capital from one of our existing joint ventures and the sale of wholly owned projects with a carrying value of $5 million.

The following table sets forth the condensed balance sheet of DSL Service Company s residential joint ventures at December 31, 2004, on a historical cost basis.

*(Dollars in Thousands)*

| | |
|---|---|
| **Assets** | |
| Cash | $ 23,325 |
| Projects under development | 53,065 |
| Other assets | 1,688 |
| | $ 78,078 |
| **Liabilities and Equity** | |
| Liabilities: | |
| Notes payable | $ 43,870 |
| Other | 6,966 |
| Equity: | |
| DSL Service Company [(a)] | 25,649 |
| Other partners [(b)] | 1,593 |
| Net equity | 27,242 |
| | $ 78,078 |

| | |
|---|---|
| Number of joint venture projects | 4 |

*[a] We included in this amount interest-bearing joint venture advances with priority interest payments from joint ventures to DSL Service Company.*
*[b] The aggregate other partners equity of $2 million represents their equity interest in the accumulated retained earnings of the respective joint ventures. Those results include the net profit on sales and the operating results of the real estate assets, net of depreciation and funding costs. Except for any secured financing which has been obtained, DSL Service Company has provided all other financing. As part of our internal asset review process, we compare the fair value of the joint venture real estate assets to the secured notes payable to the Bank and DSL Service Company s equity investment. To the extent the fair value of the real estate assets is less than the aggregate of those amounts, we make a provision to create a valuation allowance. No valuation allowance was required at December 31, 2004.*

The following table sets forth by property type our investments in real estate and related allowances for losses at December 31, 2004. For further information regarding the establishment of loss allowances, see Allowance for Losses on Loans and Real Estate on page 55.

| *(Dollars in Thousands)* | *Residential* | *Retail Neighborhood Shopping Centers* | *Land* | *Total* |
|---|---|---|---|---|
| Investment in wholly owned projects [a] | $ - | $ 11,504 | $ 15,757 | $ 27,261 |
| Investment in Affordable Housing Funds | 3,937 | - | - | 3,937 |
| Allowance for losses | - | (1,333 ) | (103 ) | (1,436 ) |
| Net investment in real estate projects | $ 3,937 | $ 10,171 | $ 15,654 | $ 29,762 |
| Number of projects | 5 | 4 | 6 | 15 |

*[a] Included five free-standing stores that are part of neighborhood shopping centers totaling less than $1 million, which we counted as one project.*

Real estate investments entail risks similar to those our construction and commercial lending activities present. 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. Owners of real property also may incur liabilities with respect to environmental matters, including financial responsibility for clean-up of hazardous waste or other conditions, under various federal and state laws.

 **Navigation Links**

**Deposits**

Our deposits increased $1.4 billion or 16.4% in 2004 and totaled $9.7 billion at December 31, 2004. Compared to the year-ago period, our certificates of deposit increased $2.3 billion or 72.2%, which was partially offset by a decrease in our lower-rate transaction accounts i.e., checking, money market and regular passbook of $963 million or 19.0%. Given the relatively low level of interest rates, certain of our depositors in prior periods moved monies from certificates of deposit to transaction accounts as they seemed more interested in liquidity. Now that short-term market interest rates have begun to rise, those monies are now beginning to flow back into certificates of deposit. During 2004:

- Seven in-store branches were closed due to the closure or sale of the grocery stores in which they were located;
- One traditional branch was closed due to its consolidation into a nearby branch; and
- Five traditional branches were opened, four of which replaced closed in-store branches and the fifth, a new branch in Arizona.

At December 31, 2004, the total number of branches was 169, of which 165 were in California and four were in Arizona. The average deposit size of our 76 traditional branches was $103 million, while the average deposit size of our 93 in-store branches was $19 million.

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

| | *December 31,* | | | | | |
|---|---|---|---|---|---|---|
| | *2004* | | *2003* | | *2002* | |
| *(Dollars in Thousands)* | *Weighted Average Rate* | *Amount* | *Weighted Average Rate* | *Amount* | *Weighted Average Rate* | *Amount* |
| Transaction accounts: | | | | | | |
| Non-interest-bearing checking | - % | $ 601,588 | - % | $ 429,743 | - % | $ 388,376 |
| Interest-bearing checking [a] | 0.33 | 534,775 | 0.21 | 462,733 | 0.25 | 422,417 |
| Money market | 1.05 | 158,519 | 1.05 | 142,418 | 1.37 | 120,105 |
| Regular passbook | 1.12 | 2,813,078 | 1.12 | 4,036,464 | 1.70 | 3,639,798 |
| Total transaction accounts | 0.85 | 4,107,960 | 0.94 | 5,071,358 | 1.41 | 4,570,696 |
| Certificates of deposit: | | | | | | |
| Less than 2.00% | 1.59 | 912,234 | 1.17 | 1,548,398 | 1.57 | 919,864 |
| 2.00-2.49 | 2.38 | 3,003,000 | 2.23 | 338,763 | 2.28 | 401,657 |
| 2.50-2.99 | 2.80 | 495,119 | 2.73 | 222,436 | 2.79 | 528,557 |
| 3.00-3.49 | 3.19 | 327,552 | 3.27 | 305,258 | 3.38 | 1,188,078 |
| 3.50-3.99 | 3.84 | 94,611 | 3.78 | 106,861 | 3.89 | 700,250 |
| 4.00-4.49 | 4.26 | 257,369 | 4.27 | 240,459 | 4.25 | 374,424 |
| 4.50-4.99 | 4.83 | 424,937 | 4.83 | 420,262 | 4.80 | 473,399 |
| 5.00 and greater | 5.62 | 35,196 | 5.59 | 39,963 | 5.63 | 81,425 |
| Total certificates of deposit | 2.66 | 5,550,018 | 2.44 | 3,222,400 | 3.19 | 4,667,654 |
| Total deposits | 1.89 % | $ 9,657,978 | 1.52 % | $ 8,293,758 | 2.31 % | $ 9,238,350 |

[a] *Included amounts swept into money market deposit accounts.*

The following table shows at December 31, 2004 our certificates of deposit maturities by interest rate category.

| *(Dollars in Thousands)* | *Less Than 2.50%* | *2.50% - 2.99%* | *3.00% - 3.49%* | *3.50% - 3.99%* | *4.00% - 4.99%* | *5.00% and Greater* | *Total [(a)]* | *Percent of Total* |
|---|---|---|---|---|---|---|---|---|
| Within 3 months | $ 1,432,318 | $ 22,592 | $ 4,700 | $ 13,394 | $ 69,018 | $ 5,098 | $ 1,547,120 | 28 % |
| 4 to 6 months | 1,133,948 | 95,567 | 6,546 | 56 | 52,331 | 1,227 | 1,289,675 | 23 |
| 7 to 12 months | 1,131,337 | 101,034 | 113,145 | 14,634 | 58,581 | 12,856 | 1,431,587 | 26 |
| 13 to 24 months | 216,536 | 236,243 | 48,765 | 1,810 | 131,524 | 6,273 | 641,151 | 12 |
| 25 to 36 months | 830 | 22,283 | 34,279 | 21,083 | 340,074 | 9,742 | 428,291 | 8 |
| 37 to 60 months | 265 | 17,400 | 120,117 | 43,634 | 30,678 | - | 212,094 | 3 |
| Over 60 months | - | - | - | - | 100 | - | 100 | - |
| Total | $ 3,915,234 | $ 495,119 | $ 327,552 | $ 94,611 | $ 682,306 | $ 35,196 | $ 5,550,018 | 100 % |

[(a)] *Includes certificates of deposit of $100,000 and over totaling $620 million with maturities within 3 months, $517 million with maturities of 4 to 6 months, $507 million with maturities of 7 to 12 months and $490 million with a remaining term of over 12 months.*

**Borrowings**

At December 31, 2004, borrowings totaled $4.8 billion, up from $2.3 billion at year-end 2003 and $1.7 billion at year-end 2002. The increase during 2004 was due primarily to an increase of $2.4 billion in FHLB advances. During 2004, the holding company issued $200 million of 6.5% 10-year unsecured senior notes. The net proceeds, after deducting underwriting discounts and our offering expenses, were approximately $198 million. Those proceeds were used to redeem our $124 million of 10% junior subordinated debentures prior to their maturity and in turn to redeem the related capital securities, and to make a capital investment in the Bank to support its asset growth. We redeemed our junior subordinated debentures because of the lower interest rate at which we were able to issue the senior debt, which will result in lower future interest expense.

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

| | *December 31,* | | | | |
|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
| Federal Home Loan Bank advances [(a)] | $ 4,559,622 | $ 2,125,150 | $ 1,624,084 | $ 1,522,705 | $ 1,978,348 |
| Real estate notes | - | 4,161 | - | 7 | 224 |

| | | | | | |
|---|---|---|---|---|---|
| Senior notes | 197,924 | - | - | - | - |
| Junior subordinated debentures [(b)] | - | 123,711 | 123,711 | 123,711 | 123,711 |
| Total borrowings | $ 4,757,546 | $ 2,253,022 | $ 1,747,795 | $ 1,646,423 | $ 2,102,283 |
| Weighted average rate on borrowings during the year [(a)] | 2.62 % | 4.46 % | 4.79 % | 5.83 % | 6.38 % |
| Total borrowings as a percentage of total assets | 30.40 | 19.35 | 14.59 | 14.82 | 19.29 |

*[(a)] 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.*
*[(b)] On July 23, 2004, we redeemed our junior subordinated debentures before maturity.*



**Navigation Links**

The following table sets forth certain information with respect to our short-term borrowings.

| *(Dollars in Thousands)* | *2004* | *2003* | *2002* |
|---|---|---|---|
| FHLB advances with original maturities less than one year: | | | |
| Balance at end of year | $ 3,552,000 | $ 915,000 | $ 341,234 |
| Average balance outstanding during the year | 2,261,018 | 248,905 | 218,404 |
| Maximum amount outstanding at any month-end during the year | 3,660,400 | 915,000 | 497,081 |
| Weighted average interest rate during the year | 1.59 % | 1.20 % | 2.12 % |
| Weighted average interest rate at end of year | 2.30 | 1.11 | 1.38 |
| Securities sold under agreement to repurchase: | | | |
| Balance at end of year | $ - | $ - | $ - |
| Average balance outstanding during the year | 155,204 | - | 7,494 |
| Maximum amount outstanding at any month-end during the year | 507,027 | - | 182,358 |
| Weighted average interest rate during the year | 0.87 % | - % | 1.86 % |
| Total short-term borrowings: | | | |
| Average balance outstanding during the year | $ 2,416,222 | $ 248,905 | $ 225,898 |
| Weighted average interest rate during the year | 1.54 % | 1.20 % | 2.11 % |

At year-end 2004, intermediate and long-term borrowings totaled $1.2 billion, down from $1.3 billion at December 31, 2003. The weighted average rate on our intermediate and long-term borrowings at year-end 2004 was 4.70%.

The following table sets forth the maturities of our intermediate and long-term borrowings at December 31, 2004.

*(In Thousands)*

| | |
|---|---|
| 2005 | $ 415,750 |
| 2006 | 76,300 |
| 2007 | 65,000 |
| 2008 | 421,572 |
| 2009 | - |
| Thereafter | 226,924 |
| Total intermediate and long-term borrowings | $ 1,205,546 |

**Off-Balance Sheet Arrangements**

We consolidate majority-owned subsidiaries that we control. We account for other affiliates, including joint ventures, in which we do not exhibit significant control or have majority ownership, by the equity method of accounting. For those relationships in which we own less than 20%, we generally carry them at cost. In the course of our business, we participate in real estate joint ventures through our wholly-owned subsidiary, DSL Service Company. Our real estate joint ventures do not require consolidation as a result of applying the provisions of Financial Accounting Standards Board Interpretation 46 (revised December 2003). For further information regarding our real estate joint venture partnerships, see Note 6 of Notes to the Consolidated Financial Statements on page 87.

We also utilize financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to originate fixed and variable rate mortgage loans held for investment, undisbursed loan funds, lines and letters of credit, and commitments to purchase loans and mortgage-backed securities for our portfolio. The contract or notional amounts of these instruments reflect the extent of involvement we have in particular classes of financial instruments. For further information regarding these commitments, see Asset/Liability Management and Market Risk on page 46, Contractual Obligations and Other Commitments on page 62 and Note 23 of Notes to the Consolidated Financial Statements on page 102.

We use the same credit policies in making commitments to originate or purchase loans, lines of credit and letters of credit as we do for on-balance sheet instruments. For commitments to originate loans held for investment, the contract amounts represent exposure to loss from market fluctuations as well as credit loss. In



regard to these commitments, adverse changes from market fluctuations are generally not hedged. We control the credit risk of our commitments to originate loans held for investment through credit approvals, limits and monitoring procedures.

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

**Transactions with Related Parties**

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



**Asset/Liability Management and Market Risk**

Market risk is the risk of loss from adverse changes in market prices and interest rates. Our market risk arises primarily from interest rate risk in our lending and deposit taking activities. Interest rate risk primarily occurs to the degree that our interest-bearing liabilities reprice or mature on a different basis than our interest-earning assets. Since our earnings depend primarily on our net interest income, which is the difference between the interest and dividends earned on interest-earning assets and the interest paid

on interest-bearing liabilities, our principal objectives are to actively monitor and manage the effects of adverse changes in interest rates on net interest income. Our primary strategy to manage interest rate risk is to emphasize the origination for investment of adjustable rate mortgages or loans with relatively short maturities. Interest rates on adjustable rate mortgages are primarily tied to COFI, MTA, LIBOR and CMT. We also may execute swap contracts to change interest rate characteristics of our interest-earning assets or interest-bearing liabilities to better manage interest rate risk.

In addition to the interest rate risk associated with our lending for investment and deposit taking activities, we also have market risk associated with our secondary marketing activities. Changes in mortgage interest rates, primarily fixed rate mortgages, impact the fair value of loans held for sale as well as our interest rate lock commitment derivatives, where we have committed to an interest rate with a potential borrower for a loan we intend to sell. Our objective is to hedge against fluctuations in interest rates through use of 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. We continue to hedge as previously done before the issuance of SFAS 133. As applied to our risk management strategies, SFAS 133 may increase or decrease reported net income and stockholders equity, depending on interest rates and other variables affecting the fair values of derivative instruments and hedged items, but will have no effect on the overall economics of the transactions. The method used for assessing the effectiveness of a hedging derivative, as well as the measurement approach for determining the ineffective aspects of the hedge, is established at the inception of the hedge. We generally do not enter into hedging contracts for speculative purposes.

Changes in mortgage interest rates also impact the value of our MSRs. Rising interest rates typically result in slower prepayment speeds on the loans being serviced for others which increase the value of MSRs. Declining interest rates typically result in faster prepayment speeds which decrease the value of MSRs. During the first quarter of 2004, we implemented a fairly simple hedging strategy by purchasing securities classified as available for sale as a partial economic hedge against future value changes in our MSRs. During periods when long-term interest rates decline, the value of our MSRs will fall and the resultant MSR valuation addition will, in general, be partially offset by securities gains. However, if long-term interest rates rise causing MSR values to improve, the securities will be in a loss position and may be sold with the intention to reset the hedge at a higher market interest rate. Any realized loss from the securities sales will be mitigated by the favorable earnings impact associated with the recapture of any existing MSR valuation allowance. While this strategy is not constructed to be a perfect hedge, it is expected to reduce earnings volatility from changing MSR values. Over time, we may use derivatives in lieu of securities, or a combination of both, to provide an economic hedge against value changes in our MSRs. In addition, the dollar amount used as an economic hedge may vary as we reset the hedge due to changes in the volume of MSRs or their sensitivity to changes in market interest rates. In connection with the sale of approximately 80% of our MSRs during the fourth quarter of 2004 which thereby reduced the risk of changing MSR values, the partial economic hedge established in the first quarter of 2004 was closed in October 2004.

Our Asset/Liability Management Committee is responsible for implementing the interest rate risk management policy which sets forth limits established by the Board of Directors of acceptable changes in net interest income and net portfolio value from specified changes in interest rates. The OTS defines net portfolio value as the present value of expected net cash flows from existing assets minus the present value of expected net cash flows from existing liabilities plus the present value of expected cash flows from existing off-balance sheet contracts. Our Asset/Liability Management Committee reviews, among other items, economic conditions, the interest rate outlook, the demand for loans, the availability of deposits and borrowings, and our current operating results, liquidity, capital and interest rate exposure. In addition, our Asset/Liability Management Committee monitors asset and liability maturities and repricing characteristics on a regular basis and performs various simulations and other analyses to determine the potential impact of various business strategies in controlling interest rate risk and the potential impact of those strategies upon future earnings under various interest rate scenarios. Based on these reviews, our Asset/Liability Management Committee formulates a strategy that is intended to implement the objectives set forth in our business plan without exceeding the net interest income and net portfolio value limits set forth in our interest rate risk policy.



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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 December 31, 2004, as well as other information regarding the repricing and maturity differences between our interest-earning assets and the total of deposits and borrowings in future periods. We refer to these differences as "gap." We have determined the repricing frequencies by reference to projected maturities, based upon contractual maturities as adjusted for scheduled repayments and "repricing mechanisms" provisions for changes in the interest and dividend rates of assets and liabilities. We assume prepayment rates on substantially all of our loan portfolio based upon our historical loan prepayment experience and anticipated future prepayments. Repricing mechanisms on a number of our assets are subject to limitations, such as caps on the amount that interest rates and payments on our loans may adjust, and accordingly, these assets do not normally respond to changes in market interest rates as completely or rapidly as our liabilities. The interest rate sensitivity of our assets and liabilities illustrated in the following table would vary substantially if we used different assumptions or if actual experience differed from the assumptions set forth.

| | December 31, 2004 | | | | | |
|---|---|---|---|---|---|---|
| (Dollars in Thousands) | Within 6 Months | 7 12 Months | 1 5 Years | 6 10 Years | Over 10 Years | Total Balance |
| Interest-earning assets: | | | | | | |
| Investment securities and stock [(a)] | $ 330,283 | $ 56,037 | $ 354,302 | $ - | $ - | $ 740,622 |
| Loans and mortgage-backed securities: [(b)] | | | | | | |
| Loans secured by real estate: | | | | | | |
| Residential: | | | | | | |
| Adjustable | 13,028,062 | 289,983 | 655,129 | - | - | 13,973,174 |
| Fixed | 154,605 | 12,011 | 36,144 | 5,159 | 848 | 208,767 |
| Commercial real estate | 19,373 | 3,070 | 8,689 | 379 | - | 31,511 |
| Construction | 33,541 | - | - | - | - | 33,541 |
| Land | 11,262 | 7 | 651 | - | - | 11,920 |
| Non-mortgage loans: | | | | | | |
| Commercial | 1,481 | - | - | - | - | 1,481 |
| Consumer | 281,455 | 241 | 384 | - | - | 282,080 |
| Mortgage-backed securities | 304 | - | - | - | - | 304 |
| Total loans and mortgage-backed securities | 13,530,083 | 305,312 | 700,997 | 5,538 | 848 | 14,542,778 |
| Total interest-earning assets | $ 13,860,366 | $ 361,349 | $ 1,055,299 | $ 5,538 | $ 848 | $ 15,283,400 |
| Transaction accounts: | | | | | | |
| Non-interest-bearing checking | $ 601,588 | $ - | $ - | $ - | $ - | $ 601,588 |
| Interest-bearing checking [(c)] | 534,775 | - | - | - | - | 534,775 |
| Money market [(d)] | 158,519 | - | - | - | - | 158,519 |
| Regular passbook [(d)] | 2,813,078 | - | - | - | - | 2,813,078 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total transaction accounts | 4,107,960 | - | - | - | - | 4,107,960 |
| Certificates of deposit [e] | 2,836,795 | 1,431,587 | 1,281,536 | 100 | - | 5,550,018 |
| Total deposits | 6,944,755 | 1,431,587 | 1,281,536 | 100 | - | 9,657,978 |
| FHLB advances and other borrowings | 3,817,000 | 150,750 | 562,872 | 29,000 | - | 4,559,622 |
| Senior notes | - | - | - | 197,924 | - | 197,924 |
| Impact of swap contracts hedging borrowings | 430,000 | - | (430,000 ) | - | - | - |
| Total deposits and borrowings | $ 11,191,755 | $ 1,582,337 | $ 1,414,408 | $ 227,024 | $ - | $ 14,415,524 |
| Excess (shortfall) of interest-earning assets over deposits and borrowings | $ 2,668,611 | $ (1,220,988 ) | $ (359,109 ) | $ (221,486 ) | $ 848 | $ 867,876 |
| Cumulative gap | 2,668,611 | 1,447,623 | 1,088,514 | 867,028 | 867,876 | |
| Cumulative gap as a percentage of total assets: | | | | | | |
| December 31, 2004 | 17.05 % | 9.25 % | 6.96 % | 5.54 % | 5.55 % | |
| December 31, 2003 | 14.95 | 13.42 | 6.95 | 6.76 | 5.74 | |
| December 31, 2002 | 16.80 | 12.53 | 9.33 | 5.79 | 4.83 | |

[a] *Includes FHLB stock and is based upon contractual maturity and repricing date.*
[b] *Based upon contractual maturity, repricing date and projected repayment and prepayments of principal.*
[c] *Included amounts swept into money market deposit accounts and is subject to immediate repricing.*
[d] *Subject to immediate repricing.*
[e] *Based upon contractual maturity and repricing date.*

Our six-month gap at December 31, 2004 was a positive 17.05%. This means that more interest-earning assets mature or reprice within six months than the total of deposits and borrowings. This is up from a positive six-month gap of 14.95% at December 31, 2003 and 16.80% at December 31, 2002. We originated and purchased for investment loans and mortgage-backed securities with adjustable interest rates or maturities of five years or less of approximately $8.9 billion during 2004, $5.0 billion during 2003 and $4.7 billion during 2002. These loans represented essentially all loans and mortgage-backed securities originated and purchased for investment during 2004, 2003 and 2002.

At December 31, 2004, 2003 and 2002, essentially all of our interest-earning assets mature, reprice or are estimated to prepay within five years. At December 31, 2004, $13.2 billion or 99% of our loans held for investment and mortgage-backed securities portfolios consisted of adjustable rate loans and loans with a due date of five years or less, compared to $10.0 billion or 99% at December 31, 2003 and $10.1 billion or 98% at December 31, 2002. During 2005, we will continue to offer residential fixed rate loan products to our customers to meet customer demand. We primarily originate fixed rate loans for sale in the secondary market and price them accordingly to create loan servicing income and to increase opportunities for originating adjustable rate mortgages. However, we may originate fixed rate loans for investment when funded with long-term funds to mitigate interest rate risk and small volumes to facilitate the sale of real estate acquired through foreclosure or that meet required yield and other approved guidelines. For further information, see Secondary Marketing and Loan Servicing Activities on page 5.

We are better protected against rising interest rates with a positive six-month gap. However, we remain subject to possible interest rate spread compression, which would adversely impact our net interest income if interest rates rise. This is primarily due to the lag in repricing of the indices to which our adjustable rate loans and mortgage-backed securities are tied, as well as the repricing frequencies and periodic interest rate caps on these adjustable rate loans and mortgage-backed securities. The amount of such interest rate spread compression would depend upon the frequency and severity of such interest rate fluctuations.

In addition to measuring interest rate risk via a gap analysis, we establish limits on, and measure the sensitivity of, our net interest income and net portfolio value to changes in interest rates. Changes in interest rates are defined as instantaneous and sustained movements in interest rates in 100 basis point increments. We utilize an internally maintained asset/liability management simulation model to make the calculations which, for net portfolio value, are calculated on a discounted cash flow basis. First, we estimate our net interest income for the next twelve months and the current net portfolio value assuming no change in interest rates from those at period end. Once the base case has been estimated, we make calculations for each of the defined changes in interest rates, to include any associated differences in the anticipated prepayment speed of loans. We then compare those results against the base case to determine the estimated change to net interest income and net portfolio value due to the changes in interest rates. The following are the estimated impacts to net interest income and net portfolio value from various instantaneous, parallel shifts in interest rates based upon our asset and liability structure as of year-ends 2004 and 2003. Since we base these estimates upon numerous assumptions, like the expected maturities of our interest-bearing assets and liabilities and the shape of the period-end interest rate yield curve, our actual sensitivity to interest rate changes could vary significantly if actual experience differs from those assumptions used in making the calculations.

| | *2004* | | *2003* | |
|---|---|---|---|---|
| | *Percentage Change in* | | *Percentage Change in* | |
| *Change in Interest Rates (In Basis Points)* | *Net Interest Income [a]* | *Net Portfolio Value [b]* | *Net Interest Income [a]* | *Net Portfolio Value [b]* |
| +200 | (10.1 )% | (5.5 )% | (3.9 )% | 10.9 % |
| +100 | (4.6 ) | (1.1 ) | (1.9 ) | 6.1 |
| (100) | 2.9 | (3.7 ) | 0.8 | (8.3 ) |
| (200) [c] | N/A | N/A | N/A | N/A |

*[a] The percentage change in this column represents net interest income for 12 months in a stable interest rate environment versus the net interest income in the various rate scenarios.*
*[b] The percentage change in this column represents the net portfolio value of the Bank in a stable interest rate environment versus the net portfolio value in the various rate scenarios.*
*[c] The change in interest rates is not applicable due to their low level.*

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The following table shows our financial instruments that are sensitive to changes in interest rates, categorized by expected maturity, and the instruments fair values at December 31, 2004. This data differs from that in the gap table as it does not incorporate the repricing characteristics of assets and liabilities. Rather, it only reflects contractual maturities adjusted for anticipated prepayments and call provisions for investment securities. Market risk sensitive instruments are generally defined as on and off balance sheet derivatives and other financial instruments. Our assets and liabilities that do not have a stated maturity date, such as certain deposits, are considered to be long term in nature and are reported in the "thereafter" column. We do not consider these financial instruments to be materially sensitive to interest rate fluctuations, and historically, the balances have remained fairly constant over various economic conditions. The weighted average interest rates for the various fixed-rate and variable-rate assets and liabilities presented are based on the actual rates that existed at December 31, 2004. The fair value of our financial instruments is determined as follows:

- Fed funds and FHLB Stock equal their book values due to their short-term repricing characteristics.
- Investment securities and mortgage-backed securities are based on the closing market price quotations from financial market monitoring firms.
- Loans held for sale are based on bid quotations from financial market monitoring firms.
- Loans held for investment takes into consideration discounted cash flows through the estimated maturity or repricing dates using estimated market discount rates.
- Demand deposits, money market and savings accounts are equal to their book values.
- Time deposits and borrowings are based on the discounted value of contractual cash flows, which is estimated using wholesale borrowing rates offered for similar terms.
- Senior notes are based on bid prices published in financial newspapers, or bid quotations received from securities dealers or readily available market quote systems.

The degree of market risk inherent in loans with prepayment features may not be completely reflected in the disclosures. Although we have taken into consideration our historical prepayment trends adjusted for current market conditions to determine expected maturity categories, prepayment features are triggered by changes in the market rates of interest. Unexpected changes may increase the rate of prepayments above those anticipated. As such, the potential loss from such market rate changes may be significantly larger.

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| | *Expected Maturity at December 31, 2004* [a] | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| *Thousands)* | *2005* | *2006* | *2007* | *2008* | *2009* | *Thereafter* | *Total Balance* | *Fair Value* |
| t securities and stock [b] | $ 54,131 | $ 219,482 | $ 223,331 | $ - | $ - | $ 243,678 | $ 740,622 | $ 740,622 |
| average interest rate [c] | 3.41 % | 3.66 % | 4.21 % | - % | - % | 3.89 % | 3.88 % | |
| backed securities | | | | | | | | |
| for sale | 48 | 41 | 35 | 30 | 26 | 124 | 304 | 304 |
| average interest rate [c] | 3.47 % | 3.47 % | 3.47 % | 3.47 % | 3.47 % | 3.47 % | 3.47 % | |
| ured by real estate: [d] | | | | | | | | |
| al: | | | | | | | | |
| le | 4,022,905 | 2,057,759 | 1,590,726 | 1,244,449 | 1,000,623 | 4,056,712 | 13,973,174 | 14,270,209 |
| ed average interest rate | 4.68 % | 4.78 % | 4.78 % | 4.77 % | 4.77 % | 4.77 % | 4.75 % | |
| | 166,424 | 16,507 | 9,943 | 6,012 | 3,622 | 6,259 | 208,767 | 212,138 |
| ed average interest rate | 6.40 % | 7.26 % | 7.25 % | 7.22 % | 7.17 % | 7.14 % | 6.57 % | |
| | 46,901 | 9,243 | 4,385 | 3,477 | 2,626 | 10,340 | 76,972 | 80,509 |
| d average interest rate | 6.48 % | 6.40 % | 6.34 % | 6.25 % | 6.12 % | 6.03 % | 6.38 % | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| age: [d] | | | | | | | | |
| ial | 700 | - | - | - | - | 781 | 1,481 | 1,950 |
| d average interest rate | 4.60 % | - % | - % | - % | - % | 3.86 % | 4.21 % | |
| r | 469 | 309 | 57 | 281,245 | - | - | 282,080 | 284,681 |
| d average interest rate | 5.32 % | 5.31 % | 5.30 % | 5.30 % | - % | - % | 5.30 % | |
| earing advances to | | | | | | | | |
| ures | 25,959 | - | - | - | - | - | 25,959 | 25,959 |
| average interest rate | 10.00 % | - % | - % | - % | - % | - % | 10.00 % | |
| rate lock commitments | 1,957 | - | - | - | - | - | 1,957 | 8,620 |
| d loan servicing portfolio | 3,558 | 2,957 | 2,306 | 1,826 | 1,466 | 5,851 | 17,964 | 17,968 |
| ted loan forward sale | 87 | - | - | - | - | - | 87 | 87 |
| est-sensitive assets | $ 4,323,139 | $ 2,306,298 | $ 1,830,783 | $ 1,537,039 | $ 1,008,363 | $ 4,323,745 | $ 15,329,367 | $ 15,643,047 |
| n accounts: | | | | | | | | |
| est-bearing checking | $ 109,879 | $ 89,810 | $ 73,406 | $ 59,999 | $ 49,040 | $ 219,454 | $ 601,588 | $ 601,588 |
| earing checking [g] | 97,676 | 79,835 | 65,254 | 53,335 | 43,594 | 195,081 | 534,775 | 534,775 |
| arket | 28,953 | 23,665 | 19,343 | 15,810 | 12,922 | 57,826 | 158,519 | 158,519 |
| assbook | 513,803 | 419,958 | 343,254 | 280,559 | 229,315 | 1,026,189 | 2,813,078 | 2,813,078 |
| nsaction accounts | 750,311 | 613,268 | 501,257 | 409,703 | 334,871 | 1,498,550 | 4,107,960 | 4,107,960 |
| ed average interest rate | 0.85 % | 0.85 % | 0.85 % | 0.85 % | 0.85 % | 0.85 % | 0.85 % | |
| s of deposit | 4,268,382 | 641,151 | 428,291 | 107,367 | 104,727 | 100 | 5,550,018 | 5,513,844 |
| average interest rate | 2.37 % | 3.06 % | 4.52 % | 3.20 % | 3.77 % | 4.00 % | 2.66 % | |
| d forward sale contracts | 1,272 | - | - | - | - | - | 1,272 | 1,272 |
| ances [h] | 3,967,750 | 76,300 | 65,000 | 421,572 | - | 29,000 | 4,559,622 | 4,577,474 |
| average interest rate | 2.48 % | 4.72 % | 5.01 % | 4.68 % | - % | 4.03 % | 2.77 % | |
| es | - | - | - | - | - | 197,924 | 197,924 | 208,160 |
| average interest rate | - % | - % | - % | - % | - % | 6.50 % | 6.50 % | |
| sits and borrowings | $ 8,987,715 | $ 1,330,719 | $ 994,548 | $ 938,642 | $ 439,598 | $ 1,725,574 | $ 14,416,796 | $ 14,408,710 |

*[a] We use a number of assumptions to estimate fair values and expected maturities. For assets, we base expected maturities upon contractual maturity, projected repayments and prepayments of principal and call provisions for investment securities. The prepayment experience reflected herein is based on our historical experience adjusted for current market conditions. Our average projected constant prepayment rate ("CPR") is 35.7% on our fixed-rate and 26.5% on our adjustable rate mortgage portfolio for interest-earning assets, excluding investment securities which are not subject to prepayment except for call provisions, if any. For deposits, in accordance with standard industry practice and our own historical experience, we have applied "decay factors," used to estimate deposit runoff, of 20.0% per year. The actual maturities of these instruments could vary substantially if future prepayments differ from our historical experience.*

*[b] Included FHLB stock.*

*[c] 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.*

*[d] The carrying amount is stated net of undisbursed loan funds, unearned fees and discounts, and allowances for loan losses. Included loans held for sale with capitalized basis adjustment reflecting the change in fair value of the rate lock derivative from the date of commitment to the date of funding.*

*[e] At December 31, 2004, the carrying value reflected the change in fair value of the rate lock derivative from the date of commitment to the date of funding. The estimated fair value also includes the initial value at rate lock of $5.5 million and the value of MSRs of $1.1 million not to be recognized in the financial statements until the expected loans are sold.*

*[f] The estimated fair value included MSRs acquired prior to January 1, 1996 when we began capitalizing the asset.*

*[g] Included amounts swept into money market deposit accounts.*

*[h] 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 FHLB advances.*

For further information regarding the sensitivity of our MSRs to changes in interest rates, see Note 11 of Notes to Consolidated Financial Statements on page 91. For further information regarding commitments, contingencies and hedging activities, see Note 23 of Notes to Consolidated Financial Statements on page 102.

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

| | *December 31,* | | | | |
|---|---|---|---|---|---|
| | *2004* | *2003* | *2002* | *2001* | *2000* |
| Weighted average yield: [a] | | | | | |
| Loans and mortgage-backed securities | 4.67 % | 4.61 % | 5.83 % | 7.15 % | 8.45 % |
| Federal Home Loan Bank stock | 3.89 | 4.18 | 5.24 | 5.31 | 5.52 |
| Investment securities [b] | 3.88 | 3.02 | 3.07 | 3.54 | 6.45 |
| Interest-earning assets yield | 4.63 | 4.51 | 5.72 | 6.98 | 8.36 |
| Weighted average cost: | | | | | |
| Deposits | 1.89 | 1.52 | 2.31 | 3.65 | 5.56 |
| Borrowings: | | | | | |
| Federal Home Loan Bank advances [c] | 2.77 | 3.08 | 3.88 | 3.73 | 6.26 |
| Real estate notes | - | 6.63 | - | 7.88 | 8.12 |
| Senior notes | 6.50 | - | - | - | - |
| Junior subordinated debentures [d] | - | 10.00 | 10.00 | 10.00 | 10.00 |
| Total borrowings | 2.93 | 3.46 | 4.31 | 4.20 | 6.48 |
| Combined funds cost | 2.23 | 1.94 | 2.63 | 3.74 | 5.75 |
| Interest rate spread | 2.40 % | 2.57 % | 3.09 % | 3.24 % | 2.61 % |

[a] *Excludes adjustments for non-accrual loans, and amortization of net deferred costs to originate loans, premiums and discounts.*
[b] *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.*
[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] *On July 23, 2004, we redeemed our junior subordinated debentures before maturity.*

The weighted average yield on our loan portfolio increased to 4.67% at December 31, 2004, from 4.61% at December 31, 2003. The weighted average rate on new loans originated during 2004 was 2.31%, compared to 4.43% during 2003 and 5.43%

during 2002. The lower rate in 2004 primarily reflects a higher volume of monthly adjustable loans at low initial incentive rates that typically only last one month. At December 31, 2004, our adjustable rate mortgage portfolio of single family residential loans, including mortgage-backed securities, totaled $13.9 billion with a weighted average rate of 4.61%, compared to $9.8 billion with a weighted average rate of 4.55% at December 31, 2003 and $9.9 billion with a weighted average rate of 5.75% at December 31, 2002.

**Problem Loans and Real Estate**

***Non-Performing Assets***

Non-performing assets consist of loans on which we have ceased accruing interest (which we refer to as non-accrual loans), loans restructured at an interest rate below market, real estate acquired in settlement of loans and repossessed automobiles. Our non-performing assets totaled $34 million at December 31, 2004, down from $49 million at December 31, 2003 and $80 million at December 31, 2002. The decrease in our non-performing assets during 2004 was primarily attributed to declines in our residential one-to-four unit prime category of $8 million and subprime category of $7 million. Of the total, real estate acquired in settlement of loans represented $3 million at December 31, 2004, down from $6 million at December 31, 2003 and $12 million at December 31, 2002. Our non-performing assets as a percentage of total assets was 0.22% at year-end 2004, down from 0.42% at year-end 2003 and 0.67% at year-end 2002.



**Navigation Links**

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

| | *December 31,* | | | | |
|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
| Non-accrual loans: | | | | | |
| Residential one-to-four units | $ 20,470 | $ 26,325 | $ 34,504 | $ 43,210 | $ 20,746 |
| Residential one-to-four units subprime | 10,696 | 15,980 | 32,263 | 31,166 | 22,296 |
| Other | 468 | 523 | 681 | 2,668 | 1,708 |
| Total non-accrual loans | 31,634 | 42,828 | 67,448 | 77,044 | 44,750 |
| Troubled debt restructure below market rate [a] | - | - | - | 203 | 206 |
| Real estate acquired in settlement of loans | 2,555 | 5,803 | 12,360 | 15,366 | 9,942 |
| Repossessed automobiles | - | - | 6 | 19 | 76 |
| Total non-performing assets | $ 34,189 | $ 48,631 | $ 79,814 | $ 92,632 | $ 54,974 |
| 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 % |
| Non-performing assets as a percentage of total assets | 0.22 | 0.42 | 0.67 | 0.83 | 0.50 |

[a] *Represented one residential one-to-four unit loan.*

It is our policy to take appropriate, timely and aggressive action when necessary to resolve non-performing assets. When resolving problem loans, it is our policy to determine collectibility under various circumstances which are intended to result in our maximum financial benefit. We accomplish this by either working with the borrower to bring the loan current or by foreclosing and selling the asset. We perform ongoing reviews of loans that display weaknesses and maintain adequate loss allowances for them. For a discussion on our internal asset review policy, refer to Allowance for Losses on Loans and Real Estate on page 55.

At December 31, 2004, $9 million of our non-performing assets were located outside of California, compared to $13 million outside of California a year ago.

We evaluate the need for appraisals of non-performing assets on a periodic basis. We will generally obtain a new appraisal when we believe that there may have been an adverse change in the property operations or in the economic conditions of the geographic market of the property securing our loans. Our policy is to obtain new appraisals at least annually for all real estate acquired in settlement of loans.

*Non-Accrual Loans*

It is our general policy to account for a loan as non-accrual when the loan becomes 90 days delinquent or when collection of interest appears doubtful. In a number of cases, loans may remain on accrual status past 90 days when we determine that continued accrual is warranted because the loan is well-secured and in process of collection. As of December 31, 2004, we had no loans 90 days or more delinquent which remained on accrual status. We reverse and charge against interest income any interest previously accrued with respect to non-accrual loans. We recognize interest income on non-accrual loans to the extent that we receive payments and to the extent that we believe we will recover the remaining principal balance of the loan. We restore these loans to an accrual status only if all past due payments are made by the borrower and the borrower has demonstrated the ability to make future payments of principal and interest. At December 31, 2004, non-accrual loans aggregating $8 million were less than 90 days delinquent relative to their contractual terms.

*Troubled Debt Restructurings*

We consider a restructuring of a debt a troubled debt restructuring when we, for economic or legal reasons related to the borrower s financial difficulties, grant a concession to the borrower that we would not otherwise grant. Troubled debt restructurings may include changing repayment terms, reducing the stated interest rate or reducing the amounts of principal and/or interest due or extending the maturity date. The restructuring of a loan is intended to recover as much of our investment as possible and to achieve the highest yield possible. At December 31, 2004, we had no troubled debt restructurings.

*Real Estate Acquired in Settlement of Loans*

Real estate acquired in settlement of loans consists of real estate acquired through foreclosure or deeds in lieu of foreclosure and totaled $3 million at December 31, 2004.



***Delinquent Loans***

When a borrower fails to make required payments on a loan and does not cure the delinquency within 60 days, we normally record a notice of default to commence foreclosure proceedings, so long as we have given any required prior notice to the borrower. If the loan is not reinstated within the time permitted by law for reinstatement, which is normally five business days prior to the date set for the non-judicial trustee s sale, we may then sell the property at a foreclosure sale. In general, if we have elected to pursue a non-judicial foreclosure, we are not permitted under applicable law to obtain a deficiency judgment against the borrower, even if the security property is insufficient to cover the balance owed. At these foreclosure sales, we generally acquire title to the property.

At December 31, 2004, loans delinquent 30 days or more as a percentage of total loans was 0.33%, down from 0.59% at year-end 2003 and 0.86% at year-end 2002. The decrease from the prior year occurred primarily in all of our delinquent categories, most notably within our residential one-to-four unit categories. As a percentage of its loan category, residential one-to-four units decreased from 0.48% at year-end 2003 to 0.27% at year-end 2004, while subprime residential one-to-four units decreased from 1.84% at year-end 2003 to 0.95% at year-end 2004. A higher incidence of delinquency is expected on subprime loans as these borrowers have a history of delinquencies for which we charge higher interest rates to compensate for that risk. In addition, the loan-to-value ratio on these loans is generally lower thereby providing more equity protection against loss.

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

| | December 31, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2004 | | | | 2003 | | | |
| ollars in Thousands) | 30-59 Days | 60-89 Days | 90+ Days [a] | Total | 30-59 Days | 60-89 Days | 90+ Days [a] | Total |
| ans secured by real estate: | | | | | | | | |
| esidential: | | | | | | | | |
| ne-to-four units | $ 13,446 | $ 4,089 | $ 16,949 | $ 34,484 | $ 15,501 | $ 7,244 | $ 20,081 | $ 42,826 |
| ne-to-four units subprime | 3,756 | 2,143 | 5,998 | 11,897 | 6,084 | 2,801 | 9,283 | 18,168 |
| ive or more units | - | - | - | - | - | - | - | - |
| ommercial real estate | - | - | - | - | - | - | - | - |
| onstruction | - | - | - | - | - | - | - | - |
| nd | - | - | - | - | - | - | - | - |
| otal real estate loans | 17,202 | 6,232 | 22,947 | 46,381 | 21,585 | 10,045 | 29,364 | 60,994 |
| n-mortgage: | | | | | | | | |
| ommercial | - | - | 428 | 428 | - | - | 428 | 428 |
| utomobile | 22 | 2 | - | 24 | 34 | 4 | 7 | 45 |
| her consumer | 31 | 44 | 40 | 115 | 41 | 22 | 88 | 151 |
| otal delinquent loans | $ 17,255 | $ 6,278 | $ 23,415 | $ 46,948 | $ 21,660 | $ 10,071 | $ 29,887 | $ 61,618 |
| inquencies as a centage of total loans | 0.13 % | 0.04 % | 0.16 % | 0.33 % | 0.20 % | 0.10 % | 0.29 % | 0.59 % |

| | 2002 | | | | 2001 | | | |
|---|---|---|---|---|---|---|---|---|
| ans secured by real estate: | | | | | | | | |
| esidential: | | | | | | | | |
| ne-to-four units | $ 19,881 | $ 8,066 | $ 27,333 | $ 55,280 | $ 19,170 | $ 12,797 | $ 33,449 | $ 65,416 |
| ne-to-four units subprime | 8,971 | 5,944 | 23,831 | 38,746 | 13,159 | 9,104 | 20,958 | 43,221 |
| ive or more units | - | - | - | - | - | - | - | - |
| ommercial real estate | - | - | - | - | - | - | - | - |
| onstruction | - | - | - | - | - | - | - | - |
| nd | - | - | - | - | - | - | - | - |
| otal real estate loans | 28,852 | 14,010 | 51,164 | 94,026 | 32,329 | 21,901 | 54,407 | 108,637 |
| n-mortgage: | | | | | | | | |
| ommercial | - | - | 466 | 466 | - | - | 1,163 | 1,163 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| tomobile | 98 | 13 | 4 | 115 | 174 | 85 | 46 | 305 |
| her consumer | 48 | 47 | 211 | 306 | 356 | 62 | 173 | 591 |
| otal delinquent loans | $ 28,998 | $ 14,070 | $ 51,845 | $ 94,913 | $ 32,859 | $ 22,048 | $ 55,789 | $ 110,696 |
| linquencies as a centage of total loans | 0.26 % | 0.13 % | 0.47 % | 0.86 % | 0.33 % | 0.22 % | 0.55 % | 1.10 % |

| | | 2000 | | |
|---|---|---|---|---|
| ans secured by real estate: | | | | |
| esidential: | | | | |
| ne-to-four units | $ 12,400 | $ 8,611 | $ 15,246 | $ 36,257 |
| ne-to-four units subprime | 7,300 | 7,658 | 14,427 | 29,385 |
| ve or more units | - | - | - | - |
| ommercial real estate | - | - | - | - |
| nstruction | - | - | - | - |
| nd | - | - | - | - |
| otal real estate loans | 19,700 | 16,269 | 29,673 | 65,642 |
| n-mortgage: | | | | |
| ommercial | - | - | - | - |
| tomobile | 393 | 26 | 151 | 570 |
| her consumer | 98 | 29 | 246 | 373 |
| otal delinquent loans | $ 20,191 | $ 16,324 | $ 30,070 | $ 66,585 |
| inquencies as a centage of total loans | 0.20 % | 0.16 % | 0.30 % | 0.66 % |

[a] *All 90 day or greater delinquencies are on non-accrual status and reported as part of non-performing assets.*



**Navigation Links**

***Allowance for Losses on Loans and Real Estate***

We maintain a valuation allowance for losses on loans and real estate to provide for losses inherent in those portfolios. Management evaluates the adequacy of the allowance quarterly to maintain the allowance at levels sufficient to provide for inherent losses. A key component to our evaluation is our internal asset review process.

Our Internal Asset Review Department conducts independent reviews to evaluate the risk and quality of all our assets. Our Internal Asset Review Committee is responsible for the review and classification of assets. The Internal Asset Review Committee members include the Director of Internal Asset Review, President and Chief Executive Officer, Chief Operating Officer and Chief Financial Officer, Chief Lending Officer, General Counsel and Director of Compliance/Risk Management. The Internal Asset Review Committee meets quarterly to review and determine asset classifications and recommend any changes to asset valuation

allowances. With the exception of payoffs or asset sales, the classification of an asset, once established, can be removed or upgraded only upon approval of the Internal Asset Review Committee or the Director of Internal Asset Review as delegated by the Committee. The Audit Committee of the Board of Directors quarterly reviews the overall asset quality, the adequacy of valuation allowances on classified and non-classified assets, and our adherence to policies and procedures regarding asset classification and valuation through reports from the Director of Internal Asset Review and others.

We use an internal asset review system and loss allowance methodology designed to provide for timely recognition of problem assets and adequate general valuation allowances to cover asset losses. Our current asset monitoring process includes the use of asset classifications to segregate the assets, largely loans and real estate, into various risk categories. We use the various asset classifications as a means of measuring risk for determining the valuation allowance at a point in time. We currently use a six grade system to classify our assets. The current grades are:

- pass;
- watch;
- special mention;
- substandard;
- doubtful; and
- loss.

We consider substandard, doubtful and loss assets "classified assets" for regulatory purposes. A brief description of these classifications follows:

- The pass classification represents a level of credit quality which contains no well-defined deficiency or weakness.
- The watch classification identifies an asset that currently contains no well-defined deficiency or weakness, but warrants close monitoring  e.g., loans to facilitate the sale of real estate acquired in settlement of loans. This category may also be used for assets upgraded from lower classifications where continuing monitoring is deemed appropriate.
- A special mention asset does not currently expose us to a sufficient degree of risk to warrant an adverse classification, but does possess a correctable deficiency or potential weakness deserving management s close attention.
- Substandard assets have a well-defined weakness or weaknesses. They are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected.
- An asset classified doubtful has all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable on the basis of currently existing facts, conditions and values. We consider doubtful to be a temporary classification until resolution of pending weakness issues enables us to more clearly define the potential for loss.



- That portion of an asset classified as loss is considered uncollectible and of so little value that its continuance as an asset, without establishment of a specific valuation allowance, is not warranted. A loss classification does not mean that an asset has absolutely no recovery or salvage value, but rather it is not reasonable to defer writing off or providing for all or a portion of the asset even though partial recovery may occur. We will generally classify as loss the balance of the asset that is greater than the net fair value of the asset unless we can expect payment from another source. Therefore, the amount of an asset classified as loss reflects the specific valuation allowance established for the particular asset. Specific valuation allowances are not includable in determining the Bank s total regulatory capital.

The OTS has the authority to require us to change our asset classifications. If the change results in an asset being classified in whole or in part as loss, a specific allowance must be established against the amount so classified or that amount must be charged off. OTS guidelines set forth quantitative benchmarks as a starting point for the determination of appropriate levels of general valuation allowances. The OTS directs its examiners to rely on management s estimates of adequate general valuation allowances if the Bank s process for determining adequate allowances is deemed to be sound.

The allowance for losses on loans and real estate are maintained at an amount management deems adequate to cover inherent losses. We have implemented and 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 specific large loans (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 composition of collateral as a whole because of their relatively homogeneous nature, unless an individual loan or borrower relationship warrants separate analysis. Given the above evaluations, the amount of the allowance is based upon the total of general valuation allowances, allocated allowances and an unallocated allowance.

We utilize the asset classifications from our internal asset review process in the following manner to determine the amount of our allowances:

- General valuation allowances: This element relates to assets with no well-defined deficiency or weakness (i.e., assets classified pass or watch) and takes into consideration loss that is imbedded within the portfolio but has not yet been realized. Generally, we believe that borrowers are impacted by events well in advance of a lender s knowledge that may ultimately result in loan default and eventual loss. Examples of such loss-causing events would be job loss, divorce or medical crisis in the case of single family residential and consumer loans, or loss of a major tenant in the case of commercial real estate loans. We determine general valuation allowances by applying against asset balances the associated factors for each major asset type that consider past loss experience and asset duration.
- Allocated allowances: This element relates to assets with well-defined deficiencies or weaknesses (i.e., assets classified special mention, substandard, doubtful or loss). We calculate losses on an ongoing basis by credit classification for each major asset type. Factors based upon those loss statistics are applied against current classified asset balances to determine the amount of allocated allowances. Included in these allowances are those amounts associated with assets where it is probable that the value of the asset has been impaired and the loss can be reasonably estimated. If we determine our carrying value of the asset exceeds the net fair value and no alternative payment source exists, then we record a specific allowance for the amount of that difference.
- Unallocated allowance: This element is more subjective and is reviewed quarterly to take into consideration estimation errors and economic trends that are not necessarily captured in determining the general valuation and allocated allowances.



During 2004, our provision for loan losses was $2.9 million, compared to a reversal of $3.7 million in 2003. The current year provision primarily reflected an increase in our loan portfolio. Our provision for loan losses and net loan recoveries resulted in an increase of $4.4 million in our allowance for loan losses to $34.7 million at December 31, 2004. The increase in our allowance primarily reflected an increase of $5.2 million in general valuation allowances to $28.8 million. Allocated allowances decreased by $0.8 million, primarily in our commercial real estate portfolio. There was no change in our unallocated allowance of $2.8 million.

During 2003, we reversed $3.7 million of provision for loan losses, compared to an expense of $0.9 million in 2002. The 2003 reversal reflected both an improvement in our credit quality and a decline in our loan portfolio. Our net loan charge-offs and the reversal of provision for loan losses resulted in a decline of $4.7 million in our allowance for loan losses to $30.3 million at December 31, 2003. The decline in our allowance primarily reflected a decline of $3.2 million in general valuation allowances to $23.6 million. Allocated allowances declined by $1.5 million, primarily in our single-family portfolio. There was no change in our unallocated allowance of $2.8 million.

The following table summarizes the activity in our allowance for loan losses for the years indicated.

| *(In Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
|---|---|---|---|---|---|
| Balance at beginning of year | $ 30,330 | $ 34,999 | $ 36,120 | $ 34,452 | $ 38,342 |
| Provision (reduction) | 2,895 | (3,718 ) | 939 | 2,564 | 3,251 |
| Charge-offs | (383 ) | (1,139 ) | (2,231 ) | (1,348 ) | (1,749 ) |
| Recoveries | 1,872 | 188 | 171 | 452 | 419 |
| Transfers [(a)] | - | - | - | - | (5,811 ) |
| Balance at end of year | $ 34,714 | $ 30,330 | $ 34,999 | $ 36,120 | $ 34,452 |

[(a)] *Reduction in 2000 was due to the sale of subsidiary.*

We had net loan recoveries of $1.5 million in 2004, compared to net charge-offs of $1.0 million in 2003 and $2.1 million in 2002. The current year net recovery reflected a recovery of a previous period charge-off of a commercial real estate loan that was repaid in full.

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**Navigation Links**

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

| *(Dollars in Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
|---|---|---|---|---|---|
| **Gross loan charge-offs** | | | | | |
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | $ 206 | $ 462 | $ 435 | $ 530 | $ 352 |
| One-to-four units subprime | - | 388 | 166 | 344 | 383 |
| Five or more units | - | - | - | - | - |
| Commercial real estate | - | - | 1,188 | - | - |
| Construction | - | - | - | - | - |
| Land | - | - | - | - | - |
| Non-mortgage: | | | | | |
| Commercial | - | 20 | - | - | - |
| Automobile | 22 | 54 | 104 | 197 | 832 |
| Other consumer | 155 | 215 | 338 | 277 | 182 |
| Total gross loan charge-offs | 383 | 1,139 | 2,231 | 1,348 | 1,749 |
| **Gross loan recoveries** | | | | | |
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | - | 164 | 111 | 267 | 19 |
| One-to-four units subprime | 26 | - | - | 166 | - |
| Five or more units | - | - | - | - | - |
| Commercial real estate | 1,819 | - | - | 1 | 250 |
| Construction | - | - | - | - | - |
| Land | - | - | - | - | - |
| Non-mortgage: | | | | | |
| Commercial | - | - | - | - | - |
| Automobile | 12 | 4 | 47 | 4 | 136 |
| Other consumer | 15 | 20 | 13 | 14 | 14 |
| Total gross loan recoveries | 1,872 | 188 | 171 | 452 | 419 |
| **Net loan charge-offs** | | | | | |
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| One-to-four units | 206 | 298 | 324 | 263 | 333 |
| One-to-four units subprime | (26 ) | 388 | 166 | 178 | 383 |
| Five or more units | - | - | - | - | - |
| Commercial real estate | (1,819 ) | - | 1,188 | (1 ) | (250 ) |
| Construction | - | - | - | - | - |
| Land | - | - | - | - | - |
| Non-mortgage: | | | | | |
| Commercial | - | 20 | - | - | - |
| Automobile | 10 | 50 | 57 | 193 | 696 |
| Other consumer | 140 | 195 | 325 | 263 | 168 |
| Total net loan charge-offs (recoveries) | $ (1,489 ) | $ 951 | $ 2,060 | $ 896 | $ 1,330 |
| Net loan charge-offs as a percentage of average loans | (0.01 )% | 0.01 % | 0.02 % | 0.01 % | 0.01 % |



**Navigation Links**

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

| | *December 31,* | | | | |
|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | $ 20,452 | $ 17,040 | $ 18,562 | $ 19,033 | $ 15,254 |
| One-to-four units subprime | 6,130 | 5,382 | 8,642 | 9,633 | 10,157 |
| Five or more units | 724 | 697 | 80 | 84 | 146 |
| Commercial real estate | 492 | 1,127 | 1,364 | 1,848 | 2,935 |
| Construction | 797 | 1,257 | 1,223 | 1,005 | 1,390 |
| Land | 352 | 209 | 636 | 274 | 332 |
| Non-mortgage: | | | | | |
| Commercial | 451 | 460 | 586 | 573 | 442 |
| Automobile | 13 | 38 | 100 | 277 | 269 |
| Other consumer | 2,503 | 1,320 | 1,006 | 593 | 727 |
| Not specifically allocated | 2,800 | 2,800 | 2,800 | 2,800 | 2,800 |
| Total for loans held for investment | $ 34,714 | $ 30,330 | $ 34,999 | $ 36,120 | $ 34,452 |

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

| (Dollars in Thousands) | December 31, 2004 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | 0.18 % | 0.20 % | 0.21 % | 0.25 % | 0.20 % |
| One-to-four units subprime | 0.49 | 0.54 | 0.62 | 0.64 | 0.58 |
| Five or more units | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 |
| Commercial real estate | 1.51 | 2.29 | 1.91 | 1.64 | 1.78 |
| Construction | 1.18 | 1.19 | 1.18 | 1.18 | 1.18 |
| Land | 1.38 | 1.24 | 1.19 | 1.24 | 1.24 |
| Non-mortgage: | | | | | |
| Commercial | 9.03 | 9.25 | 3.90 | 2.60 | 2.03 |
| Automobile | 1.52 | 0.99 | 0.86 | 1.13 | 0.68 |
| Other consumer | 0.88 | 1.38 | 1.77 | 1.16 | 1.20 |
| Total for loans held for investment | 0.26 % | 0.30 % | 0.34 % | 0.38 % | 0.35 % |

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

| (Dollars in Thousands) | December 31, 2004 | 2003 | 2002 | 2001 | 2000 |
|---|---|---|---|---|---|
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | 86.69 % | 86.56 % | 83.50 % | 80.75 % | 77.72 % |
| One-to-four units subprime | 9.45 | 9.79 | 13.38 | 15.80 | 17.70 |
| Five or more units | 0.73 | 0.92 | 0.10 | 0.12 | 0.20 |
| Commercial real estate | 0.25 | 0.49 | 0.69 | 1.18 | 1.67 |
| Construction | 0.51 | 1.05 | 1.00 | 0.89 | 1.20 |
| Land | 0.19 | 0.17 | 0.52 | 0.23 | 0.27 |
| Non-mortgage: | | | | | |
| Commercial | 0.04 | 0.05 | 0.15 | 0.23 | 0.22 |
| Automobile | 0.01 | 0.04 | 0.11 | 0.26 | 0.40 |
| Other consumer | 2.13 | 0.93 | 0.55 | 0.54 | 0.62 |
| Total for loans held for investment | 100.00 % | 100.00 % | 100.00 % | 100.00 % | 100.00 % |

We consider a loan to be impaired when, based upon current information and events, we believe it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. We carry impaired loans at the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s observable market price or the net fair value of the collateral securing the loan. Impaired loans exclude large groups of smaller balance homogeneous loans that we collectively evaluate for impairment. Generally, loans we collectively review for impairment include all single family loans and performing multi-family and non-residential loans having principal balances of less than $5 million, unless an individual loan or borrower relationship warrants separate analysis.

In determining impairment, we consider large non-homogeneous loans that are on non-accrual, have been restructured or are performing but exhibit, among other characteristics, high loan-to-value ratios or delinquent taxes. We base the measurement of collateral dependent impaired loans on the net fair value of the loan s collateral. We value non-collateral dependent loans based on a present value calculation of expected future cash flows discounted at the loan s effective rate or the loan s observable market price. We generally use cash receipts on impaired loans not performing according to contractual terms to reduce the carrying value of the loan, unless we believe we will recover the remaining principal balance of the loan. We include impairment losses in the allowance for loan losses through a charge to provision for loan losses. We include adjustments to impairment losses due to changes in the fair value of the collateral of impaired loans in provision for loan losses. Upon disposition of an impaired loan, we record loss of principal through a charge-off to the allowance for loan losses. At December 31, 2004, the recorded investment in loans for which we have recognized impairment totaled $3 million, down from $12 million at December 31, 2003 as the result of a commercial real estate loan that was repaid in full. The total allowance for losses related to impaired loans was less than $1 million for both December 31, 2004 and 2003. During 2004, the total interest recognized on the impaired portfolio was $0.8 million, compared to $1.4 million in 2003. For further information regarding impaired loans, see Note 5 of the Notes to Consolidated Financial Statements on page 85.

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

| *(In Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
|---|---|---|---|---|---|
| Balance at beginning of year | $ 709 | $ 725 | $ 759 | $ 800 | $ 797 |
| Provision (reduction) [a] | (516 ) | (16 ) | 1,154 | (41 ) | 3 |
| Charge-offs [a] | - | - | (1,188 ) | - | - |
| Recoveries | - | - | - | - | - |
| Balance at end of year | $ 193 | $ 709 | $ 725 | $ 759 | $ 800 |

[a] *The provision of $1.2 million during 2002 and resultant $1.2 million charge-off related to a commercial real estate loan for which a short-pay was accepted in full consideration.*

In addition to losses charged against the allowance for loan losses, we have maintained a valuation allowance for losses on real estate and joint ventures held for investment. The provision in 2003 is related to one property under construction. The provision reductions in the two years prior to 2003 were, in general, due to a continuing improvement in the real estate market which favorably impacted the valuation of certain neighborhood shopping center investments and to a reduction in the investment in certain joint venture investments.

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

| *(In Thousands)* | *2004* | *2003* | *2002* | *2001* | *2000* |
|---|---|---|---|---|---|
| Balance at beginning of year | $ 1,436 | $ 908 | $ 2,690 | $ 2,997 | $ 2,131 |
| Provision (reduction) | - | 528 | (448 ) | (307 ) | 866 |
| Charge-offs | - | - | (1,334 ) | - | - |

| | | | | | |
|---|---|---|---|---|---|
| Recoveries | - | - | - | - | - |
| Balance at end of year | $ 1,436 | $ 1,436 | $ 908 | $ 2,690 | $ 2,997 |

We do not maintain an allowance for real estate acquired in settlement of loans as we record the related individual assets at the lower of cost or fair value and any losses are recorded as a direct write-off to net operations.



**Capital Resources and Liquidity**

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

Our primary sources of funds generated during 2004 were from:

- principal repayments of $3.9 billion including prepayments, but excluding refinances of our existing loans on loans and mortgage-backed securities;
- a net increase of $2.5 billion in borrowings;
- sales and maturities of $2.2 billion in U.S. Treasury securities, agency obligations and other investment securities available for sale; and
- an increase of $1.4 billion in deposits.

We used these funds to:

- originate and purchase $8.3 billion of loans held for investment, excluding refinances of our existing loans;
- purchase $2.0 billion of U.S. Treasury securities, agency obligations and other investment securities available for sale; and
- fund a net increase of $839 million in our loans held for sale.

Our principal source of liquidity is our ability to utilize borrowings, as needed. Our primary source of borrowings is the FHLB. At December 31, 2004, our FHLB borrowings totaled $4.6 billion, representing 29.1% of total assets. We currently are approved by the FHLB to borrow up to 50% of total assets to the extent we provide qualifying collateral and hold sufficient FHLB stock. That approved limit would have permitted us, as of year end, to borrow an additional $3.3 billion. To the extent 2005 deposit growth falls short of satisfying ongoing commitments to fund maturing and withdrawable deposits, repay maturing borrowings, fund existing and future loans, make investments, and continue branch improvement programs, we may utilize the additional capacity from our FHLB borrowing arrangement or other sources. As of December 31, 2004, we had commitments to borrowers for short-term rate locks, excluding expected fallout, of $1.2 billion, undisbursed loan funds and unused lines of credit of $458 million, operating leases of $17 million and commitments to invest in affordable housing funds of $5 million. We believe our current sources of funds, including repayments of existing loans, enable us to meet our obligations while maintaining liquidity at appropriate levels.

The holding company currently has adequate liquid assets to meet its obligations and can obtain further funds by means of dividends from subsidiaries, subject to certain limitations, or issuance of further debt or equity. At December 31, 2004, the holding company s liquid assets, including due from Bank interest bearing balances, totaled $32 million, down from $70 million at the end of 2003. The decrease from a year-ago was primarily due to capital contributions of $117 million made to the Bank to support its asset growth.

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. Since inception of the repurchase program, 420,800 shares of our common stock have been repurchased at an aggregate cost of $43.68 per share, leaving approximately $32 million unused from the original $50 million authorized. On September 27, 2004, the Board of Directors terminated the stock repurchase program due to significant asset growth this year. During 2004, 39,561 shares of

treasury stock were reissued at below cost upon the exercise of Downey stock options at an average exercise price of $21.32.

Stockholders equity totaled $1.0 billion at December 31, 2004, up from $917 million at December 31, 2003 and $823 million at December 31, 2002.

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***Contractual Obligations and Other Commitments***

Through the normal course of operations, we have entered into certain contractual obligations and other commitments. Our obligations generally relate to funding of our operations through deposits and borrowings as well as leases for premises and equipment, and our commitments generally relate to our lending operations.

We have obligations under long-term operating leases, principally for building space and land. Lease terms generally cover a five-year period, with options to extend, and are non-cancelable. Currently, we have no significant contractual vendor obligations.

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

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

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

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

We enter into derivative financial instruments as part of our interest rate risk management process, including forward sale and purchase contracts related to our sale of loans in the secondary market. The associated fair value changes to the notional amount of the derivative instruments are recorded on-balance sheet. The total notional amount of our derivative financial instruments do not represent future cash requirements. For further information regarding our derivative instruments, see Asset/Liability Management and Market Risk on page 46 and Note 23 of Notes to the Consolidated Financial Statements on page 102.

We sell all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty made to the investor in connection with the sale. If such a defect is identified, we may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, we have no commitment to repurchase the loan. There were no repurchases or indemnification losses related to such defects in either 2004 or 2003. These loan and servicing sale contracts may also contain provisions to refund purchase price premiums to the investor if the loans prepay during a period not to exceed 120 days from the sale settlement date. We reserved $7 million at December 31, 2004 and less than $1 million at December 31, 2003 to cover the estimated loss exposure related to early payoffs. See Note 23 of Notes to the Consolidated Financial Statements on page 102.

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At December 31, 2004, scheduled maturities of obligations and commitments were as follows:

| *(In Thousands)* | *Within 1 Year* | *1 3 Years* | *4 5 Years* | *Over 5 Years* | *Total Balance* |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Certificates of deposit | $ 4,268,382 | $ 1,069,442 | $ 212,094 | $ 100 | $ 5,550,018 |
| FHLB advances | 3,967,750 | 141,300 | 421,572 | 29,000 | 4,559,622 |
| Senior notes | - | - | - | 197,924 | 197,924 |
| Secondary marketing activities: | | | | | |
| Non-qualifying hedge transactions: | | | | | |
| Expected rate lock commitments | 367,650 | - | - | - | 367,650 |
| Associated forward sale contracts | 368,822 | - | - | - | 368,822 |
| Qualifying cash flow hedge transactions: | | | | | |
| Loans held for sale, at lower of cost or fair value | 1,118,475 | - | - | - | 1,118,475 |
| Associated forward sale contracts | 1,115,636 | - | - | - | 1,115,636 |
| Qualifying fair value hedge transactions: | | | | | |
| Designated FHLB advances pay-fixed | - | - | 430,000 | - | 430,000 |
| Associated interest rate swap contracts | | | | | |
| pay-variable, receive-fixed | - | - | 430,000 | - | 430,000 |
| Commitments to originate adjustable loans held for investment | 738,102 | - | - | - | 738,102 |
| Undisbursed loan funds and unused lines of credit | 39,350 | 4,790 | - | 413,675 | 457,815 |
| Operating leases | 4,858 | 6,900 | 3,616 | 1,370 | 16,744 |
| Commitments to invest in affordable housing funds | - | - | - | 5,129 | 5,129 |
| Total obligations and commitments | $ 11,989,025 | $ 1,222,432 | $ 1,497,282 | $ 647,198 | $ 15,355,937 |

**Regulatory Capital Compliance**

Our core and tangible capital ratios were both 7.09% and our risk-based capital ratio was 13.71% at December 31, 2004. These levels are down from ratios of 7.96% for both core and tangible capital and 15.55% for risk-based capital at December 31, 2003. However, we continue to exceed the "well capitalized" standards of 5.00% for core capital and 10.00% for risk-based capital, as defined by regulation.

The following table is a reconciliation of the Bank s stockholder s equity to federal regulatory capital as of December 31, 2004.

| | *Tangible Capital* | | *Core Capital* | | *Risk-Based Capital* | |
|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *Amount* | *Ratio* | *Amount* | *Ratio* | *Amount* | *Ratio* |
| Stockholder s equity | $ 1,174,469 | | $ 1,174,469 | | $ 1,174,469 | |
| Adjustments: | | | | | | |
| Deductions: | | | | | | |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Investment in subsidiary, primarily real estate | (65,368 ) | | | (65,368 ) | | | (65,368 ) | | |
| Excess cost over fair value of branch acquisitions | (3,150 ) | | | (3,150 ) | | | (3,150 ) | | |
| Non-permitted mortgage servicing rights | (1,796 ) | | | (1,796 ) | | | (1,796 ) | | |
| Unrealized gains on securities available for sale | (318 ) | | | (318 ) | | | (318 ) | | |
| Additions: | | | | | | | | | |
| General loss allowance investment in DSL Service Company | 730 | | | 730 | | | 730 | | |
| Allowance for loan losses, net of specific allowances [a] | - | | | - | | | 34,263 | | |
| Regulatory capital | 1,104,567 | 7.09 % | | 1,104,567 | 7.09 % | | 1,138,830 | 13.71 % | |
| Well capitalized requirement | 233,582 | 1.50 | (b) | 778,607 | 5.00 | | 830,614 | 10.00 | (c) |
| Excess | $ 870,985 | 5.59 % | | $ 325,960 | 2.09 % | | $ 308,216 | 3.71 % | |

*[a] Limited to 1.25% of risk-weighted assets.*
*[b] Represents the minimum requirement for tangible capital, as no "well capitalized" requirement has been established for this category.*
*[c] A third requirement is Tier 1 capital to risk-weighted assets of 6.00%, which the Bank met and exceeded with a ratio of 13.30%.*



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**CURRENT ACCOUNTING STANDARDS**

*Interest Rate Lock Derivatives*

In accordance with Statement of Financial Accounting Standards No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"), expected interest rate lock commitments on mortgage loans that will be held for sale must be accounted for as derivatives and marked to market in accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). All other interest rate lock commitments are excluded from SFAS 133, pursuant to SFAS 149.

In October 2003, the FASB decided to add a project to its agenda that would clarify how fair value should be measured for interest rate lock derivatives. To our knowledge, no timetable has been established yet for the completion of this project. In the meantime, the Securities and Exchange Commission ("SEC") issued guidance in Staff Accounting Bulletin No. 105 ("SAB 105"). SAB 105 requires that fair-value measurement include only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected future cash flows related to the customer relationship or loan servicing. Servicing assets are to be recognized only once the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained. The guidance in SAB 105 must be applied to interest rate locks initiated after March 31, 2004 and is to be applied prospectively. There is no financial impact from SAB 105, as our accounting for expected interest rate lock commitments has been in accordance with the bulletin.

At December 31, 2004, we had an asset recorded for interest rate lock derivatives of $2.0 million and a contra asset for the capitalized basis adjustment to loans held for sale of $4.1 million, which reflects the change in fair value of the interest rate lock derivative from the date of commitment to the date of funding. At December 31, 2003, we had assets recorded for interest rate lock derivatives of $0.1 million and capitalized basis adjustment to loans held for sale of $0.3 million, which reflects the change in fair

value of the interest rate lock derivative from the date of commitment to the date of funding. The offsetting credit to these assets was recorded as SFAS 133 gains in net gains on sales of loans and mortgage-backed securities.

*Statement of Financial Accounting Standards No. 123R*

Statement of Financial Accounting Standards No. 123R, "Share-Based Payment" ("SFAS 123R"), is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS 123R does not change the accounting guidance for share-based payment transactions with parties other than employees provided in SFAS 123 as originally issued and EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." Accounting for employee-stock-ownership-plan transaction ("ESOP s") will continue to be accounted for in accordance with SOP 93-6, "Employers Accounting for Employee Stock Ownership Plans." SFAS 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees, but expresses no preference for a type of valuation model. SFAS 123R is effective for interim or annual periods beginning after June 15, 2005. It is not expected that SFAS 123R will have a material financial impact on us unless a significant number of new option grants are made.

*Statement of Financial Accounting Standards No. 153*

Statement of Financial Accounting Standards No. 153, "Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29" ("SFAS 153"), require exchanges of nonmonetary assets be measured based on the fair value of the assets exchanged. The amendments eliminate the narrow exception for nonmonetary exchanges of similar productive assets and replace it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has a commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. Previously, APB Opinion No. 29, "Accounting for Nonmonetary Transactions," required that the accounting for an exchange of a productive asset for a similar productive asset should be based on the recorded amount of the asset relinquished with no gain recognition. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 and is to be applied prospectively. SFAS 153 is not expected to have a material financial impact on us.

*Emerging Issues Task Force Issue No. 03-1*

In March of 2004, the Emerging Issues Task Force ("EITF") reached consensus on the guidance provided in EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments." Among other investments, this guidance is applicable to debt and equity securities that are within the scope of Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. Paragraph 10



of EITF 03-1 specifies that an impairment would be considered other-than-temporary unless (a) the investor has the ability and intent to hold an investment for a reasonable period of time sufficient for the recovery of the fair value up to (or beyond) the cost of the investment and (b) evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. A company s liquidity and capital requirements should be considered when assessing its intent and ability to hold an investment for a reasonable period of time that would allow the fair value of the investment to recover up to or beyond its cost. A pattern of selling investments prior to the forecasted fair value recovery may call into question a company s intent. In addition, the severity and duration of the impairment should also be considered when determining whether the impairment is other-than-temporary. This guidance was effective for reporting periods beginning after June 15, 2004 with the exception of paragraphs 10 - 20 of EITF 03-1, which will be deliberated further. This delay does not suspend the requirement to recognize other-than-temporary impairments as required by existing authoritative literature. The outcome of this deliberation may accelerate the recognition of losses from declines in value on debt securities due to interest rates; however, it is not anticipated to have a significant impact on stockholders equity as changes in market value of available-for-sale securities are already included in Accumulated Other Comprehensive Income.

*Statement of Position 03-3*

Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer" ("SOP 03-3"), addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor s initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. SOP 03-3 does not apply to loans originated by the entity. SOP 03-3 limits the yield that may be accreted (accretable yield) to the excess of the investor s estimate of undiscounted expected principal, interest, and other cash

flows (cash flows expected at acquisition to be collected) over the investor s initial investment in the loan. SOP 03-3 requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. SOP 03-3 prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan s yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment. SOP 03-3 prohibits "carrying over" or creation of valuation allowances in the initial accounting of all loans acquired in a transfer that are within the scope of SOP 03-3. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination. SOP 03-3 is effective for fiscal years beginning after December 15, 2004 and is to be applied prospectively. SOP 03-3 is not expected to have a material financial impact on us.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For information regarding quantitative and qualitative disclosures about market risk, see Asset/Liability Management and Market Risk on page 46.



## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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**Management s Report on Internal Control Over Financial Reporting**

Management of Downey Financial Corp. ("Downey") is responsible for establishing and maintaining adequate internal control over financial reporting. Downey s internal control over financial reporting is a process designed under the supervision of Downey s Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of Downey s financial statements for external reporting purposes in accordance with generally accepted accounting principles.

As of December 31, 2004, management conducted an assessment of the effectiveness of Downey s internal control over financial reporting based on the framework established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that Downey s internal control over financial reporting as of December 31, 2004 is effective.

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of Downey s management and the directors; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Downey s assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree or compliance with the policies or procedures may deteriorate.

KPMG LLP, the independent registered public accounting firm that audited the consolidated financial statements of Downey included in this Annual Report on Form 10-K, has issued an attestation report on management s assessment of the effectiveness of Downey s internal control over financial reporting as of December 31, 2004. The report, which expresses unqualified opinions on management s assessment and on the effectiveness of Downey s internal control over financial reporting as of December 31, 2004, is included in this Item under the heading "Report of Independent Registered Public Accounting Firm."

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

Downey Financial Corp.:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that Downey Financial Corp. and subsidiaries ("Downey") maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Downey s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of Downey s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that Downey maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Downey maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Downey Financial Corp. and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, comprehensive income, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2004, and our report dated March 1, 2005 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Los Angeles, California

March 1, 2005



**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

Downey Financial Corp.:

We have audited the accompanying consolidated balance sheets of Downey Financial Corp. and subsidiaries ("Downey") as of December 31, 2004 and 2003, and the related consolidated statements of income, comprehensive income, stockholders equity and cash flows for each of the years in the three-year period ended December 31, 2004. These consolidated financial statements are the responsibility of Downey s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Downey Financial Corp. and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Downey s internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 1, 2005 expressed an unqualified opinion on management s assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Los Angeles, California

March 1, 2005



Downey Financial Corp. And Subsidiaries

## Consolidated Balance Sheets

| | December 31, | |
|---|---|---|
| *(Dollars in Thousands, Except Per Share Data)* | *2004* | *2003* |
| **Assets** | | |
| Cash | $ 119,502 | $ 111,667 |
| Federal funds | - | 1,500 |
| Cash and cash equivalents | 119,502 | 113,167 |
| U.S. Treasury securities, agency obligations and other investment securities | | |
| available for sale, at fair value | 497,009 | 690,347 |
| Loans held for sale, at lower of cost or fair value | 1,118,475 | 279,657 |
| Mortgage-backed securities available for sale, at fair value | 304 | 334 |
| Loans receivable held for investment | 13,423,999 | 10,116,519 |
| Investments in real estate and joint ventures | 55,411 | 35,716 |
| Real estate acquired in settlement of loans | 2,555 | 5,803 |
| Premises and equipment | 106,238 | 110,316 |
| Federal Home Loan Bank stock, at cost | 243,613 | 123,089 |
| Investment in Downey Financial Capital Trust I | - | 3,711 |
| Mortgage servicing rights, net | 17,964 | 82,175 |
| Other assets | 63,738 | 85,146 |
| | $ 15,648,808 | $ 11,645,980 |
| **Liabilities and Stockholders Equity** | | |
| Deposits | $ 9,657,978 | $ 8,293,758 |
| Federal Home Loan Bank advances | 4,559,622 | 2,125,150 |
| Real estate notes | - | 4,161 |
| Senior notes | 197,924 | - |
| Junior subordinated debentures | - | 123,711 |
| Accounts payable and accrued liabilities | 108,217 | 63,584 |
| Deferred income taxes | 117,416 | 118,598 |
| Total liabilities | 14,641,157 | 10,728,962 |

| | | |
|---|---|---|
| **Stockholders equity** | | |
| Preferred stock, par value of $0.01 per share; authorized 5,000,000 shares; | | |
| outstanding none | - | - |
| Common stock, par value of $0.01 per share; authorized 50,000,000 shares; | | |
| issued 28,235,022 shares at both December 31, 2004 and 2003; | | |
| outstanding 27,853,783 shares at December 31, 2004 and 27,928,722 | | |
| shares at December 31, 2003 | 282 | 282 |
| Additional paid-in capital | 93,792 | 93,792 |
| Accumulated other comprehensive income | 318 | 807 |
| Retained earnings | 930,051 | 834,307 |
| Treasury stock, at cost, 381,239 shares at December 31, 2004 and | | |
| 306,300 shares at December 31, 2003 | (16,792 ) | (12,170 ) |
| Total stockholders equity | 1,007,651 | 917,018 |
| | $ 15,648,808 | $ 11,645,980 |

*See accompanying notes to consolidated financial statements.*



**Navigation Links**

Downey Financial Corp. And Subsidiaries

## Consolidated Statements of Income

| *(Dollars in Thousands, Except Per Share Data)* | *Years Ended December 31,* | | |
|---|---|---|---|
| | *2004* | *2003* | *2002* |
| **Interest income** | | | |
| Loans receivable | $ 540,138 | $ 504,480 | $ 612,762 |
| U.S. Treasury securities and agency obligations | 20,750 | 12,502 | 9,682 |
| Mortgage-backed securities | 12 | 61 | 3,637 |
| Other investments | 6,810 | 5,407 | 6,957 |
| Total interest income | 567,710 | 522,450 | 633,038 |
| **Interest expense** | | | |
| Deposits | 152,258 | 161,825 | 244,541 |
| Federal Home Loan Bank advances and other borrowings | 83,651 | 59,477 | 60,936 |
| Senior notes | 6,881 | - | - |

| | | | |
|---|---|---|---|
| Junior subordinated debentures | 7,033 | 12,535 | 12,535 |
| Total interest expense | 249,823 | 233,837 | 318,012 |
| **Net interest income** | 317,887 | 288,613 | 315,026 |
| **Provision for (reduction of) loan losses** | 2,895 | (3,718 ) | 939 |
| Net interest income after provision for (reduction of) loan losses | 314,992 | 292,331 | 314,087 |
| **Other income, net** | | | |
| Loan and deposit related fees | 60,539 | 53,076 | 47,220 |
| Real estate and joint ventures held for investment, net | 13,902 | 9,835 | 10,250 |
| Secondary marketing activities: | | | |
| Loan servicing loss, net | (19,225 ) | (27,060 ) | (39,629 ) |
| Net gains on sales of loans and mortgage-backed securities | 54,443 | 61,436 | 45,860 |
| Net gains on sales of mortgage servicing rights | 616 | 23 | 331 |
| Net losses on trading securities | - | (10,449 ) | - |
| Net gains (losses) on sales of investment securities | (16,103 ) | 8 | 219 |
| Litigation award | - | 2,851 | - |
| Loss on extinguishment of debt | (4,111 ) | - | - |
| Other | 1,324 | 1,222 | 2,803 |
| Total other income, net | 91,385 | 90,942 | 67,054 |
| **Operating expense** | | | |
| Salaries and related costs | 148,221 | 134,610 | 119,514 |
| Premises and equipment costs | 33,980 | 32,261 | 30,694 |
| Advertising expense | 5,525 | 3,712 | 4,418 |
| SAIF insurance premiums and regulatory assessments | 3,151 | 3,205 | 3,078 |
| Professional fees | 1,828 | 2,383 | 1,435 |
| Other general and administrative expense | 37,061 | 31,828 | 27,505 |
| Total general and administrative expense | 229,766 | 207,999 | 186,644 |
| Net operation of real estate acquired in settlement of loans | (256 ) | (929 ) | 11 |
| Total operating expense | 229,510 | 207,070 | 186,655 |
| **Income before income taxes** | 176,867 | 176,203 | 194,486 |
| Income taxes | 69,205 | 74,462 | 82,193 |
| **Net income** | $ 107,662 | $ 101,741 | $ 112,293 |
| **PER SHARE INFORMATION** | | | |
| **Basic** | $ 3.86 | $ 3.64 | $ 3.99 |

| | | | |
|---|---|---|---|
| **Diluted** | $ 3.85 | $ 3.64 | $ 3.99 |
| **Cash dividends declared and paid** | $ 0.40 | $ 0.36 | $ 0.36 |
| Weighted average diluted shares outstanding | 27,948,179 | 27,963,449 | 28,173,659 |

*See accompanying notes to consolidated financial statements.*



**Navigation Links**

Downey Financial Corp. And Subsidiaries

## Consolidated Statements of Comprehensive Income

| | *Years Ended December 31,* | | |
|---|---|---|---|
| *(In Thousands)* | *2004* | *2003* | *2002* |
| **Net income** | $ 107,662 | $ 101,741 | $ 112,293 |
| **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 | 44 | (207 ) | 61 |
| Mortgage-backed securities available for sale, at fair value | (4 ) | (21 ) | 935 |
| Reclassification of realized amounts included in net income | (621 ) | (5 ) | (284 ) |
| Unrealized gains (losses) on cash flow hedges: | | | |
| Net derivative instruments | 1,682 | 996 | (11,434 ) |
| Reclassification of realized amounts included in net income | (1,590 ) | 1,466 | 9,539 |
| Total other comprehensive income (loss), net of income taxes (benefits) | (489 ) | 2,229 | (1,183 ) |
| **Comprehensive income** | $ 107,173 | $ 103,970 | $ 111,110 |

## Consolidated Statements of Stockholders   Equity

*Accumulated*

| *(Dollars in Thousands, Except Per Share Data)* | *Common Stock* | *Additional Paid-in Capital* | *Other Comprehensive Income (Loss)* | *Retained Earnings* | *Treasury Stock* | *Total* |
|---|---|---|---|---|---|---|
| Balances at December 31, 2001 | $ 282 | $ 93,400 | $ (239 ) | $ 640,453 | $ - | $ 733,896 |
| Cash dividends, $0.36 per share | - | - | - | (10,124 ) | - | (10,124 ) |
| Exercise of stock options | - | 392 | - | - | - | 392 |
| Unrealized gains on securities | | | | | | |
| available for sale | - | - | 712 | - | - | 712 |
| Unrealized losses on cash flow hedges | - | - | (1,895 ) | - | - | (1,895 ) |
| Purchase of treasury stock | - | - | - | - | (12,170 ) | (12,170 ) |
| Net income | - | - | - | 112,293 | - | 112,293 |
| Balances at December 31, 2002 | 282 | 93,792 | (1,422 ) | 742,622 | (12,170 ) | 823,104 |
| Cash dividends, $0.36 per share | - | - | - | (10,056 ) | - | (10,056 ) |
| Unrealized losses on securities | | | | | | |
| available for sale | - | - | (233 ) | - | - | (233 ) |
| Unrealized gains on cash flow hedges | - | - | 2,462 | - | - | 2,462 |
| Net income | - | - | - | 101,741 | - | 101,741 |
| Balances at December 31, 2003 | 282 | 93,792 | 807 | 834,307 | (12,170 ) | 917,018 |
| Cash dividends, $0.40 per share | - | - | - | (11,172 ) | - | (11,172 ) |
| Unrealized losses on securities | | | | | | |
| available for sale | - | - | (581 ) | - | - | (581 ) |
| Unrealized gains on cash flow hedges | - | - | 92 | - | - | 92 |
| Exercise of stock options | - | - | - | (746 ) | 1,589 | 843 |
| Purchase of treasury stock | - | - | - | - | (6,211 ) | (6,211 ) |
| Net income | - | - | - | 107,662 | - | 107,662 |
| Balances at December 31, 2004 | $ 282 | $ 93,792 | $ 318 | $ 930,051 | $ (16,792 ) | $ 1,007,651 |

*See accompanying notes to consolidated financial statements.*

Downey Financial Corp. And Subsidiaries

## Consolidated Statements of Cash Flows

| (In Thousands) | Years Ended December 31, 2004 | 2003 | 2002 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Net income | $ 107,662 | $ 101,741 | $ 112,293 |
| Adjustments to reconcile net income to net cash used for operating activities: | | | |
| Depreciation and amortization | 90,211 | 87,239 | 61,840 |
| 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 | 19,762 | 9,029 | 37,712 |
| Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, trading and investment securities, real estate and other assets | (50,546 ) | (69,527 ) | (55,046 ) |
| Interest capitalized on loans (negative amortization) | (22,949 ) | (8,531 ) | (25,615 ) |
| Federal Home Loan Bank stock dividends | (5,804 ) | (5,526 ) | (4,424 ) |
| Loans originated and purchased for sale | (6,783,718 ) | (6,223,868 ) | (6,172,572 ) |
| Proceeds from sales of loans held for sale, including those sold as mortgage-backed securities | 5,934,588 | 6,611,710 | 6,036,671 |
| Proceeds from sales of mortgage servicing rights | 62,279 | 23 | 1,685 |
| Other, net | (100,907 ) | (88,654 ) | (6,372 ) |
| Net cash provided by (used for) operating activities | (749,422 ) | 413,636 | (13,828 ) |
| **Cash flows from investing activities** | | | |
| Proceeds from sales of: | | | |
| U.S. Treasury securities, agency obligations and other investment securities available for sale | 1,527,035 | 15,275 | 92,137 |
| Mortgage-backed securities available for sale | - | - | 1,080,491 |
| Loans originated for investment | 983,014 | 3,663 | - |
| Wholly owned real estate and real estate acquired in settlement of loans | 29,004 | 24,102 | 41,811 |
| Redemption of common securities in Downey Financial Capital Trust I | 3,711 | - | - |
| Proceeds from maturities or calls of U.S. Treasury securities, agency obligations and other investment securities available for sale | 673,931 | 656,724 | 525,440 |
| Purchase of: | | | |
| U.S. Treasury securities, agency obligations and other investment securities available for sale | (2,025,088 ) | (899,522 ) | (674,740 ) |
| Mortgage-backed securities available for sale | - | - | (1,014,098 ) |
| Loans receivable held for investment | (238,444 ) | (705,887 ) | (466,702 ) |

| | | | |
|---|---|---|---|
| Premises and equipment | (14,470 ) | (15,298 ) | (20,369 ) |
| Federal Home Loan Bank stock | (114,720 ) | - | - |
| Originations of loans receivable held for investment (net of refinances | | | |
| of $636,459 for the year ended December 31, 2004, $389,360 for | | | |
| the year ended December 31, 2003 and $287,166 for the year ended | | | |
| December 31, 2002) | (8,046,161 ) | (3,930,536 ) | (3,987,922 ) |
| Principal payments on loans receivable held for investment and | | | |
| mortgage-backed securities available for sale | 3,934,195 | 4,824,628 | 3,675,999 |
| Net change in undisbursed loan funds | 217,589 | 50,190 | 60,342 |
| Investments in real estate held for investment | (29,380 ) | (4,332 ) | (18,134 ) |
| Other, net | 3,337 | 3,866 | 4,318 |
| Net cash provided by (used for) investing activities | (3,096,447 ) | 22,873 | (701,427 ) |

*See accompanying notes to consolidated financial statements.*



**Navigation Links**

Downey Financial Corp. And Subsidiaries

## Consolidated Statements of Cash Flows (Continued)

| *(In Thousands)* | *Years Ended December 31,* 2004 | 2003 | 2002 |
|---|---|---|---|
| **Cash flows from financing activities** | | | |
| Net increase (decrease) in deposits | $ 1,364,220 | $ (944,592 ) | $ 618,784 |
| Proceeds from FHLB advances and other borrowings | 22,862,169 | 11,680,361 | 7,220,550 |
| Repayments of FHLB advances and other borrowings | (20,423,430 ) | (11,175,134 ) | (7,119,178 ) |
| Proceeds from the issuance of senior notes | 197,844 | - | - |
| Redemption of junior subordinated debentures | (123,711 ) | - | - |
| Purchase of treasury stock | (6,211 ) | - | (12,170 ) |
| Proceeds from exercise of stock options | 843 | - | 392 |
| Cash dividends | (11,172 ) | (10,056 ) | (10,124 ) |
| Other, net | (8,348 ) | - | - |
| Net cash provided by (used for) financing activities | 3,852,204 | (449,421 ) | |