DOWNEY FINANCIAL CORP
Form 10-Q
November 01, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **September 30, 2007**

OR

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

For the transition period from __________ to __________

Commission File Number **1-13578**

DOWNEY FINANCIAL CORP.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**33-0633413** (I.R.S. Employer Identification No.)
3501 Jamboree Road, Newport Beach, CA (Address of principal executive office)	**92660** (Zip Code)
Registrant s telephone number, including area code	**(949) 854-0300**

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

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

was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes_X_ No__

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

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

At Septmeber 30, 2007, 27,853,783 shares of the Registrant s Common Stock, $0.01 par value were outstanding.

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DOWNEY FINANCIAL CORP.

September 30, 2007 QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Data)	*September 30, 2007*	*December 31, 2006*	*September 30, 2006*
Assets			
Cash	$ 86,072	$ 124,865	$ 179,780
Federal funds	1,551	1	1
Cash and cash equivalents	87,623	124,866	179,781
U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value	2,142,278	1,433,176	1,162,614
Loans held for sale, at lower of cost or fair value	90,228	363,215	323,428
Mortgage-backed securities available for sale, at fair value	112	251	257
Loans held for investment	11,744,063	13,868,227	14,872,642
Allowance for loan losses	(142,218)	(60,943)	(60,784)
Loans held for investment, net	11,601,845	13,807,284	14,811,858
Investments in real estate and joint ventures	58,715	59,843	55,663
Real estate acquired in settlement of loans	59,773	8,524	5,761
Premises and equipment, net	117,535	114,052	115,442
Federal Home Loan Bank stock, at cost	70,058	152,953	187,186
Mortgage servicing rights, net	21,849	21,196	20,310
Other assets	167,701	122,022	119,257
	$ 14,417,717	$ 16,207,382	$ 16,981,557
Liabilities and Stockholders Equity			
Deposits	$ 10,662,618	$ 11,784,869	$ 11,945,758
Securities sold under agreements to repurchase	566,350	469,971	463,678
Federal Home Loan Bank advances	1,308,867	2,140,785	2,680,546
Senior notes	198,398	198,260	198,216
Accounts payable and accrued liabilities	237,258	220,262	338,814
Deferred income taxes	-	-	9,952
Total liabilities	12,973,491	14,814,147	15,636,964
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 September 30, 2007, December 31, 2006 and			
September 30, 2006; outstanding 27,853,783 shares at September 30, 2007,			
December 31, 2006 and September 30, 2006	282	282	282
Additional paid-in capital	93,792	93,792	93,792
Accumulated other comprehensive income (loss)	388	(5,204)	(4,516)
Retained earnings	1,366,556	1,321,157	1,271,827
Treasury stock, at cost, 381,239 shares at September 30, 2007,			
December 31, 2006 and September 30, 2006	(16,792)	(16,792)	(16,792)
Total stockholders equity	1,444,226	1,393,235	1,344,593
	$ 14,417,717	$ 16,207,382	$ 16,981,557

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in Thousands, Except Per Share Data)	*2007*	*2006*	*2007*	*2006*
Interest income				
Loans	$ 208,314	$ 277,974	$ 690,869	$ 808,552
U.S. Treasury and government sponsored entities securities	26,350	11,404	65,644	27,670
Mortgage-backed securities	3	3	9	9
Other investment securities	1,207	2,419	5,396	6,941
Total interest income	235,874	291,800	761,918	843,172
Interest expense				
Deposits	108,514	110,033	333,977	301,666
Federal Home Loan Bank advances and other borrowings	26,088	48,229	83,494	143,109
Senior notes	3,302	3,299	9,904	9,895
Total interest expense	137,904	161,561	427,375	454,670
Net interest income	97,970	130,239	334,543	388,502
Provision for credit losses	81,562	9,640	91,684	26,359
Net interest income after provision for credit losses	16,408	120,599	242,859	362,143
Other income, net				
Loan and deposit related fees	8,913	9,279	27,087	27,008
Real estate and joint ventures held for investment, net	(7,892)	5,331	(7,527)	10,173
Secondary marketing activities:				
Loan servicing income (loss), net	(294)	(377)	(1,519)	264
Net gains on sales of loans and mortgage-backed securities	2,506	14,847	20,224	35,120
Litigation award	-	1,625	-	1,625
Other	(197)	(36)	(16)	719
Total other income, net	3,036	30,669	38,249	74,909
Operating expense				
Salaries and related costs	36,699	38,943	119,931	120,596
Premises and equipment costs	9,736	8,804	27,667	25,752
Advertising expense	1,400	1,211	4,469	4,332

Deposit insurance premiums and regulatory assessments	2,413	2,224	7,659	4,246
Professional fees	489	254	1,779	1,496
Other general and administrative expense	8,275	7,087	24,271	24,557
Total general and administrative expense	59,012	58,523	185,776	180,979
Net operation of real estate acquired in settlement of loans	3,664	166	4,903	185
Total operating expense	62,676	58,689	190,679	181,164
Income (loss) before income taxes (tax benefits)	(43,232)	92,579	90,429	255,888
Income taxes (tax benefits)	(19,871)	36,959	38,183	108,347
Net income (loss)	$ (23,361)	$ 55,620	$ 52,246	$ 147,541
Per share information				
Basic	$ (0.84)	$ 2.00	$ 1.87	$ 5.30
Diluted	$ (0.84)	$ 1.99	$ 1.87	$ 5.29
Cash dividends declared and paid	$ 0.12	$ 0.10	$ 0.36	$ 0.30
Weighted average shares outstanding				
Basic	27,853,783	27,853,783	27,853,783	27,853,783
Diluted	27,853,783	27,883,198	27,882,804	27,883,567

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

	Three Months Ended September 30,		*Nine Months Ended September 30,*	
(In Thousands)	*2007*	*2006*	*2007*	*2006*
Net income (loss)	$ (23,361)	$ 55,620	$ 52,246	$ 147,541
Other comprehensive income (loss), net of income taxes (benefits)				
Unrealized gains on securities available for sale:				
U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value	6,644	7,874	5,926	899
Mortgage-backed securities available for sale, at fair value	1	-	1	-
Reclassification of realized amounts included in net income	-	-	-	-
Unrealized gains (losses) on cash flow hedges:				
Net derivative instruments	(216)	(516)	609	923
Reclassification of realized amounts included in net income	27	315	(944)	(930)
Total other comprehensive income, net of income taxes	6,456	7,673	5,592	892
Comprehensive income (loss)	$ (16,905)	$ 63,293	$ 57,838	$ 148,433

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In Thousands)	*Nine Months Ended September 30,* 2007	2006
Cash flows from operating activities		
Net income	$ 52,246	$ 147,541
Adjustments to reconcile net income to net cash used for operating activities:		
Depreciation	10,811	9,809
Amortization	79,541	86,356
Provision for losses on loans, loan-related commitments, investments in		
real estate and joint ventures, mortgage servicing rights,		
real estate acquired in settlement of loans, and other assets	94,833	26,282
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights,		
investment securities, real estate and other assets	(21,952)	(44,535)
Interest capitalized on loans (negative amortization)	(199,382)	(212,744)
Federal Home Loan Bank stock dividends	(5,185)	(6,903)
Loans originated and purchased for sale	(1,380,371)	(2,696,550)
Proceeds from sales of loans held for sale, including those sold		
as mortgage-backed securities	1,635,997	2,839,563
Other, net	(196,610)	(84,734)
Net cash provided by operating activities	69,928	64,085
Cash flows from investing activities		
Proceeds from:		
Sales of Federal Home Loan Bank stock	95,046	-
Maturities or calls of U.S. Treasury, government sponsored entities		
and other investment securities available for sale	276,200	51,450
Sales of wholly owned real estate and real estate acquired in settlement of loans	20,560	11,080
Purchase of:		
U.S. Treasury, government sponsored entities and other investment securities		
available for sale	(825,030)	(486,220)
Loans held for investment	-	(21,671)
Premises and equipment	(17,134)	(25,413)
Federal Home Loan Bank stock	(6,967)	(439)
Originations of loans held for investment (net of refinances of $572,331 for the		

nine months ended September 30, 2007 and $608,708 for the nine months ended		
September 30, 2006)	(1,209,487)	(3,161,923)
Principal payments on loans held for investment and mortgage-backed securities		
available for sale	3,457,620	3,944,788
Net change in undisbursed loan funds	(36,655)	(39,625)
Investments in real estate held for investment	2,061	(3,810)
Other, net	4,293	9,690
Net cash provided by investing activities	$ 1,760,507	$ 277,907

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

(In Thousands)	*Nine Months Ended September 30,* 2007	2006
Cash flows from financing activities		
Net increase (decrease) in deposits	$ (1,122,251)	$ 68,910
Proceeds from Federal Home Loan Bank advances and other borrowings	12,583,559	23,999,521
Repayments of Federal Home Loan Bank advances and other borrowings	(13,326,330)	(24,415,143)
Cash dividends	(10,027)	(8,355)
Other, net	7,371	2,460
Net cash used for financing activities	(1,867,678)	(352,607)
Net increase (decrease) in cash and cash equivalents	(37,243)	(10,615)
Cash and cash equivalents at beginning of period	124,866	190,396
Cash and cash equivalents at end of period	$ 87,623	$ 179,781
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 431,774	$ 459,210
Income taxes	186,100	125,671
Supplemental disclosure of non-cash investing:		
Loans transferred to held for investment from held for sale	26,417	22,297
Loans transferred from held for investment to held for sale	2,856	953
U.S. Treasury, government sponsored entities and other investment securities		
available for sale, purchased and not settled	150,000	100,000
Real estate acquired in settlement of loans	74,886	5,937
Loans to facilitate the sale of real estate acquired in settlement of loans	1,413	-

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) Basis of Financial Statement Presentation

In the opinion of Downey Financial Corp. and subsidiaries (Downey, we, us and our), the accompanying consolidated financial statemen contain all adjustments (consisting of normal recurring accruals unless otherwise disclosed in this Form 10-Q) necessary for a fair presentation of Downey s financial condition as of September 30, 2007, December 31, 2006 and September 30, 2006, the results of operations and comprehensive income for the three months and nine months ended September 30, 2007 and 2006, and changes in cash flows for the nine months ended September 30, 2007 and 2006. Certain prior period amounts have been reclassified to conform to the current period presentation. For a discussion and amounts related to Downey s revision of prior period data for the tax treatment of certain loan origination costs and the adoption of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) effective January 1, 2007, see Note (4) Income Taxes.

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements and are in compliance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial condition, results of operations, comprehensive income and cash flows. The information under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations presumes that the interim consolidated financial statements will be read in conjunction with Downey s Annual Report on Form 10-K for the year ended December 31, 2006, which contains among other things, a description of the business, the latest audited consolidated financial statements and notes thereto, together with Management s Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2006 and for the year then ended. Therefore, only material changes in financial condition and results of operations are discussed in the remainder of Part I.

NOTE (2) Mortgage Servicing Rights (MSRs)

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

	Three Months Ended				
(Dollars in Thousands)	*September 30, 2007*	*June 30, 2007*	*March 31, 2007*	*December 31, 2006*	*September 30, 2006*
Gross balance at beginning of period	$ 21,707	$ 20,871	$ 21,435	$ 20,483	$ 20,665
Additions [(a)]	1,394	1,926	1,341	2,122	896
Amortization	(950)	(967)	(1,024)	(1,087)	(1,056)
Sales	-	-	(868)	-	-
Impairment write-down	(37)	(123)	(13)	(83)	(22)
Gross balance at end of period	22,114	21,707	20,871	21,435	20,483
Allowance balance at beginning of period	88	182	239	173	104
Provision for (reduction of) impairment	214	29	(44)	149	91
Impairment write-down	(37)	(123)	(13)	(83)	(22)
Allowance balance at end of period	265	88	182	239	173
Total mortgage servicing rights, net	$ 21,849	$ 21,619	$ 20,689	$ 21,196	$ 20,310
As a percentage of associated mortgage loans	0.90 %	0.91 %	0.88 %	0.89 %	0.87 %
Estimated fair value [(b)]	$ 23,935	$ 25,080	$ 22,461	$ 22,828	$ 22,383
Weighted average expected life (in months)	69	65	56	54	51
Custodial account earnings rate	4.57 %	5.35 %	5.26 %	5.28 %	5.28 %
Weighted average discount rate	11.63	10.13	10.27	10.28	9.41
At period end					
Mortgage loans serviced for others:					
Total	$ 5,622,331	$ 6,002,907	$ 6,021,673	$ 5,908,233	$ 6,595,462
With capitalized mortgage servicing rights:[(b)]					
Amount	2,419,432	2,383,290	2,348,060	2,394,754	2,345,880
Weighted average interest rate	5.83 %	5.79 %	5.77 %	5.75 %	5.70 %
Total loans sub-serviced without mortgage servicing rights: [(c)]					
Term less than six months	$ 76,870	$ 398,530	$ 125,425	$ 93,074	$ 981,883
Term indefinite	3,112,895	3,207,087	3,533,200	3,404,342	3,249,905

Custodial account balances	$ 84,819	$ 156,433	$ 176,171	$ 172,462	$ 171,481

[a] Included minor amounts repurchased.
[b] The estimated fair value may exceed book value for certain asset strata and excludes loans sold or securitized prior to 1996 and loans sub-serviced without capitalized MSRs.
[c] Servicing is performed for a fixed fee per loan each month.

The following table summarizes the activity in MSRs and its related allowance for the year-to-date periods indicated.

	Nine Months Ended September 30,	
(Dollars in Thousands)	*2007*	*2006*
Gross balance at beginning of period	$ 21,435	$ 21,157
Additions [a]	4,661	3,203
Amortization	(2,941)	(3,283)
Sales	(868)	-
Impairment write-down	(173)	(594)
Gross balance at end of period	22,114	20,483
Allowance balance at beginning of period	239	855
Provision for (reduction of) impairment	199	(88)
Impairment write-down	(173)	(594)
Allowance balance at end of period	265	173
Total mortgage servicing rights, net	$ 21,849	$ 20,310

[a] Includes minor amounts repurchased.

Downey capitalizes MSRs at fair value for residential one-to-four unit mortgage loans we originate and sell with servicing rights retained and at the lower of cost or fair value for MSRs acquired through purchase. Downey discloses MSRs associated with the origination and sale of loans in the financial statements as a component of the net gains on sales of loans and mortgage-backed securities. MSRs are amortized over the estimated servicing period as a component of loan servicing income (loss), net. Downey recognizes impairment losses on the MSRs through a valuation allowance and records any associated provision as a component of loan servicing income (loss), net category.

Downey s loan servicing portfolio normally increases in value as interest rates rise and loan prepayments decrease and declines in value as interest rates fall and loan prepayments increase. Key assumptions used to determine the fair value of MSRs, which vary due to changes in market interest rates, include: expected prepayment speeds, which impact the average life of the portfolio; the earnings rate on custodial accounts, which impacts the value of custodial accounts; and the discount rate used in valuing future cash flows. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, which include loans by loan term and coupon rate (stratified in 50 basis point increments). Impairment losses are recognized through a valuation allowance for each impaired stratum. Certain stratum may have impairment, while other stratum may not. Therefore, changes in overall fair value may not equal provisions for or reductions of the valuation allowance. Once a quarter, Downey conducts model validation procedures by obtaining three independent broker results for the fair value of MSRs and comparing them to the results of its MSR model.

The following table summarizes the estimated changes in the fair value of MSRs for changes in those assumptions individually and in combination associated with an immediate 100 basis point increase or decrease in market rates. The table also summarizes the earnings impact associated with provisions for or reductions of the valuation allowance for MSRs . The sensitivity analysis in the table below is hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 100 basis point variation in assumptions generally cannot be easily extrapolated because the relationship of the change in the assumptions to the change in fair value may not be linear. Also, in this table, the effect that a change in a particular assumption may have on the fair value is calculated without changing any other assumptions. In reality, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities.

(Dollars in Thousands)	*Expected Prepayment Speeds*	*Custodial Accounts Rate*	*Discount Rate*	*Combination*
Increase rates 100 basis points: [a]				
Increase (decrease) in fair value	$ 2,549	$ 1,213	$ (773)	$ 2,606
Reduction of (increase in) valuation allowance	191	179	(271)	227
Decrease rates 100 basis points: [b]				
Increase (decrease) in fair value	(5,786)	(1,557)	497	(6,665)
Reduction of (increase in) valuation allowance	(4,709)	(452)	130	(5,343)

[a] *The weighted-average expected life of the MSRs portfolio becomes 84 months.*
[b] *The weighted-average expected life of the MSRs portfolio becomes 42 months.*

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

	Three Months Ended				
(In Thousands)	*September 30, 2007*	*June 30, 2007*	*March 31, 2007*	*December 31, 2006*	*September 30, 2006*
Net cash servicing fees	$ 1,657	$ 1,598	$ 1,607	$ 1,647	$ 1,583
Payoff and curtailment interest cost [a]	(787)	(1,391)	(1,063)	(1,269)	(813)
Amortization of mortgage servicing rights	(950)	(967)	(1,024)	(1,087)	(1,056)

(Provision for) reduction of impairment of					
mortgage servicing rights	(214)	(29)	44	(149)	(91)
Total loan servicing loss, net	$ (294)	$ (789)	$ (436)	$ (858)	$ (377)

[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. However, loan servicing income (loss), net does not reflect interest income derived from the use of loan repayments which is included in net interest income.*

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

	Nine Months Ended September 30,	
(In Thousands)	*2007*	*2006*
Net cash servicing fees	$ 4,862	$ 4,723
Payoff and curtailment interest cost [a]	(3,241)	(1,264)
Amortization of mortgage servicing rights	(2,941)	(3,283)
(Provision for) reduction of impairment of mortgage servicing rights	(199)	88
Total loan servicing income (loss), net	$ (1,519)	$ 264

[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. However, loan servicing income (loss), net does not reflect interest income derived from the use of loan repayments which is included in net interest income.*

NOTE (3) Derivatives, Hedging Activities, Financial Instruments with Off-Balance Sheet Risk and Other Contractual Obligations (Risk Management)

Derivatives

Downey offers short-term interest rate lock commitments to help attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if underwriting standards are met, but do not obligate the potential borrower. Accordingly, some commitments never become loans and merely expire. The residential one-to-four unit interest rate lock commitments Downey ultimately expects to result in loans and sell in the secondary market are treated as derivatives. Consequently, as derivatives, the hedging of the interest rate lock commitments does not qualify for hedge accounting. Associated fair value adjustments to the notional amount of interest rate lock commitments are recorded in current earnings under net gains on sales of loans and mortgage-backed securities with an offset to the balance sheet in either other assets, or accounts payable and accrued liabilities. Fair values for the notional amount of interest rate lock commitments are based on dealer quoted market prices acquired from third parties. The carrying amount of loans held for sale includes a basis adjustment to the loan balance at funding resulting from the change in fair value of the interest rate lock derivative from the date of rate lock to the date of funding. At September 30, 2007, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $93 million, with a change in fair value resulting in a recorded loss of less than $0.1 million.

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

Derivative Hedging Activities

As part of its secondary marketing activities, Downey typically utilizes short-term loan forward sale and purchase contracts derivatives that mature in less than one year to offset the impact of changes in market interest rates on the value of residential one-to-four unit interest rate lock commitments and loans held for sale. In general, interest rate lock commitments associated with fixed rate loans require a higher percentage of loan forward sale contracts to mitigate interest rate risk than those associated with adjustable rate loans. Contracts designated as hedges for the forecasted sale of loans from the held for sale portfolio are accounted for as cash flow hedges because these contracts have a high correlation to the price movement of the loans being hedged (within a range of 80% - 125%). The measurement approach for determining the ineffective aspects of the hedge is established at the inception of the hedge. Changes in fair value of the notional amount of loan forward sale contracts not designated as cash flow hedges and the ineffectiveness of hedge transactions are recorded in net gains on sales of loans and mortgage-backed securities. Changes in expected future cash flows related to the fair value of the notional amount of loan forward sale contracts designated as cash flow hedges for the forecasted sale of loans held for sale are recorded in other comprehensive income (loss), net of tax, provided cash flow hedge requirements are met. The offset to these changes are recorded in the balance sheet as either other assets, or accounts payable and accrued liabilities. The amounts recorded in accumulated other comprehensive income (loss) will be recognized in the income statement when the hedged forecasted transactions impact earnings. Downey estimates that all of the related unrealized gains or losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. Fair values for the notional amount of loan forward sale contracts are based on dealer quoted market prices acquired from third parties. At September 30, 2007, the notional amount of loan forward sale

contracts amounted to $172 million, with virtually no change in fair value. Of the total loan forward sale contracts, $77 million were designated as cash flow hedges. The notional amount of loan forward purchase contracts at September 30, 2007 amounted to $10 million, with a change in fair value resulting in a loss of $0.4 million.

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

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In connection with its interest rate risk management, Downey from time-to-time enters into interest rate exchange agreements (swap contracts) with certain national investment banking firms or the Federal Home Loan Bank (FHLB) under terms that provide mutual payment of interest on the outstanding notional amount of swap contracts. These swap contracts help Downey manage the effects of adverse changes in interest rates on net interest income. Downey has interest rate swap contracts on which it pays variable interest based on the 3-month London Inter-Bank Offered Rate (LIBOR) while receiving fixed interest. The swaps were designated as a hedge against changes in the fair value of certain FHLB fixed rate advances due to changes in market interest rates. The payment and maturity dates of the swap contracts match those of the advances. This hedge effectively converts fixed interest rate advances into debt that adjusts quarterly to movements in 3-month LIBOR. Because the terms of the swap contracts match those of the advances, the hedge has no ineffectiveness and results are reported in interest expense. The fair value of interest rate swap contracts is based on dealer quoted market prices acquired from third parties and represents the estimated amount Downey would receive or pay upon terminating the contracts, taking into consideration current interest rates and the remaining contract terms. The fair value of the swap contracts is recorded on the balance sheet in either other assets or accounts payable and accrued liabilities. With no ineffectiveness, the recorded swap contract values will essentially act as fair value adjustments to the advances being hedged. At September 30, 2007, swap contracts with a notional amount totaling $430 million were outstanding and had a fair value loss of $7.0 million recorded on the balance sheet in accounts payable and accrued liabilities and as a decrease to the advances being hedged.

The following table summarizes Downey s interest rate swap contracts at September 30, 2007.

(Dollars in Thousands)	*Notional Amount*	*Weighted Average Interest Rate*	*Term*	
Pay Variable (3-month LIBOR)	$ (100,000)	5.54 %	March 2004	October 2008
Receive Fixed	100,000	3.20		
Pay Variable (3-month LIBOR)	(130,000)	5.54	March 2004	October 2008
Receive Fixed	130,000	3.21		
Pay Variable (3-month LIBOR)	(100,000)	5.54	March 2004	November 2008
Receive Fixed	100,000	3.26		
Pay Variable (3-month LIBOR)	(100,000)	5.54	March 2004	November 2008
Receive Fixed	100,000	3.27		

Navigation Links

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

	Three Months Ended				
(In Thousands)	*September 30, 2007*	*June 30, 2007*	*March 31, 2007*	*December 31, 2006*	*September 30, 2006*
Net gains (losses) on non-qualifying hedge transactions	$ (553)	$ 866	$ 251	$ (309)	$ (304)
Net gains on qualifying cash flow hedge transactions:					
Unrealized hedge ineffectiveness	-	-	-	-	-
Less reclassification of realized hedge ineffectiveness	-	-	-	-	-
Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	(553)	866	251	(309)	(304)
Other comprehensive income (loss)	(189)	(86)	(60)	434	(201)
Notional amount or balance at period end					
Non-qualifying hedge transactions:					
Interest rate lock commitments [(a)]	$ 92,742	$ 122,668	$ 224,546	$ 196,751	$ 236,435
Associated loan forward sale contracts	94,567	126,675	209,818	187,804	213,783
Associated loan forward purchase contracts	10,000	-	-	-	-
Qualifying cash flow hedge transactions:					
Loans held for sale, at lower of cost or fair value	90,228	187,752	267,862	363,215	323,428
Associated loan forward sale contracts	77,433	175,825	254,260	341,696	307,982
Qualifying fair value hedge transactions:					
Designated FHLB advances pay-fixed	430,000	430,000	430,000	430,000	430,000
Associated interest rate swap contracts pay-variable, receive-fixed	430,000	430,000	430,000	430,000	430,000

[(a)] *Amount represents the notional amount of the commitments or contracts reduced by an anticipated fallout factor for those commitments not expected to fund. The notional amount for interest rate lock commitments before the reduction of expected fallout was $119 million.*

The following table shows the impact from non-qualifying hedges and the ineffectiveness of cash flow hedges on net gains (losses) on sales of loans and mortgage-backed securities (*i.e.*, SFAS 133 effect), as well as the impact to other comprehensive income (loss) from qualifying cash flow transactions for the year-to-date periods indicated.

	Nine Months Ended September 30,	
(In Thousands)	*2007*	*2006*

Net gains (losses) on non-qualifying hedge transactions	$ 564	$ (799)
Net gains on qualifying cash flow hedge transactions:		
Unrealized hedge ineffectiveness	-	-
Less reclassification of realized hedge ineffectiveness	-	-
Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	564	(799)
Other comprehensive income (loss)	(335)	(7)

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

Financial Instruments with Off-Balance Sheet Risk

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

Navigation Links

Commitments to originate fixed and variable rate mortgage loans held for investment are agreements to lend to a customer as long as there is no violation of any condition established in the commitment. Commitments generally have fixed expiration dates or other termination clauses and 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. Undisbursed loan funds on construction projects and unused lines of credit on home equity and commercial loans include committed funds not disbursed. Letters of credit are conditional commitments issued by Downey to guarantee the performance of a customer to a third party. Downey also enters into commitments to purchase loans and mortgage-backed securities, investment securities and to invest in community development funds.

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

(In Thousands)	*September 30, 2007*	*June 30, 2007*	*March 31, 2007*	*December 31, 2006*	*September 30, 2006*
Commitments to originate adjustable rate loans					
held for investment	$ 211,277	$ 138,510	$ 340,849	$ 139,145	$ 201,662
Undisbursed loan funds and unused lines of credit	310,677	316,931	334,803	347,338	370,159

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

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

Downey maintains an allowance for losses to provide for inherent losses for loan-related commitments associated with undisbursed loan funds and unused lines of credit. The allowance for losses on loan-related commitments was $1 million at September 30, 2007, December 31, 2006 and September 30, 2006.

Other Contractual Obligations

Downey sells all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms of the note, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty made to the investor in connection with the sale. If such a defect is identified, Downey may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, Downey has no commitment to repurchase the loan. During the first nine months of 2007, Downey recorded repurchase or indemnification losses related to defects in the origination process of $0.5 million and repurchased $15 million of loans. Included in the repurchased loans were $8 million of one-to-four single family residential loans from Fannie Mae, due to loans being outside Fannie Mae s underwriting guidelines.

The loan and servicing sale contracts may also contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period typically 90 days, but never more than 120 days, from the sale s settlement date. Downey reserved less than $1 million at September 30, 2007, December 31, 2006 and September 30, 2006 to cover the estimated loss exposure related to early payoffs. However, if all the loans related to those sales prepaid within the refund period, as of September 30, 2007, Downey s maximum sales price premium refund would be $2.6 million.

Through the normal course of operations, Downey has entered into certain contractual obligations. Downey s obligations generally relate to the funding of operations through deposits and borrowings, loan servicing, as well as leases for premises and equipment. Downey has 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. Downey also has vendor contractual relationships, but the contracts are not considered to be material.

At September 30, 2007, scheduled maturities of certificates of deposit, FHLB advances and other borrowings, senior notes and future operating minimum lease commitments were as follows:

(In Thousands)	*Within 1 Year*	*After 1 Through 3 Years*	*After 3 Through 5 Years*	*Beyond 5 Years*	*Total Balance*
Certificates of deposit	$ 7,996,545	$ 227,439	$ 86,529	$ -	$ 8,310,513
Securities sold under agreements to repurchase	566,350	-	-	-	566,350
FHLB advances	885,850	423,017	-	-	1,308,867
Senior notes	-	-	-	198,398	198,398
Operating leases	5,494	8,224	3,527	622	17,867
Total other contractual obligations	$ 9,454,239	$ 658,680	$ 90,056	$ 199,020	$ 10,401,995

Litigation

On October 29, 2004, two former traditional branch employees brought an action in Los Angeles Superior Court, Case No. BC323796, entitled Margie Holman and Alice A. Mesec, et al. v. Downey Savings and Loan Association. The first amended complaint seeks unspecified damages for alleged unpaid regular and overtime wages, inadequate meal breaks, failure to pay split-shift and reporting time wages, and related claims. The plaintiffs are seeking class action status to represent all other current and former Downey Savings employees who held the position of Customer Service Supervisor and/or Customer Service Representative at Downey Savings in-store branches at any time from October 29, 2000 to date. Based on a review of the current facts and circumstances with retained outside counsel, (i) Downey Savings plans to oppose the claim and assert all appropriate defenses and (ii) management has provided for what is believed to be a reasonable estimate of exposure for this matter in the event of loss. While acknowledging the uncertainties of litigation, management believes that the ultimate outcome of this matter will not have a material adverse effect on Downey s operations, cash flows or financial position.

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

NOTE (4) Income Taxes

FIN 48 was adopted during the first quarter of 2007. FIN 48 requires the affirmative evaluation that it is more likely than not, based on the technical merits of a tax position, that an enterprise is entitled to economic benefits resulting from positions taken in income tax returns. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements. Adoption of FIN 48 resulted in an increase to the opening balance of retained earnings of $3.2 million, relating to the recognition of a previously unrecognized tax benefit associated with bad debt reserves for tax purposes. Management has determined that there are no additional unrecognized tax benefits to be reported in Downey s financial statements, and none are anticipated during the next 12 months.

The Internal Revenue Service (IRS) is currently examining Downey s tax returns for 2003, 2004 and 2005. All tax years subsequent to 2002 are subject to federal examination, while state tax returns for years subsequent to 2001 are subject to examination by taxing authorities. Downey has determined that its treatment of certain loan origination costs in tax years 2003 through 2005 was improper and has filed amended tax returns for those years and paid tax (previously provided in prior periods) and interest to federal and state taxing authorities in the amount of $145.0 million to resolve this issue. The after-tax interest assessment related to Downey s tax returns for 2003 through 2005 totaled $11.1 million. Of that amount, $1.9 million was accrued for 2007 and has been recorded as additional income taxes, and $9.2 million was accrued for 2004 through 2006 and has been reflected in income taxes. When applicable, Downey classifies interest (net of tax) and penalties on the underpayment of taxes as income tax expense.

Management has determined that it is unlikely that IRS will assert a penalty against Downey related to its treatment of loan origination costs on prior tax returns, and, accordingly, Downey has not accrued such penalty.

NOTE (5) Employee Stock Option Plans

During 1994, Downey Savings and Loan Association, F.A. ("Bank") adopted and the stockholders approved the Downey Savings and Loan Association 1994 Long Term Incentive Plan (LTIP). The LTIP provided for the granting of stock appreciation rights, restricted stock, performance awards and other awards. The LTIP specified an authorization of 434,110 shares (adjusted for stock dividends and splits) of the Bank s common stock available for issuance under the LTIP. Effective January 23, 1995, Downey Financial Corp. and the Bank executed an amendment to the LTIP by which Downey Financial Corp. adopted and ratified the LTIP such that shares of Downey Financial Corp. shall be issued upon exercise of options or payment of other awards, for which payment is to be made in stock, in lieu of the Bank s common stock. The LTIP terminated in 2004; however, options granted and outstanding at termination remain exercisable until the specific termination date of the option. At September 30, 2007, options for 52,914 shares were outstanding, all of which were exercisable at a weighted average option price per share of $25.44, which represented at least the fair market value of such shares on the date the options were granted and expire at December 31, 2008. At September 30, 2007, 381,239 shares of treasury stock existed that may be used to satisfy the exercise of the options or for payment of other awards. No other stock based plan exists.

NOTE (6) Earnings Per Share

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

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

	Three Months Ended September 30,					
	2007			*2006*		
(Dollars in Thousands, Except Per Share Data)	*Net Loss*	*Weighted Average Shares Outstanding*	*Per Share Amount*	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*
Basic earnings (loss) per share	$ (23,361)	27,853,783	$ (0.84)	$ 55,620	27,853,783	$ 2.00
Effect of dilutive stock options [a]	-	-	-	-	29,415	(0.01)
Diluted earnings (loss) per share	$ (23,361)	27,853,783	$ (0.84)	$ 55,620	27,883,198	$ 1.99

[a] *For the 3 months ended September 30, 2007, the dilutive effect of 26,534 shares from our 52,914 outstanding stock options was excluded from the computation of earnings per share due to anti-dilution.*

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

Nine Months Ended September 30,	
2007	*2006*
Weighted	*Weighted*

(Dollars in Thousands, Except Per Share Data)	*Net Income*	*Average Shares Outstanding*	*Per Share Amount*	*Net Income*	*Average Shares Outstanding*	*Per Share Amount*
Basic earnings per share	$ 52,246	27,853,783	$ 1.87	$ 147,541	27,853,783	$ 5.30
Effect of dilutive stock options	-	29,021	-	-	29,784	(0.01)
Diluted earnings per share	$ 52,246	27,882,804	$ 1.87	$ 147,541	27,883,567	$ 5.29

For the nine months ended September 30, 2007 and 2006, there were no options excluded from the computation of earnings per share due to anti-dilution.

NOTE (7) Business Segment Reporting

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

(In Thousands)	*Banking*	*Real Estate Investment*	*Elimination*	*Totals*
Three months ended September 30, 2007				
Net interest income	$ 97,656	$ 314	$ -	$ 97,970
Provision for credit losses	81,562	-	-	81,562
Other income (loss)	10,756	(7,720)	-	3,036
Operating expense	62,365	311	-	62,676
Net intercompany income (expense)	22	(22)	-	-
Loss before income tax benefits	(35,493)	(7,739)	-	(43,232)
Income tax benefits	(16,642)	(3,229)	-	(19,871)
Net loss	$ (18,851)	$ (4,510)	$ -	$ (23,361)
At September 30, 2007				
Assets:				
Loans and mortgage-backed securities, net	$ 11,692,185	$ -	$ -	$ 11,692,185
Investments in real estate and joint ventures	-	58,715	-	58,715
Other	2,710,006	30,420	(73,609)	2,666,817
Total assets	14,402,191	89,135	(73,609)	14,417,717
Equity	$ 1,444,226	$ 73,609	$ (73,609)	$ 1,444,226
Three months ended September 30, 2006				
Net interest income	$ 129,870	$ 369	$ -	$ 130,239
Provision of credit losses	9,640	-	-	9,640
Other income	25,090	5,579	-	30,669
Operating expense	59,801	(1,112)	-	58,689
Net intercompany income (expense)	(38)	38	-	-
Income before income taxes	85,481	7,098	-	92,579
Income taxes	34,049	2,910	-	36,959
Net income	$ 51,432	$ 4,188	$ -	$ 55,620
At September 30, 2006				
Assets:				
	$ 15,135,543	$ -	$ -	$ 15,135,543

Loans and mortgage-backed securities, net				
Investments in real estate and joint ventures	-	55,663	-	55,663
Other	1,837,714	28,978	(76,341)	1,790,351
Total assets	16,973,257	84,641	(76,341)	16,981,557
Equity	$ 1,344,593	$ 76,341	$ (76,341)	$ 1,344,593

(In Thousands)	*Banking*	*Real Estate Investment*	*Elimination*	*Totals*
Nine months ended September 30, 2007				
Net interest income	$ 333,505	$ 1,038	$ -	$ 334,543
Provision for loan losses	91,684	-	-	91,684
Other income (loss)	45,056	(6,807)	-	38,249
Operating expense	189,700	979	-	190,679
Net intercompany income (expense)	53	(53)	-	-
Income (loss) before income taxes (tax benefits)	97,230	(6,801)	-	90,429
Income taxes (tax benefits)	41,044	(2,861)	-	38,183
Net income (loss)	$ 56,186	$ (3,940)	$ -	$ 52,246
Nine months ended September 30, 2006				
Net interest income	$ 387,523	$ 979	$ -	$ 388,502
Provision for loan losses	26,359	-	-	26,359
Other income	63,949	10,960	-	74,909
Operating expense	181,250	(86)	-	181,164
Net intercompany income (expense)	(5)	5	-	-
Income before income taxes	243,858	12,030	-	255,888
Income taxes	103,416	4,931	-	108,347
Net income	$ 140,442	$ 7,099	$ -	$ 147,541

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NOTE (8) Recently Issued Accounting Standards

Statement of Financial Accounting Standards No. 157

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. Additionally, it establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. Downey is currently evaluating the impact, if any, that SFAS 157 will have on its financial condition and results of operations.

Statement of Financial Accounting Standards No. 158

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), ("SFAS 158"), which requires employers to recognize the underfunded or overfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through accumulated other comprehensive income. Additionally, SFAS 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position. The new reporting requirements and related new footnote disclosure rules of SFAS No. 158 are effective for fiscal years ending after December 15, 2006. The new measurement date requirement applies for fiscal years ending after December 15, 2008. Adoption of SFAS 158 is not expected to have a material impact on Downey.

Statement of Financial Accounting Standards No. 159

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ("SFAS 159"), which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS 159 is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities and to more easily understand the effect of the company s choice to use fair value on its earnings. SFAS 159 also requires entities to display the fair value of the selected assets and liabilities on the face of the balance sheet. SFAS 159 does not eliminate disclosure requirements of other accounting standards, including fair value measurement disclosures in SFAS 157. This Statement is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of Statement 157. Adoption of SFAS 159 is not expected to have a material impact on Downey.

NOTE (9) Subsequent Event

In late October, wild fires erupted in Southern California, primarily in Los Angeles, Orange, Riverside, San Bernardino, San Diego, Santa Barbara and Ventura counties, causing partial or total destruction to numerous homes. While it is likely some homes we have financed have been damaged, we do not expect any significant loss, as our borrowers are required to have fire insurance. As of the filing of this Form 10-Q, none of our branch offices have been damaged.

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

Certain statements under this caption may constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995, which involve risks and uncertainties. Forward-looking statements do not relate strictly to historical information or current facts. Some forward-looking statements may be identified by use of terms such as expects, anticipates, intends, plans, believes, seeks, estimates, o similar meaning, or future or conditional verbs such as will, would, should, could or may. Our actual results may differ significantly fro 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, the outcome of ongoing audits by regulatory and taxing authorities and government regulation and factors, identified under Part II Other Information Item 1A. Risk Factors on page 56. 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, except as required by law.

OVERVIEW

A net loss was recorded for the third quarter of 2007 of $23.4 million or $0.84 per share on a diluted basis, compared to net income of $55.6 million or $1.99 per share in the third quarter of 2006.

Our $135.8 million unfavorable change in pre-tax income/(loss) between third quarters was due primarily to:

- A $71.9 million increase in provision for credit losses;
- A $32.3 million or 24.8% decline in net interest income due to a lower level of interest-earning assets and, to a lesser extent, a lower effective interest rate spread;
- A $13.2 million unfavorable change in income from real estate and joint ventures held for investment, as the current quarter included a writedown of $9.0 million to reflect declines in the value of single family home lots in which the company is a joint venture partner and net gains from sales were below a year ago; and
- A $12.3 million or 83.1% decline in net gains on the sale of loans due to both a lower level of loans sold and gain per dollar of loan sold.

For the first nine months of 2007, our net income totaled $52.2 million or $1.87 per share on a diluted basis, down 64.6% from the $147.5 million or $5.29 per share for the first nine months of 2006. The decline primarily reflected an increase in our provision for credit losses, lower net interest income, an unfavorable change in income from real estate held for investment, a decline in net gains from sales of loans and mortgage-backed securities, and higher operating expenses.

For the third quarter, our return on average assets was a negative 0.64%, and our return on equity was a negative 6.36%. These compare to year-ago positive returns of 1.29% on average assets and 16.94% on average equity. For the first nine-month periods, our return on average assets declined from 1.13% a year ago to 0.46%, while our return on average equity declined from 15.52% to 4.82%.

At September 30, 2007, assets totaled $14.418 billion, down $2.564 billion or 15.1% from a year ago and down $1.790 billion or 11.0% from year-end 2006. During the current quarter, assets declined $485 million due primarily to declines of $602 million in loans held for investment and $98 million in loans held for sale. Those declines were partially offset by an increase of $225 million in securities available for sale. Included within loans held for investment at quarter end were $8.255 billion of single family adjustable rate mortgages subject to negative amortization, down $659 million from June 30, 2007. These loans comprised 74% of the single family residential loan portfolio held for investment at quarter end, compared to 87% a year ago. The amount of negative amortization included in loan balances increased $11 million during the current quarter to $388 million or 4.70% of loans subject to negative amortization. During the current quarter, approximately 26% of loan interest income represented negative amortization, down from 29% in the second quarter of 2007 and down from 28% in the year-ago third quarter.

Loan originations (including purchases) totaled $694 million in the current quarter, down $911 million or 56.8% from $1.605 billion a year ago. Loans originated for sale declined $579 million or 70.3% to $245 million, while single family residential loans originated for portfolio declined $332 million or 43.5% to $432 million. In addition to single family residential loans, $17 million of other loans were originated in the current quarter, similar to the amount a year ago. For the first nine months of 2007, loan originations totaled $3.164 billion, down 51.2% from $6.489 billion in the same period a year ago.

Deposits totaled $10.663 billion at quarter end, down $1.283 billion or 10.7% from a year ago and down $1.122 billion or 9.5% from year-end 2006. At quarter end, the number of branches totaled 172 (168 in California and four in Arizona). At quarter end, the average deposit size of our 82 traditional branches was $103 million, while the average deposit size of our 90 in-store branches was $25 million. Since the end of 2006, borrowings have declined by $735 million and at the end of the current quarter represented 14.4% of total assets.

Non-performing assets increased during the quarter by $97 million or 42.5% to $324 million and represented 2.25% of total assets, compared with 0.68% at year-end 2006 and 0.39% a year ago. Virtually all of the increase in the current quarter was related to single family residential loans.

At September 30, 2007, Downey Savings and Loan Association, F.A. (the Bank), our primary subsidiary, exceeded all regulatory capital requirements, with capital-to-asset ratios of 10.21% for both tangible and core capital and 21.34% for risk-based capital. These capital levels are significantly above the well capitalized standards defined by the federal banking regulators of 5% for core capital and 10% for risk-based capital.

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CRITICAL ACCOUNTING POLICIES

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey s Annual Report on Form 10-K for the year ended December 31, 2006. Certain accounting policies require us to make significant estimates and assumptions which could have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the future carrying value of assets and liabilities and our results of operations for the reporting periods. Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors.

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

- The valuation of interest rate lock commitments. We enter into commitments to make loans that we intend to sell to investors whereby the interest rate on the loan is set prior to funding. These interest rate lock commitments are considered to be derivatives and are recorded at fair value. This value is calculated using market sources, reduced by an anticipated fallout factor for interest rate lock commitments that are not expected to fund. At September 30, 2007, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $93 million, with virtually no change in fair value, compared with a notional amount of interest rate lock commitments of $236 million with a change in fair value resulting in a gain of $0.1 million at September 30, 2006. For further information, see Note 3 on page 9 of Notes to Consolidated Financial Statements.
- The allowance for credit and real estate losses. The allowance for credit losses, which includes an allowance for loan losses reported as a reduction of outstanding loans and an allowance for loan-related commitments included in accounts payable and accrued liabilities, and the allowance for real estate losses reported as a reduction to real estate held for investment are maintained at amounts management deems adequate to cover inherent losses in the portfolios at the balance sheet date. We use an internal asset review system and credit loss allowance methodology designed to provide for the detection of problem assets and an adequate allowance to cover credit and real estate losses. In determining the allowance for credit losses related to loan relationships of $5 million or more, we evaluate the loans on an individual basis, including an analysis of the borrower s creditworthiness, cash flows and financial status, and the condition and the estimated value of the collateral. Unless an individual loan or borrower relationship warrants separate analysis, we generally determine the allowance for credit losses related to loans under $5 million through a statistical analysis of the expected performance of each loan based on historical trends for similar types of borrowers, loans, collateral and economic circumstances. Those amounts may be adjusted based upon an analysis of qualitative factors that are likely to affect a borrower s ability to repay their loan according to their loan terms. The allowance for credit and real estate losses totaled $144 million at September 30, 2007, compared with $62 million at September 30, 2006. For further information, see Allowance for Credit and Real Estate Losses on page 48.
- The valuation of mortgage servicing rights (MSRs). The fair value of MSRs is measured using a discounted cash flow analysis based on available market quotes, anticipated prepayment speeds, a custodial account rate and market-adjusted discount rates. Market sources are used to determine prepayment speeds, the net cost of servicing per loan, inflation rate, and default and interest rates for mortgage loans. MSRs are reviewed for impairment based on their fair value. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, which include loans by loan term and coupon rate stratified at 50 basis point increments. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income (loss), net. The MSR valuation allowance totaled less than $1 million at September 30, 2007 and September 30, 2006. For further information, see Note 2 on page 7 of Notes to Consolidated Financial Statements.
- The prepayment reserves related to sales of loans and MSRs. The gains on sales of loans and of MSRs are recorded net of reserves for anticipated prepayments. These loans and MSR sales contracts typically contain provisions to refund sale price premiums to the purchaser if the related loans prepay during a period typically 90 days, but not to exceed 120 days from the sale s settlement date. Loan and MSR sales reserves are estimated using the prepayment experience of similar products. The estimates are updated during the applicable period for actual payoffs. The reserve was less than $1 million at both September 30, 2007 and September 30, 2006. For further information, see Note 2 on page 7 and Note 3 on page 9 of Notes to Consolidated Financial Statements and Secondary Marketing Activities on page 25.

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 $98.0 million in the third quarter of 2007, down $32.3 million or 24.8% from a year ago, reflecting a $2.747 billion or 16.4% decline in average interest-earning assets and a decline in the effective interest rate spread. The effective interest rate spread averaged 2.79% in the current quarter, down 0.31% from a year ago and down 0.28% from the second quarter of 2007.

Compared to a year ago, our current quarter effective interest rate spread was unfavorably impacted by a lower proportion of loan prepayment fees to the amount of deferred loan origination costs written-off as a result of those payoffs, which declined to 52.4% in the current quarter from 100.8% a year ago. This decline was the result of a higher proportion of loans being repaid that were no longer subject to a prepayment fee primarily due to the increasing age of our loan portfolio. In addition, our current quarter effective interest rate spread was unfavorably impacted by a higher proportion of earning assets being comprised of investment securities and hybrid adjustable rate mortgage loans, both of which have lower yields than those of option ARM loans that comprised a larger proportion of interest-earning assets a year ago. However, these unfavorable items were essentially offset by a higher proportion of interest-earning assets being funded with interest free funds (the excess of interest-earning assets over interest-bearing deposits and borrowings).

For the first nine months of 2007, net interest income totaled $334.5 million, down $54.0 million or 13.9% from the year-ago period. The decline was due to lower interest-earning assets in the current period, as the effective interest rate spread was unchanged between periods.

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

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

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

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

The table also sets forth the difference between the average balance of interest-earning assets and the average balance of total deposits and borrowings for the quarters indicated. While we included non-accrual loans in the average interest-earning assets balance, interest from non-accrual loans has not been included in interest income unless we received payments and we believe the remaining principal balance of the loans will be recovered. We computed average balances for the quarter using the average of each month s daily average balance during the periods indicated.

	Three Months Ended September 30,					
	2007			*2006*		
(Dollars in Thousands)	*Average Balance*	*Interest*	*Average Yield/Rate*	*Average Balance*	*Interest*	*Average Yield/Rate*
Average balance sheet data						
Interest-earning assets:						
Loans:						
Loan prepayment fees		$ 8,542	0.29 %		$ 26,451	0.67 %
Write-off of deferred costs and premiums from loan payoffs		(16,315)	(0.55)		(26,248)	(0.67)
All other		216,087	7.22		277,771	7.11
Total loans	$ 11,973,516	208,314	6.96	$ 15,629,328	277,974	7.11
Mortgage-backed securities	113	3	5.77	260	3	4.62
Investment securities [a]	2,068,187	27,557	5.29	1,159,674	13,823	4.73
Total interest-earnings assets	14,041,816	$ 235,874	6.72 %	16,789,262	$ 291,800	6.95 %
Non-interest-earning assets	485,648			451,281		
Total assets	$ 14,527,464			$ 17,240,543		
Transaction accounts:						
Non-interest-bearing checking [b]	$ 730,179	$ -	- %	$ 764,207	$ -	- %
Interest-bearing checking [b]	470,516	340	0.29	487,811	426	0.35
Money market	139,808	367	1.04	153,777	404	1.04
Regular passbook	1,117,084	2,660	0.94	1,413,319	3,533	0.99
Total transaction accounts	2,457,587	3,367	0.54	2,819,114	4,363	0.61
Certificates of deposit	8,455,461	105,147	4.93	9,168,872	105,670	4.57
Total deposits	10,913,048	108,514	3.94	11,987,986	110,033	3.64
FHLB advances and other borrowings [c]	1,766,933	26,088	5.86	3,386,019	48,229	5.65
Senior notes	198,381	3,302	6.66	198,199	3,299	6.66
Total deposits and borrowings	12,878,362	137,904	4.25	15,572,204	161,561	4.12
Other liabilities	179,944			354,897		
Stockholders equity	1,469,158			1,313,442		
Total liabilities and stockholders equity	$ 14,527,464			$ 17,240,543		

Net interest income/interest rate spread		$ 97,970	2.47 %		$ 130,239	2.83 %
Excess of interest-earning assets over						
deposits and borrowings	$ 1,163,454			$ 1,217,058		
Effective interest rate spread			2.79			3.10

[(a)] *Yields for securities available for sale are calculated using historical cost balances and are not adjusted for changes in fair value that are reflected as a separate component of stockholders equity.*
[(b)] *Included amounts swept into money market deposit accounts.*
[(c)] *The impact of swap contracts was included, with notional amounts totaling $430 million of receive-fixed, pay-3-month London Inter-Bank Offered Rate (LIBOR) variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.*

Navigation Links

	Nine Months Ended September 30,					
	2007			2006		
(Dollars in Thousands)	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
Average balance sheet data						
Interest-earning assets:						
Loans:						
Loan prepayment fees		$ 47,937	0.50 %		$ 73,810	0.61 %
Write-off of deferred costs and premiums from loan payoffs		(66,454)	(0.69)		(74,311)	(0.62)
All other		709,386	7.37		809,053	6.74
Total loans	$ 12,829,398	690,869	7.18	$ 16,016,713	808,552	6.73
Mortgage-backed securities	127	9	5.85	268	9	4.48
Investment securities [a]	1,781,837	71,040	5.33	994,502	34,611	4.65
Total interest-earnings assets	14,611,362	$ 761,918	6.95 %	17,011,483	$ 843,172	6.61 %
Non-interest-earning assets	478,398			432,356		
Total assets	$ 15,089,760			$ 17,443,839		
Transaction accounts:						
Non-interest-bearing checking [b]	$ 762,050	$ -	- %	$ 736,206	$ -	- %
Interest-bearing checking [b]	481,867	1,117	0.31	503,844	1,300	0.34
Money market	145,141	1,128	1.04	159,842	1,248	1.04
Regular passbook	1,183,810	8,423	0.95	1,568,114	11,857	1.01
Total transaction accounts	2,572,868	10,668	0.55	2,968,006	14,405	0.65
Certificates of deposit	8,742,787	323,309	4.94	9,035,528	287,261	4.25
Total deposits	11,315,655	333,977	3.95	12,003,534	301,666	3.36
FHLB advances and other borrowings [c]	1,909,513	83,494	5.85	3,654,092	143,109	5.24
Senior notes	198,334	9,904	6.66	198,156	9,895	6.66
Total deposits and borrowings	13,423,502	427,375	4.26	15,855,782	454,670	3.83
Other liabilities	219,667			320,811		
Stockholders equity	1,446,591			1,267,246		
Total liabilities and stockholders equity	$ 15,089,760			$ 17,443,839		

Net interest income/interest rate spread		$ 334,543	2.69 %		$ 388,502	2.78 %
Excess of interest-earning assets over						
deposits and borrowings	$ 1,187,860			$ 1,155,701		
Effective interest rate spread			3.05			3.05

[a] Yields for securities available for sale are calculated using historical cost balances and are not adjusted for changes in fair value that are reflected as a separate component of stockholders equity.
[b] Included amounts swept into money market deposit accounts.
[c] The impact of swap contracts was included, with notional amounts totaling $430 million of receive-fixed, pay-3-month LIBOR variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.

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

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

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

	Three Months Ended September 30, 2007 Versus 2006 Changes Due To				*Nine Months Ended September 30, 2007 Versus 2006 Changes Due To*			
(In Thousands)	*Volume*	*Rate*	*Rate/ Volume*	*Net*	*Volume*	*Rate*	*Rate/ Volume*	*Net*
Interest income:								
Loans	$ (65,020)	$ (6,057)	$ 1,417	$ (69,660)	$ (160,901)	$ 53,955	$ (10,737)	$ (117,683)
Mortgage-backed securities	-	-	-	-	-	-	-	-
Investment securities	10,829	1,629	1,276	13,734	27,401	5,039	3,989	36,429
Change in interest income	(54,191)	(4,428)	2,693	(55,926)	(133,500)	58,994	(6,748)	(81,254)
Interest expense:								
Transaction accounts:								
Interest-bearing checking	(15)	(74)	3	(86)	(57)	(132)	6	(183)
Money market	(36)	-	(1)	(37)	(120)	-	-	(120)
Regular passbook	(740)	(168)	35	(873)	(2,905)	(700)	171	(3,434)
Total transaction accounts	(791)	(242)	37	(996)	(3,082)	(832)	177	(3,737)
Certificates of deposit	(8,222)	8,349	(650)	(523)	(9,307)	46,874	(1,519)	36,048
Total interest-bearing deposits	(9,013)	8,107	(613)	(1,519)	(12,389)	46,042	(1,342)	32,311
FHLB advances and other borrowings	(23,061)	1,764	(844)	(22,141)	(68,325)	16,667	(7,957)	(59,615)
Senior notes	3	-	-	3	9	-	-	9
Change in interest expense	(32,071)	9,871	(1,457)	(23,657)	(80,705)	62,709	(9,299)	(27,295)
Change in net interest income	$ (22,120)	$ (14,299)	$ 4,150	$ (32,269)	$			