DOWNEY FINANCIAL CORP
Form 10-Q
August 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 **June 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**<br>(State or other jurisdiction of incorporation or organization) | **33-0633413**<br>(I.R.S. Employer Identification No.) |
|---|---|
| **3501 Jamboree Road, Newport Beach, CA**<br>(Address of principal executive office) | **92660**<br>(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 June 30, 2007, 27,853,783 shares of the Registrant s Common Stock, $0.01 par value were outstanding.

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Page

**Navigation Links**

# DOWNEY FINANCIAL CORP.

# June 30, 2007 QUARTERLY REPORT ON FORM 10-Q

## TABLE OF CONTENTS


*PART I FINANCIAL INFORMATION*

| | | |
|---|---|---|
| ITEM 1. | FINANCIAL STATEMENTS | 1 |
| | Consolidated Balance Sheets at June 30, 2007 and 2006 and December 31, 2006 | 1 |
| | Consolidated Statements of Income for the three and six months ended June 30, 2007 and 2006 | 2 |
| | Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2007 and 2006 | 3 |
| | Consolidated Statements of Cash Flows for the six months ended June 30, 2007 and 2006 | 4 |
| | Notes To Consolidated Financial Statements | 6 |
| ITEM 2. | MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS | 17 |
| ITEM 3. | QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK | 55 |
| ITEM 4. | CONTROLS AND PROCEDURES | 55 |

*PART II OTHER INFORMATION*

| | | |
|---|---|---|
| ITEM 1. | LEGAL PROCEEDINGS | 55 |
| ITEM 1A. | RISK FACTORS | 56 |
| ITEM 2. | UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS | 56 |
| ITEM 3. | DEFAULTS UPON SENIOR SECURITIES | 56 |
| ITEM 4. | SUBMISSION OF MATTERS TO A VOTE OF SECURITIY HOLDERS | 56 |
| ITEM 5. | OTHER INFORMATION | 56 |
| ITEM 6. | EXHIBITS | 57 |
| AVAILABILITY OF REPORTS | | 57 |
| SIGNATURES | | 57 |

Navigation Links

# PART I FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

# DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

## Consolidated Balance Sheets

| *(Dollars in Thousands, Except Per Share Data)* | *June 30, 2007* | *December 31, 2006* | *June 30, 2006* |
|---|---|---|---|
| **Assets** | | | |
| Cash | $ 149,308 | $ 124,865 | $ 152,957 |
| Federal funds | - | 1 | 2 |
| Cash and cash equivalents | 149,308 | 124,866 | 152,959 |
| U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value | 1,917,603 | 1,433,176 | 892,172 |
| Loans held for sale, at lower of cost or fair value | 187,752 | 363,215 | 417,691 |
| Mortgage-backed securities available for sale, at fair value | 114 | 251 | 263 |
| Loans held for investment | 12,273,307 | 13,868,227 | 15,571,817 |
| Allowance for loan losses | (69,107 ) | (60,943 ) | (51,198 ) |
| Loans held for investment, net | 12,204,200 | 13,807,284 | 15,520,619 |
| Investments in real estate and joint ventures | 64,997 | 59,843 | 49,237 |
| Real estate acquired in settlement of loans | 29,925 | 8,524 | 1,254 |
| Premises and equipment | 115,823 | 114,052 | 110,537 |
| Federal Home Loan Bank stock, at cost | 72,429 | 152,953 | 184,796 |
| Mortgage servicing rights, net | 21,619 | 21,196 | 20,561 |
| Other assets | 139,200 | 122,022 | 114,691 |
| | $ 14,902,970 | $ 16,207,382 | $ 17,464,780 |
| **Liabilities and Stockholders Equity** | | | |
| Deposits | $ 11,246,806 | $ 11,784,869 | $ 11,887,739 |
| Securities sold under agreements to repurchase | 587,544 | 469,971 | 255,042 |
| Federal Home Loan Bank advances | 1,104,373 | 2,140,785 | 3,499,450 |
| Senior notes | 198,351 | 198,260 | 198,172 |
| Accounts payable and accrued liabilities | 289,937 | 220,262 | 327,181 |
| Deferred income taxes | 11,486 | - | 13,111 |
| Total liabilities | 13,438,497 | 14,814,147 | 16,180,695 |
| **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 June 30, 2007, December 31, 2006 and | | | |
| June 30, 2006; outstanding 27,853,783 shares at June 30, 2007, | | | |
| December 31, 2006 and June 30, 2006 | 282 | 282 | 282 |
| Additional paid-in capital | 93,792 | 93,792 | 93,792 |
| Accumulated other comprehensive loss | (6,068 ) | (5,204 ) | (12,189 ) |
| Retained earnings | 1,393,259 | 1,321,157 | 1,218,992 |
| Treasury stock, at cost, 381,239 shares at June 30, 2007, | | | |
| December 31, 2006 and June 30, 2006 | (16,792 ) | (16,792 ) | (16,792 ) |
| Total stockholders equity | 1,464,473 | 1,393,235 | 1,284,085 |
| | $ 14,902,970 | $ 16,207,382 | $ 17,464,780 |

***See accompanying notes to consolidated financial statements.***

# DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

## Consolidated Statements of Income

| (Dollars in Thousands, Except Per Share Data) | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| **Interest income** | | | | |
| Loans | $ 230,383 | $ 275,233 | $ 482,555 | $ 530,578 |
| U.S. Treasury and government sponsored entities securities | 20,120 | 8,930 | 39,294 | 16,266 |
| Mortgage-backed securities | 3 | 3 | 6 | 6 |
| Other investment securities | 1,718 | 2,243 | 4,189 | 4,522 |
| Total interest income | 252,224 | 286,409 | 526,044 | 551,372 |
| **Interest expense** | | | | |
| Deposits | 111,888 | 99,798 | 225,463 | 191,633 |
| Federal Home Loan Bank advances and other borrowings | 25,576 | 50,966 | 57,406 | 94,880 |
| Senior notes | 3,301 | 3,298 | 6,602 | 6,596 |
| Total interest expense | 140,765 | 154,062 | 289,471 | 293,109 |
| **Net interest income** | 111,459 | 132,347 | 236,573 | 258,263 |
| **Provision for credit losses** | 9,505 | 6,662 | 10,122 | 16,719 |
| Net interest income after provision for credit losses | 101,954 | 125,685 | 226,451 | 241,544 |
| **Other income, net** | | | | |
| Loan and deposit related fees | 9,338 | 9,171 | 18,174 | 17,729 |
| Real estate and joint ventures held for investment, net | (111 ) | 2,553 | 365 | 4,842 |
| Secondary marketing activities: | | | | |
| Loan servicing income (loss), net | (789 ) | 452 | (1,225 ) | 641 |
| Net gains on sales of loans and mortgage-backed securities | 8,978 | 8,619 | 17,718 | 20,273 |
| Other | 109 | 235 | 181 | 755 |
| Total other income, net | 17,525 | 21,030 | 35,213 | 44,240 |
| **Operating expense** | | | | |
| Salaries and related costs | 40,998 | 40,873 | 83,232 | 81,653 |
| Premises and equipment costs | 9,122 | 8,410 | 17,931 | 16,948 |
| Advertising expense | 1,878 | 1,879 | 3,069 | 3,121 |
| Deposit insurance premiums and regulatory assessments | 2,482 | 1,008 | 5,246 | 2,022 |

| | | | | |
|---|---|---|---|---|
| Professional fees | 731 | 450 | 1,290 | 1,242 |
| Other general and administrative expense | 6,201 | 8,295 | 15,996 | 17,470 |
| Total general and administrative expense | 61,412 | 60,915 | 126,764 | 122,456 |
| Net operation of real estate acquired in settlement of loans | 948 | 28 | 1,239 | 19 |
| Total operating expense | 62,360 | 60,943 | 128,003 | 122,475 |
| **Income before income taxes** | 57,119 | 85,772 | 133,661 | 163,309 |
| Income taxes | 24,375 | 37,548 | 58,054 | 71,388 |
| **Net income** | $ 32,744 | $ 48,224 | $ 75,607 | $ 91,921 |
| **Per share information** | | | | |
| Basic | $ 1.17 | $ 1.73 | $ 2.71 | $ 3.30 |
| Diluted | $ 1.17 | $ 1.73 | $ 2.71 | $ 3.30 |
| Cash dividends declared and paid | $ 0.12 | $ 0.10 | $ 0.24 | $ 0.20 |
| **Weighted average shares outstanding** | | | | |
| Basic | 27,853,783 | 27,853,783 | 27,853,783 | 27,853,783 |
| Diluted | 27,884,062 | 27,884,281 | 27,884,046 | 27,883,751 |

***See accompanying notes to consolidated financial statements.***

# DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

| | *Three Months Ended June 30,* | | *Six Months Ended June 30,* | |
|---|---|---|---|---|
| *(In Thousands)* | *2007* | *2006* | *2007* | *2006* |
| **Net income** | $ 32,744 | $ 48,224 | $ 75,607 | $ 91,921 |
| **Other comprehensive income (loss), net of income taxes (benefits)** | | | | |
| Unrealized gains (losses) on securities available for sale: | | | | |
| U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value | (4,306 ) | (5,608 ) | (718 ) | (6,975 ) |
| Mortgage-backed securities available for sale, at fair value | - | - | - | - |
| Reclassification of realized amounts included in net income | - | - | - | - |
| Unrealized gains (losses) on cash flow hedges: | | | | |
| Net derivative instruments | 671 | 936 | 825 | 1,439 |
| Reclassification of realized amounts included in net income | (757 ) | (1,321 ) | (971 ) | (1,245 ) |
| Total other comprehensive loss, net of income tax benefits | (4,392 ) | (5,993 ) | (864 ) | (6,781 ) |
| **Comprehensive income** | $ 28,352 | $ 42,231 | $ 74,743 | $ 85,140 |

***See accompanying notes to consolidated financial statements.***

# DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

| | Six Months Ended June 30, | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| **Cash flows from operating activities** | | |
| Net income | $ 75,607 | $ 91,921 |
| Adjustments to reconcile net income to net cash used for operating activities: | | |
| Depreciation | 7,138 | 6,543 |
| Amortization | 59,362 | 56,203 |
| 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 | 11,032 | 16,584 |
| Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, | | |
| investment securities, real estate and other assets | (16,727 ) | (23,902 ) |
| Interest capitalized on loans (negative amortization) | (144,884 ) | (136,002 ) |
| Federal Home Loan Bank stock dividends | (4,036 ) | (4,513 ) |
| Loans originated and purchased for sale | (1,135,540 ) | (1,872,478 ) |
| Proceeds from sales of loans held for sale, including those sold | | |
| as mortgage-backed securities | 1,296,511 | 1,922,339 |
| Other, net | (140,160 ) | (49,911 ) |
| Net cash provided by operating activities | 8,303 | 6,784 |
| **Cash flows from investing activities** | | |
| Proceeds from: | | |
| Sales of Federal Home Loan Bank stock | 84,560 | - |
| Maturities or calls of U.S. Treasury, government sponsored entities | | |
| and other investment securities available for sale | 214,350 | 8,250 |
| Sales of wholly owned real estate and real estate acquired in settlement of loans | 8,034 | 866 |
| Purchase of: | | |
| U.S. Treasury, government sponsored entities and other investment securities | | |
| available for sale | (500,000 ) | (211,220 ) |
| Loans held for investment | - | (20,394 ) |
| Premises and equipment | (9,013 ) | (14,778 ) |
| Federal Home Loan Bank stock | - | (439 ) |
| Originations of loans held for investment (net of refinances of $450,263 for the | | |

| | | |
|---|---|---|
| six months ended June 30, 2007 and $403,664 for the six months ended | | |
| June 30, 2006) | (884,248 ) | (2,587,754 ) |
| Principal payments on loans held for investment and mortgage-backed securities | | |
| available for sale | 2,600,061 | 2,586,310 |
| Net change in undisbursed loan funds | (30,407 ) | (18,368 ) |
| Investments in real estate held for investment | (4,879 ) | 3,771 |
| Other, net | 1,176 | 7,152 |
| Net cash provided by (used for) investing activities | 1,479,634 | (246,604 ) |

***See accompanying notes to consolidated financial statements.***

# DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows (Continued)

| *(In Thousands)* | *Six Months Ended June 30,* 2007 | 2006 |
|---|---|---|
| **Cash flows from financing activities** | | |
| Net increase (decrease) in deposits | $ (538,063 ) | $ 10,891 |
| Proceeds from Federal Home Loan Bank advances and other borrowings | 8,931,573 | 16,096,285 |
| Repayments of Federal Home Loan Bank advances and other borrowings | (9,853,000 ) | (15,895,243 ) |
| Cash dividends | (6,684 ) | (5,570 ) |
| Other, net | 2,679 | (3,980 ) |
| Net cash provided by (used for) financing activities | (1,463,495 ) | 202,383 |
| Net increase (decrease) in cash and cash equivalents | 24,442 | (37,437 ) |
| Cash and cash equivalents at beginning of period | 124,866 | 190,396 |
| **Cash and cash equivalents at end of period** | $ 149,308 | $ 152,959 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | $ 291,738 | $ 302,257 |
| Income taxes | 178,968 | 68,029 |
| Supplemental disclosure of non-cash investing: | | |
| Loans transferred to held for investment from held for sale | 19,042 | 11,110 |
| Loans transferred from held for investment to held for sale | 2,151 | 488 |
| U.S. Treasury, government sponsored entities and other investment securities | | |
| available for sale, purchased and not settled | 199,980 | 75,000 |
| Loans exchanged for mortgage-backed securities | 621,651 | 490,272 |
| Real estate acquired in settlement of loans | 30,178 | 1,077 |
| Loans to facilitate the sale of real estate acquired in settlement of loans | 285 | - |

***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 June 30, 2007, December 31, 2006 and June 30, 2006, the results of operations and comprehensive income for the three months and six months ended June 30, 2007 and 2006, and changes in cash flows for the six months ended June 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)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Gross balance at beginning of period | $ 20,871 | $ 21,435 | $ 20,483 | $ 20,665 | $ 20,420 |
| Additions [a] | 1,926 | 1,341 | 2,122 | 896 | 1,285 |
| Amortization | (967 ) | (1,024 ) | (1,087 ) | (1,056 ) | (1,029 ) |
| Sales | - | (868 ) | - | - | - |
| Impairment write-down | (123 ) | (13 ) | (83 ) | (22 ) | (11 ) |
| Gross balance at end of period | 21,707 | 20,871 | 21,435 | 20,483 | 20,665 |
| Allowance balance at beginning of period | 182 | 239 | 173 | 104 | 255 |
| Provision for (reduction of) impairment | 29 | (44 ) | 149 | 91 | (140 ) |
| Impairment write-down | (123 ) | (13 ) | (83 ) | (22 ) | (11 ) |
| Allowance balance at end of period | 88 | 182 | 239 | 173 | 104 |
| Total mortgage servicing rights, net | $ 21,619 | $ 20,689 | $ 21,196 | $ 20,310 | $ 20,561 |
| As a percentage of associated mortgage loans | 0.91 % | 0.88 % | 0.89 % | 0.87 % | 0.87 % |
| Estimated fair value [b] | $ 25,080 | $ 22,461 | $ 22,828 | $ 22,383 | $ 23,644 |
| Weighted average expected life (in months) | 65 | 56 | 54 | 51 | 56 |
| Custodial account earnings rate | 5.35 % | 5.26 % | 5.28 % | 5.28 % | 5.39 % |
| Weighted average discount rate | 10.13 | 10.27 | 10.28 | 9.41 | 9.39 |
| **At period end** | | | | | |
| Mortgage loans serviced for others: | | | | | |
| Total | $ 6,002,907 | $ 6,021,673 | $ 5,908,233 | $ 6,595,462 | $ 6,377,737 |
| With capitalized mortgage servicing rights: [b] | | | | | |
| Amount | 2,383,290 | 2,348,060 | 2,394,754 | 2,345,880 | 2,369,543 |
| Weighted average interest rate | 5.79 % | 5.77 % | 5.75 % | 5.70 % | 5.66 % |
| Total loans sub-serviced without mortgage servicing rights: [c] | | | | | |
| Term less than six months | $ 398,530 | $ 125,425 | $ 93,074 | $ 981,883 | $ 228,455 |
| Term indefinite | 3,207,087 | 3,533,200 | 3,404,342 | 3,249,905 | 3,760,642 |

| | | | | | |
|---|---|---|---|---|---|
| Custodial account balances | $ 156,433 | $ 176,171 | $ 172,462 | $ 171,481 | $ 147,831 |

[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.

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(Dollars in Thousands)* | *2007* | *2006* |
| Gross balance at beginning of period | $ 21,435 | $ 21,157 |
| Additions [a] | 3,267 | 2,307 |
| Amortization | (1,991 ) | (2,227 ) |
| Sales | (868 ) | - |
| Impairment write-down | (136 ) | (572 ) |
| Gross balance at end of period | 21,707 | 20,665 |
| Allowance balance at beginning of period | 239 | 855 |
| Reduction of impairment | (15 ) | (179 ) |
| Impairment write-down | (136 ) | (572 ) |
| Allowance balance at end of period | 88 | 104 |
| Total mortgage servicing rights, net | $ 21,619 | $ 20,561 |

[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 mortgage servicing rights for changes in those assumptions individually and in combination associated with an immediate 100 basis point increase or decrease in market rates. The table also summarizes the earnings impact associated with provisions for or reductions of the valuation allowance for mortgage servicing rights. 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 | $ 1,763 | $ 1,104 | $ (980 ) | $ 1,839 |
| Reduction of (increase in) valuation allowance | 38 | 26 | (14 ) | 49 |
| Decrease rates 100 basis points: [b] | | | | |
| Increase (decrease) in fair value | (4,721 ) | (1,122 ) | 1,030 | (5,464 ) |
| Reduction of (increase in) valuation allowance | (2,284 ) | (32 ) | 13 | (2,690 ) |

[a] *The weighted-average expected life of the MSRs portfolio becomes 75 months.*
[b] *The weighted-average expected life of the MSRs portfolio becomes 44 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)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Net cash servicing fees | $ 1,598 | $ 1,607 | $ 1,647 | $ 1,583 | $ 1,574 |
| Payoff and curtailment interest cost [a] | (1,391 ) | (1,063 ) | (1,269 ) | (813 ) | (233 ) |
| Amortization of mortgage servicing rights | (967 ) | (1,024 ) | (1,087 ) | (1,056 ) | (1,029 ) |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Provision for) reduction of impairment of | | | | | | | | | | |
| mortgage servicing rights | | (29 ) | | 44 | | (149 ) | | (91 ) | | 140 |
| Total loan servicing income (loss), net | $ | (789 ) | $ | (436 ) | $ | (858 ) | $ | (377 ) | $ | 452 |

[(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.*



**Navigation Links**

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.

| *(In Thousands)* | *Six Months Ended June 30,* 2007 | 2006 |
|---|---|---|
| Net cash servicing fees | $ 3,205 | $ 3,140 |
| Payoff and curtailment interest cost [a] | (2,454 ) | (451 ) |
| Amortization of mortgage servicing rights | (1,991 ) | (2,227 ) |
| Reduction of impairment of mortgage servicing rights | 15 | 179 |
| Total loan servicing income (loss), net | $ (1,225 ) | $ 641 |

[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 June 30, 2007, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $123 million, with a change in fair value resulting in a recorded loss of $0.3 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 June 30, 2007, the notional amount of loan forward sale contracts amounted to $303 million, with a change in fair value resulting in a gain of $2.8 million. Of the total loan forward sale contracts, $176

million were designated as cash flow hedges. There were no loan forward purchase contracts at June 30, 2007.

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.



**Navigation Links**

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 of changes in the fair value of certain FHLB fixed rate advances due to changes in market interest rates. The payment and maturity dates of the swap contracts match those of the advances. This hedge effectively converts fixed interest rate advances into debt that adjusts quarterly to movements in 3-month LIBOR. Because the terms of the swap contracts match those of the advances, the hedge has no ineffectiveness and results are reported in interest expense. The fair value of interest rate swap contracts is based on dealer quoted market prices acquired from third parties and represents the estimated amount Downey would receive or pay upon terminating the contracts, taking into consideration current interest rates and the remaining contract terms. The fair value of the swap contracts is recorded on the balance sheet in either other assets or accounts payable and accrued liabilities. With no ineffectiveness, the recorded swap contract values will essentially act as fair value adjustments to the advances being hedged. At June 30, 2007, swap contracts with a notional amount totaling $430 million were outstanding and had a fair value loss of $12 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 June 30, 2007.

| *(Dollars in Thousands)* | *Notional Amount* | *Weighted Average Interest Rate* | *Term* | |
|---|---|---|---|---|
| Pay Variable (3-month LIBOR) | $ (100,000 ) | 5.36 % | March 2004 | October 2008 |
| Receive Fixed | 100,000 | 3.20 | | |
| Pay Variable (3-month LIBOR) | (130,000 ) | 5.36 | March 2004 | October 2008 |
| Receive Fixed | 130,000 | 3.21 | | |
| Pay Variable (3-month LIBOR) | (100,000 ) | 5.36 | March 2004 | November 2008 |
| Receive Fixed | 100,000 | 3.26 | | |
| Pay Variable (3-month LIBOR) | (100,000 ) | 5.36 | March 2004 | November 2008 |
| Receive Fixed | 100,000 | 3.27 | | |

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Net gains (losses) on non-qualifying hedge transactions | $ 866 | $ 251 | $ (309 ) | $ (304 ) | $ (733 ) |
| 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) | 866 | 251 | (309 ) | (304 ) | (733 ) |
| Other comprehensive income (loss) | (86 ) | (60 ) | 434 | (201 ) | (385 ) |
| **Notional amount or balance at period end** | | | | | |
| Non-qualifying hedge transactions: | | | | | |
| Interest rate lock commitments [(a)] | $ 122,668 | $ 224,546 | $ 196,751 | $ 236,435 | $ 237,867 |
| Associated loan forward sale contracts | 126,675 | 209,818 | 187,804 | 213,783 | 209,815 |
| Qualifying cash flow hedge transactions: | | | | | |
| Loans held for sale, at lower of cost or fair value | 187,752 | 267,862 | 363,215 | 323,428 | 417,691 |
| Associated loan forward sale contracts | 175,825 | 254,260 | 341,696 | 307,982 | 398,741 |
| 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 $159 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.

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |

| | | |
|---|---|---|
| Net gains (losses) on non-qualifying hedge transactions | $ 1,117 | $ (495 ) |
| 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) | 1,117 | (495 ) |
| Other comprehensive income (loss) | (146 ) | 194 |

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

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

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

Commitments to originate fixed and variable rate mortgage loans are agreements to lend to a customer as long as there is no violation of any condition established in the commitment. Commitments generally have fixed expiration dates or other termination clauses and 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)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|
| Commitments to originate adjustable rate loans held for investment | $ 138,510 | $ 340,849 | $ 139,145 | $ 201,662 | $ 338,222 |
| Undisbursed loan funds and unused lines of credit | 316,931 | 334,803 | 347,338 | 370,159 | 391,395 |

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 controls the credit risk of its commitments to originate loans held for investment through credit approvals, limits and monitoring procedures. The credit risk involved in issuing lines and letters of credit requires the same creditworthiness evaluation as that involved in extending loan facilities to customers. Downey evaluates each customer s creditworthiness.

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

Downey maintains an allowance for losses to provide for inherent losses for loan-related commitments associated with undisbursed loan funds and unused lines of credit. The allowance for losses on loan-related commitments was $1 million at June 30, 2007 and December 31, 2006, and $2 million at June 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 six months of 2007, Downey recorded repurchase or indemnification losses related to defects in the origination process of $0.7 million and repurchased $10 million of loans.

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 June 30, 2007, December 31, 2006 and June 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 June 30, 2007, Downey s maximum sales price premium refund would be $5.3 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 June 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 | $ 8,350,911 | $ 260,079 | $ 99,787 | $ - | $ 8,710,777 |
| Securities sold under agreements to repurchase | 587,544 | - | - | - | 587,544 |
| FHLB advances | 686,000 | 418,373 | - | - | 1,104,373 |
| Senior notes | - | - | - | 198,351 | 198,351 |
| Operating leases | 5,410 | 8,006 | 3,430 | 687 | 17,533 |
| Total other contractual obligations | $ 9,629,865 | $ 686,458 | $ 103,217 | $ 199,038 | $ 10,618,578 |

***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 complaint seeks unspecified damages for alleged unpaid regular and overtime wages and bonuses, inadequate meal and rest breaks, 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 any time during the four years prior to October 29, 2004. 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.

On June 21, 2005, a former loan underwriting employee brought an action in Contra Costa Superior Court, Case No. C05-01293, entitled "Teresa Sims, et al. v. Downey Savings and Loan Association." The complaint sought unspecified damages for alleged unpaid overtime wages and bonuses, inadequate meal and rest breaks, and related claims. The plaintiff sought class action status to represent all other current and former Downey Savings employees that held the position of loan underwriter, including, but not limited to, the job title of Senior Loan Underwriter within the State of California (a) at any time during the four years prior to June 21, 2005 and/or (b) who was employed by Downey Savings on or about September 30, 2002, when Downey Savings terminated an annual bonus program. During the current quarter, the court granted final approval of a settlement and all amounts due under the court approved settlement have been fully reflected in the financial statements.

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. Accordingly, Downey s effective tax rate has not been impacted by the adoption of FIN 48.

The Internal Revenue Service ( IRS ) is currently examining Downey s tax returns for 2003 and 2004. 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.



Navigation Links

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 ("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 June 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 June 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 June 30,* | | | | | |
|---|---|---|---|---|---|---|
| | *2007* | | | *2006* | | |
| *(Dollars in Thousands, Except Per Share Data)* | *Net Income* | *Weighted Average Shares Outstanding* | *Per Share Amount* | *Net Income* | *Weighted Average Shares Outstanding* | *Per Share Amount* |
| Basic earnings per share | $ 32,744 | 27,853,783 | $ 1.17 | $ 48,224 | 27,853,783 | $ 1.73 |
| Effect of dilutive stock options | - | 30,279 | - | - | 30,498 | - |
| Diluted earnings per share | $ 32,744 | 27,884,062 | $ 1.17 | $ 48,224 | 27,884,281 | $ 1.73 |

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.

| *Six Months Ended June 30,* | |
|---|---|
| *2007* | *2006* |

| *(Dollars in Thousands, Except Per Share Data)* | *Net Income* | *Weighted Average Shares Outstanding* | *Per Share Amount* | *Net Income* | *Weighted Average Shares Outstanding* | *Per Share Amount* |
|---|---|---|---|---|---|---|
| Basic earnings per share | $ 75,607 | 27,853,783 | $ 2.71 | $ 91,921 | 27,853,783 | $ 3.30 |
| Effect of dilutive stock options | - | 30,263 | - | - | 29,968 | - |
| Diluted earnings per share | $ 75,607 | 27,884,046 | $ 2.71 | $ 91,921 | 27,883,751 | $ 3.30 |

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 June 30, 2007** | | | | |
| Net interest income | $ 111,097 | $ 362 | $ - | $ 111,459 |
| Provision for credit losses | 9,505 | - | - | 9,505 |
| Other income | 17,368 | 157 | - | 17,525 |
| Operating expense | 62,060 | 300 | - | 62,360 |
| Net intercompany income (expense) | 19 | (19 ) | - | - |
| Income before income taxes | 56,919 | 200 | - | 57,119 |
| Income taxes | 24,305 | 70 | - | 24,375 |
| Net income | $ 32,614 | $ 130 | $ - | $ 32,744 |
| **At June 30, 2007** | | | | |
| Assets: | | | | |
| Loans and mortgage-backed securities, net | $ 12,392,066 | $ - | $ - | $ 12,392,066 |
| Investments in real estate and joint ventures | - | 64,997 | - | 64,997 |
| Other | 2,496,685 | 27,341 | (78,119 ) | 2,445,907 |
| Total assets | 14,888,751 | 92,338 | (78,119 ) | 14,902,970 |
| Equity | $ 1,464,473 | $ 78,119 | $ (78,119 ) | $ 1,464,473 |
| **Three months ended June 30, 2006** | | | | |
| Net interest income | $ 132,021 | $ 326 | $ - | $ 132,347 |
| Provision of credit losses | 6,662 | - | - | 6,662 |
| Other income | 18,188 | 2,842 | - | 21,030 |
| Operating expense | 60,652 | 291 | - | 60,943 |
| Net intercompany income (expense) | (54 ) | 54 | - | - |
| Income before income taxes | 82,841 | 2,931 | - | 85,772 |
| Income taxes | 36,347 | 1,201 | - | 37,548 |
| Net income | $ 46,494 | $ 1,730 | $ - | $ 48,224 |
| **At June 30, 2006** | | | | |
| Assets: | | | | |
| | $ 15,938,573 | $ - | $ - | $ 15,938,573 |

| | | | | |
|---|---|---|---|---|
| Loans and mortgage-backed securities, net | | | | |
| Investments in real estate and joint ventures | - | 49,237 | - | 49,237 |
| Other | 1,517,582 | 31,541 | (72,153 ) | 1,476,970 |
| Total assets | 17,456,155 | 80,778 | (72,153 ) | 17,464,780 |
| Equity | $ 1,284,085 | $ 72,153 | $ (72,153 ) | $ 1,284,085 |

| *(In Thousands)* | *Banking* | *Real Estate Investment* | *Elimination* | *Totals* |
|---|---|---|---|---|
| **Six months ended June 30, 2007** | | | | |
| Net interest income | $ 235,849 | $ 724 | $ - | $ 236,573 |
| Provision for loan losses | 10,122 | - | - | 10,122 |
| Other income | 34,300 | 913 | - | 35,213 |
| Operating expense | 127,335 | 668 | - | 128,003 |
| Net intercompany income (expense) | 31 | (31 ) | - | - |
| Income before income taxes | 132,723 | 938 | - | 133,661 |
| Income taxes | 57,686 | 368 | - | 58,054 |
| Net income | $ 75,037 | $ 570 | $ - | $ 75,607 |
| **Six months ended June 30, 2006** | | | | |
| Net interest income | $ 257,653 | $ 610 | $ - | $ 258,263 |
| Provision for loan losses | 16,719 | - | - | 16,719 |
| Other income | 38,859 | 5,381 | - | 44,240 |
| Operating expense | 121,449 | 1,026 | - | 122,475 |
| Net intercompany income (expense) | 33 | (33 ) | - | - |
| Income before income taxes | 158,377 | 4,932 | - | 163,309 |
| Income taxes | 69,367 | 2,021 | - | 71,388 |
| Net income | $ 89,010 | $ 2,911 | $ - | $ 91,921 |

**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.



**Navigation Links**

## 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 from results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality, the outcome of ongoing audits by 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

Our net income for the second quarter of 2007 totaled $32.7 million or $1.17 per share on a diluted basis, down 32.1% from $48.2 million or $1.73 per share in the second quarter of 2006.

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

- A $20.9 million decline in net interest income due to a lower level of interest-earning assets;
- A $2.8 million increase in the provision for credit losses;
- A $2.7 million decline in income from real estate and joint ventures held for investment;
- A $1.2 million decline in income from loan servicing activities; and
- A $0.9 million increase in the net operation of real estate acquired in settlement of loans.

For the first six months of 2007, our net income totaled $75.6 million or $2.71 per share on a diluted basis, down 17.7% from the $91.9 million or $3.30 per share for the first six months of 2006. The decrease primarily reflected declines in net interest income, income from real estate and joint ventures held for investment and gains from sales of loans and mortgage-backed securities as well as higher operating expenses. Those unfavorable items were partially offset by a decline in provision for credit losses.

For the second quarter, our return on average assets was 0.87%, down from 1.09% a year ago, while our return on average equity was 9.01%, down from 15.25% a year ago. For the first six-month periods, our return on average assets declined from 1.05% a year ago to 0.98%, while our return on average equity declined from 14.78% to 10.54%.

At June 30, 2007, assets totaled $14.903 billion, down $2.562 billion or 14.7% from a year ago and down $1.304 billion or 8.0% from year-end 2006. During the current quarter, assets declined $335 million due primarily to declines of $738 million in loans held for investment and $80 million in loans held for sale. Those declines were partially offset by an increase of $506 million in securities available for sale. Included within loans held for investment at quarter end were $8.914 billion of single family adjustable rate mortgages subject to negative amortization, down $1.140 billion from March 31, 2007. These loans comprised 76% of the single family residential loan portfolio at quarter end, compared to 89% a year ago. The amount of negative amortization included in loan balances increased $20 million during the current quarter to $377 million or 4.23% of loans subject to negative amortization. During the current quarter, approximately 29% of loan interest income represented negative amortization, down from 31% in the first quarter of 2007 but up from 26% in the year-ago second quarter.

Loan originations (including purchases) totaled $1.209 billion in the current quarter, down $862 million or 41.6% from $2.071 billion a year ago. Loans originated for sale declined $397 million or 44.5% to $495 million, while single family residential loans originated for portfolio declined $431 million or 38.1% to $699 million. In addition to single family residential loans, $15 million of other loans were originated in the current quarter. For the first six months of 2007, loan originations totaled $2.470 billion, down 49.4% from $4.884 billion in the same period a year ago.



**Navigation Links**

Deposits totaled $11.247 billion at quarter end, down $641 million or 5.4% from a year ago and down $538 million or 4.6% from year-end 2006. At quarter end, the number of branches totaled 172 (168 in California and four in Arizona), down one branch from March 31, 2007 due to the closure of the store in which it was located. At quarter end, the average deposit size of our 82 traditional branches was $108 million, while the average deposit size of our 90 in-store branches was $26 million. Since the end of 2006, borrowings have declined by $919 million and represented at the end of the current quarter 12.7% of total assets.

Non-performing assets increased during the quarter by $84 million or 58.5% to $227 million and represented 1.53% of total assets, compared with 0.68% at year-end 2006 and 0.23% a year ago. Of the increase in the current quarter, $76 million was related to single family residential loans, while $7 million represented a construction loan to build single family homes on which no significant loss is expected at this time.

At June 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 10.08% for both tangible and core capital and 20.86% 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.



**Navigation Links**

**CRITICAL ACCOUNTING POLICIES**

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey s Annual Report on Form 10-K for the year ended December 31, 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 June 30, 2007, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $123 million, with a change in fair value resulting in a loss of $0.3 million, compared with a notional amount of interest rate lock commitments of $238 million with a change in fair value resulting in a loss of $0.3 million at June 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 $71 million at June 30, 2007, compared with $53 million at June 30, 2006. For further information, see Allowance for Credit and Real Estate Losses on page 47.
- 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 June 30, 2007 and June 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 June 30, 2007 and June 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 $111.5 million in the second quarter of 2007, down $20.9 million or 15.8% from a year ago. The decline reflected a $2.725 billion or 15.8% decline in average interest-earning assets. However, the effective interest rate spread of 3.07% in the current quarter remained unchanged from a year ago.

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 72.3% in the current quarter from 99.5% 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) and the value of those funds was worth more than a year ago due to the higher interest rates prevalent during the current quarter.

For the first six months of 2007, net interest income totaled $236.6 million, down $21.7 million or 8.4% from the year-ago period. The decline was due to lower interest-earning asset levels, as our effective interest rate spread increased.

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 our net interest-earning balance the difference between the average balance of interest-earning assets and the average balance of total deposits and borrowings for the quarters indicated. 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 June 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 | | $ 17,591 | 0.55 % | | $ 25,888 | 0.64 % |
| Write-off of deferred costs and premiums from loan payoffs | | (24,325 ) | (0.76 ) | | (26,019 ) | (0.64 ) |
| All other | | 237,117 | 7.39 | | 275,364 | 6.76 |
| Total loans | $ 12,835,907 | 230,383 | 7.18 | $ 16,283,301 | 275,233 | 6.76 |
| Mortgage-backed securities | 116 | 3 | 5.92 | 267 | 3 | 4.49 |
| Investment securities [(a)] | 1,698,378 | 21,838 | 5.16 | 975,373 | 11,173 | 4.59 |
| Total interest-earnings assets | 14,534,401 | $ 252,224 | 6.94 % | 17,258,941 | $ 286,409 | 6.64 % |
| Non-interest-earning assets | 480,034 | | | 426,727 | | |
| Total assets | $ 15,014,435 | | | $ 17,685,668 | | |
| Transaction accounts: | | | | | | |
| Non-interest-bearing checking | $ 800,910 | $ - | - % | $ 744,440 | $ - | - % |
| Interest-bearing checking [(b)] | 486,909 | 382 | 0.31 | 508,205 | 439 | 0.35 |
| Money market | 145,230 | 376 | 1.04 | 161,537 | 421 | 1.05 |
| Regular passbook | 1,190,524 | 2,814 | 0.95 | 1,563,990 | 3,940 | 1.01 |
| Total transaction accounts | 2,623,573 | 3,572 | 0.55 | 2,978,172 | 4,800 | 0.65 |
| Certificates of deposit | 8,768,716 | 108,316 | 4.95 | 9,033,473 | 94,998 | 4.22 |
| Total deposits | 11,392,289 | 111,888 | 3.94 | 12,011,645 | 99,798 | 3.33 |
| FHLB advances and other borrowings [(c)] | 1,734,014 | 25,576 | 5.92 | 3,886,870 | 50,966 | 5.26 |
| Senior notes | 198,333 | 3,301 | 6.66 | 198,157 | 3,298 | 6.66 |
| Total deposits and borrowings | 13,324,636 | 140,765 | 4.24 | 16,096,672 | 154,062 | 3.84 |
| Other liabilities | 235,991 | | | 324,475 | | |
| Stockholders equity | 1,453,808 | | | 1,264,521 | | |
| Total liabilities and stockholders equity | $ 15,014,435 | | | $ 17,685,668 | | |

| | | | | |
|---|---|---|---|---|
| Net interest income/interest rate spread | | $ 111,459 | 2.70 % | | $ 132,347 | 2.80 % |
| Excess of interest-earning assets over | | | | | | |
| deposits and borrowings | $ 1,209,765 | | | $ 1,162,269 | | |
| Effective interest rate spread | | | 3.07 | | | 3.07 |

[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**

| | Six Months Ended June 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 | | $ 39,395 | 0.59 % | | $ 47,359 | 0.58 % |
| Write-off of deferred costs and premiums from loan payoffs | | (50,139 ) | (0.75 ) | | (48,063 ) | (0.59 ) |
| All other | | 493,299 | 7.44 | | 531,282 | 6.55 |
| Total loans | $ 13,257,340 | 482,555 | 7.28 | $ 16,210,406 | 530,578 | 6.55 |
| Mortgage-backed securities | 134 | 6 | 5.89 | 272 | 6 | 4.41 |
| Investment securities [(a)] | 1,638,663 | 43,483 | 5.35 | 911,916 | 20,788 | 4.60 |
| Total interest-earnings assets | 14,896,137 | $ 526,044 | 7.06 % | 17,122,594 | $ 551,372 | 6.44 % |
| Non-interest-earning assets | 474,773 | | | 422,893 | | |
| Total assets | $ 15,370,910 | | | $ 17,545,487 | | |
| Transaction accounts: | | | | | | |
| Non-interest-bearing checking | $ 777,986 | $ - | - % | $ 722,205 | $ - | - % |
| Interest-bearing checking [(b)] | 487,542 | 777 | 0.32 | 511,861 | 874 | 0.34 |
| Money market | 147,807 | 761 | 1.04 | 162,875 | 844 | 1.04 |
| Regular passbook | 1,217,173 | 5,763 | 0.95 | 1,645,512 | 8,324 | 1.02 |
| Total transaction accounts | 2,630,508 | 7,301 | 0.56 | 3,042,453 | 10,042 | 0.67 |
| Certificates of deposit | 8,886,450 | 218,162 | 4.95 | 8,968,856 | 181,591 | 4.08 |
| Total deposits | 11,516,958 | 225,463 | 3.95 | 12,011,309 | 191,633 | 3.22 |
| FHLB advances and other borrowings [(c)] | 1,980,803 | 57,406 | 5.84 | 3,788,128 | 94,880 | 5.05 |
| Senior notes | 198,311 | 6,602 | 6.66 | 198,135 | 6,596 | 6.66 |
| Total deposits and borrowings | 13,696,072 | 289,471 | 4.26 | 15,997,572 | 293,109 | 3.69 |
| Other liabilities | 239,531 | | | 303,766 | | |
| Stockholders equity | 1,435,307 | | | 1,244,149 | | |
| Total liabilities and stockholders equity | $ 15,370,910 | | | $ 17,545,487 | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Net interest income/interest rate spread | | $ 236,573 | 2.80 % | | $ 258,263 | 2.75 % |
| Excess of interest-earning assets over | | | | | | |
| deposits and borrowings | $ 1,200,065 | | | $ 1,125,022 | | |
| Effective interest rate spread | | | 3.18 | | | 3.02 |

[(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.*

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 June 30, 2007 Versus 2006 Changes Due To* | | | | *Six Months Ended June 30, 2007 Versus 2006 Changes Due To* | | | |
|---|---|---|---|---|---|---|---|---|
| *(In Thousands)* | *Volume* | *Rate* | *Rate/ Volume* | *Net* | *Volume* | *Rate* | *Rate/ Volume* | *Net* |
| Interest income: | | | | | | | | |
| Loans | $ (58,271 ) | $ 17,025 | $ (3,604 ) | $ (44,850 ) | $ (96,656 ) | $ 59,466 | $ (10,833 ) | $ (48,023 ) |
| Mortgage-backed securities | - | - | - | - | (1 ) | 1 | - | - |
| Investment securities | 8,283 | 1,368 | 1,014 | 10,665 | 16,567 | 3,410 | 2,718 | 22,695 |
| Change in interest income | (49,988 ) | 18,393 | (2,590 ) | (34,185 ) | (80,090 ) | 62,877 | (8,115 ) | (25,328 ) |
| Interest expense: | | | | | | | | |
| Transaction accounts: | | | | | | | | |
| Interest-bearing checking | (18 ) | (41 ) | 2 | (57 ) | (42 ) | (58 ) | 3 | (97 ) |
| Money market | (42 ) | (3 ) | - | (45 ) | (84 ) | - | 1 | (83 ) |
| Regular passbook | (941 ) | (243 ) | 58 | (1,126 ) | (2,167 ) | (533 ) | 139 | (2,561 ) |
| Total transaction accounts | (1,001 ) | (287 ) | 60 | (1,228 ) | (2,293 ) | (591 ) | 143 | (2,741 ) |
| Certificates of deposit | (2,784 ) | 16,588 | (486 ) | 13,318 | (1,668 ) | 38,594 | (355 ) | 36,571 |
| Total interest-bearing deposits | (3,785 ) | 16,301 | (426 ) | 12,090 | (3,961 ) | 38,003 | (212 ) | 33,830 |
| FHLB advances and other borrowings | (28,229 ) | 6,364 | (3,525 ) | (25,390 ) | (45,267 ) | 14,904 | (7,111 ) | (37,474 ) |
| Senior notes | 3 | - | - | 3 | 6 | - | - | 6 |
| Change in interest expense | (32,011 ) | 22,665 | (3,951 ) | (13,297 ) | (49,222 ) | 52,907 | (7,323 ) | (3,638 ) |
| Change in net interest income | $ (17,977 ) | $ (4,272 ) | $ 1,361 | $ (20,888 ) | $ (30,868 ) | $ 9,970 | $ (792 ) | $ (21,690 ) |

**Provision for Credit Losses**

During the current quarter, our provision for credit losses totaled $9.5 million, up $2.8 million from a year ago. The increase reflected the continued weakness of the California residential real estate market. In addition, a shift in the yield curve has resulted in higher mortgage interest rates which negatively affects the ability of certain borrowers to refinance which, in turn, increases their probability of default.

For the first six months of 2007, the provision for credit losses totaled $10.1 million, compared with $16.7 million a year ago. For further information, see Allowance for Credit and Real Estate Losses on page 47.



**Navigation Links**

**Other Income**

Our other income totaled $17.5 million in the current quarter, down $3.5 million or 16.7% from a year ago. Contributing to the decline between second quarters was:

- A $2.7 million decline in income from real estate and joint ventures held for investment, primarily due to lower gains from sales as well as a provision for losses on real estate and joint ventures; and
- A $1.2 million unfavorable change in income from loan servicing activities.

For the first six months of 2007, other income totaled $35.2 million, down $9.0 million or 20.4% from the same period a year ago. The decline primarily reflected lower income from real estate and joint ventures held for investment and net gains from sales of loans and mortgage-backed securities.

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

***Loan and Deposit Related Fees***

Our loan and deposit related fees totaled $9.3 million in the current quarter, up $0.2 million from a year ago. Loan related fees were down $0.2 million or 18.8%, while deposit related fees were up $0.4 million or 4.4%. Most of the increase in deposit related fees was in categories other than automated teller machine fees.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Loan related fees | $ 819 | $ 842 | $ 918 | $ 901 | $ 1,009 |
| Deposit related fees: | | | | | |
| Automated teller machine fees | 2,440 | 2,305 | 2,346 | 2,419 | 2,410 |
| Other fees | 6,079 | 5,689 | 5,879 | 5,959 | 5,752 |
| Total loan and deposit related fees | $ 9,338 | $ 8,836 | $ 9,143 | $ 9,279 | $ 9,171 |

For the first six months of 2007, loan and deposit related fees totaled $18.2 million, up $0.4 million from the same period of 2006. Loan related fees were down $0.4 million or 20.0%, while deposit related fees were up $0.9 million or 5.5%.

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

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Loan related fees | $ 1,661 | $ 2,075 |
| Deposit related fees: | | |
| Automated teller machine fees | 4,745 | 4,559 |
| Other fees | 11,768 | 11,095 |

| Total loan and deposit related fees | $ 18,174 | $ 17,729 |
|---|---|---|

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

Our income from real estate and joint ventures held for investment represented a loss of $0.1 million in the current quarter, compared to $2.6 million of income a year ago. The unfavorable change of $2.7 million was due to lower gains from sales as well as a $0.4 million provision for losses on real estate and joint ventures. Our gains from sales totaled $0.4 million in the current quarter, compared to $2.6 million a year ago.

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

| | Three Months Ended | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Net rental operations | $ 49 | $ 545 | $ 20 | $ 124 | $ 240 |
| Net gains on sales of wholly owned real estate | - | 22 | - | 3,051 | - |
| Equity (deficit) in net income (loss) from joint ventures | 193 | (91 ) | 760 | 2,156 | 2,313 |
| Provision for losses on real estate and joint ventures | (353 ) | - | - | - | - |
| Total income (loss) from real estate and joint ventures held for investment, net | $ (111 ) | $ 476 | $ 780 | $ 5,331 | $ 2,553 |

For the first six months of 2007, income from real estate and joint ventures held for investment totaled $0.4 million, down $4.5 million from the same period of 2006 due primarily to lower gains from sales.

The following table sets forth the key components comprising our income from real estate and joint venture operations during the year-to-date periods indicated.

| | Six Months Ended June 30, | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Net rental operations | $ 594 | $ 727 |
| Net gains on sales of wholly owned real estate | 22 | - |
| Equity in net income from joint ventures | 102 | 4,115 |
| Provision for losses on real estate and joint ventures | (353 ) | - |
| Total income from real estate and joint ventures held for investment, net | $ 365 | $ 4,842 |

***Secondary Marketing Activities***

We service loans for others and those activities generated a loss of $0.8 million in the current quarter, compared with income of $0.5 million in the year-ago quarter. The primary reason for the unfavorable change was an increase in payoff and curtailment interest costs of $1.2 million, which 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 the interest income we derive from the use of those loan repayments as it is included in net interest income.

At June 30, 2007, MSRs, net of a $0.1 million valuation allowance, totaled $21.6 million or 0.91% of the $2.383 billion of associated loans serviced for others, little changed from a year ago. In addition to the loans we serviced for others with capitalized MSRs, at June 30, 2007, we serviced $3.606 billion of loans on a sub-servicing basis where we receive a fixed fee per loan, with no risk associated with changing MSR values.

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

| | Three Months Ended | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Net cash servicing fees | $ 1,598 | $ 1,607 | $ 1,647 | $ 1,583 | $ 1,574 |
| Payoff and curtailment interest cost [a] | (1,391 ) | (1,063 ) | (1,269 ) | (813 ) | (233 ) |
| Amortization of mortgage servicing rights | (967 ) | (1,024 ) | (1,087 ) | (1,056 ) | (1,029 ) |
| (Provision for) reduction of impairment of mortgage servicing rights | (29 ) | 44 | (149 ) | (91 ) | 140 |
| Total loan servicing income (loss), net | $ (789 ) | $ (436 ) | $ (858 ) | $ (377 ) | $ 452 |

[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 activities do not include the benefit of the use of total loan repayments to increase net interest income.*

For the first six months of 2007, a loss of $1.2 million was recorded from loan servicing activities, down from income of $0.6 million for the same period of 2006. The unfavorable change primarily reflected a $2.0 million increase in payoff and curtailment interest costs from the year-ago period.

The following table presents a breakdown of the components of our loan servicing income, net during the year-to-date periods indicated.

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Net cash servicing fees | $ 3,205 | $ 3,140 |
| Payoff and curtailment interest cost [a] | (2,454 ) | (451 ) |
| Amortization of mortgage servicing rights | (1,991 ) | (2,227 ) |
| Reduction of impairment of mortgage servicing rights | 15 | 179 |
| Total loan servicing income (loss), net | $ (1,225 ) | $ 641 |

[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 activities do not include the benefit of the use of total loan repayments to increase net interest income.*

For further information regarding mortgage servicing rights, see Note 2 on page 7 of Notes to Consolidated Financial Statements.

Our net gains on sales of loans and mortgage-backed securities totaled $9.0 million in the current quarter, up $0.4 million from a year ago. The current quarter included a $0.9 million gain due to the SFAS 133 impact of valuing derivatives associated with the sale of loans, compared with a SFAS 133 loss of $0.7 million in the year-ago quarter. Excluding the impact of SFAS 133, a gain equal to 1.42% was realized in the current quarter, up from the year-ago gain of 0.91%. Despite this favorable change, the dollar gain on loan sales (excluding the impact of SFAS 133) declined $1.2 million due to a lower volume of loans sold, as loan sales declined from $1.0 billion a year ago to $0.6 billion in the current quarter.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Mortgage servicing rights | $ 1,926 | $ 1,341 | $ 2,122 | $ 837 | $ 1,285 |
| All other components excluding SFAS 133 | 6,186 | 7,148 | 6,682 | 14,314 | 8,067 |
| SFAS 133 | 866 | 251 | (309 ) | (304 ) | (733 ) |
| Total net gains on sales of loans and mortgage-backed securities | $ 8,978 | $ 8,740 | $ 8,495 | $ 14,847 | $ 8,619 |
| Secondary marketing gain excluding SFAS 133 as a percentage of associated sales | 1.42 % | 1.19 % | 1.23 % | 1.68 % | 0.91 % |

For the first six months of 2007, our sales of loans and mortgage-backed securities totaled $1.3 billion, down from $1.9 billion a year ago. Net gains associated with these sales totaled $17.7 million, $2.6 million lower than the prior year amount. Excluding the impact of SFAS 133, a

gain equal to 1.29% was realized in the current year, up from the year-ago gain of 1.09%.

The following table presents a breakdown of the components of our net gains on sales of loans and mortgage-backed securities during the year-to-date periods indicated.

| | Six Months Ended June 30, | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Mortgage servicing rights | $ 3,267 | $ 2,307 |
| All other components excluding SFAS 133 | 13,334 | 18,461 |
| SFAS 133 | 1,117 | (495 ) |
| Total net gains on sales of loans and mortgage-backed securities | $ 17,718 | $ 20,273 |
| Secondary marketing gain excluding SFAS 133 as a percentage of associated sales | 1.29 % | 1.09 % |

**Operating Expense**

Our operating expense totaled $62.4 million in the current quarter, up $1.4 million or 2.3% from a year ago. The increase reflected increases of $0.9 million in net operations of real estate owned due to a higher number of foreclosed properties and $0.5 million in general and administrative expense. All major categories of general and administrative expense were unchanged or above a year ago except for the other general and administrative expense category, with the largest increases being $1.5 million in deposit insurance premiums and regulatory assessments and $0.7 million in premises and equipment costs. The other general and administrative expense category was $2.1 million below a year ago, primarily due to an adjustment to reserves associated with workers compensation insurance claims.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Salaries and related costs | $ 40,998 | $ 42,234 | $ 40,464 | $ 38,943 | $ 40,873 |
| Premises and equipment costs | 9,122 | 8,809 | 9,207 | 8,804 | 8,410 |
| Advertising expense | 1,878 | 1,191 | 1,895 | 1,211 | 1,879 |
| Deposit insurance premiums and regulatory assessments | 2,482 | 2,764 | 2,193 | 2,224 | 1,008 |
| Professional fees | 731 | 559 | 297 | 254 | 450 |
| Other general and administrative expense | 6,201 | 9,795 | 7,920 | 7,087 | 8,295 |
| Total general and administrative expense | 61,412 | 65,352 | 61,976 | 58,523 | 60,915 |
| Net operation of real estate acquired in settlement of loans | 948 | 291 | 65 | 166 | 28 |
| Total operating expense | $ 62,360 | $ 65,643 | $ 62,041 | $ 58,689 | $ 60,943 |

For the first six months of 2007, operating expense totaled $128.0 million, up $5.5 million or 4.5% from the same period of 2006, primarily reflecting higher deposit insurance premiums, salaries and related costs, and premises and equipment costs. Those increases were partially offset by a decline in the other general and administrative expense category.

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

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Salaries and related costs | $ 83,232 | $ 81,653 |
| Premises and equipment costs | 17,931 | 16,948 |
| Advertising expense | 3,069 | 3,121 |
| Deposit insurance premiums and regulatory assessments | 5,246 | 2,022 |
| Professional fees | 1,290 | 1,242 |
| Other general and administrative expense | 15,996 | 17,470 |

| | | |
|---|---|---|
| Total general and administrative expense | 126,764 | 122,456 |
| Net operation of real estate acquired in settlement of loans | 1,239 | 19 |
| Total operating expense | $ 128,003 | $ 122,475 |

**Provision for Income Taxes**

Our effective tax rate was 42.7% for the current quarter, compared with 43.8% a year ago. For the first six months of 2007, our effective tax was 43.4% versus 43.7% a year ago. The difference in effective tax rates is due primarily to interest associated with an underpayment of taxes.

**Business Segment Reporting**

The previous discussion and analysis of the Results of Operations pertained to our consolidated results. This section discusses and analyzes the results of operations of our two business segments: banking and real estate investment. For further information, see Note 7 of Notes to Consolidated Financial Statements on page 15.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Banking net income | $ 32,614 | $ 42,423 | $ 50,907 | $ 51,432 | $ 46,494 |
| Real estate investment net income | 130 | 440 | 1,208 | 4,188 | 1,730 |
| Total net income | $ 32,744 | $ 42,863 | $ 52,115 | $ 55,620 | $ 48,224 |

The following table presents by business segment our net income for the year-to-date periods indicated.

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Banking net income | $ 75,037 | $ 89,010 |
| Real estate investment net income | 570 | 2,911 |
| Total net income | $ 75,607 | $ 91,921 |

***Banking***

Our net income from banking operations totaled $32.6 million in the current quarter, down $13.9 million from a year ago. The decline between second quarters primarily reflected:

- a $20.9 million decline in net interest income due to a lower level of interest-earning assets;
- A $2.8 million increase in the provision for credit losses due to continued weakness of the California residential real estate market coupled with a shift in the yield curve which increases the probability of certain borrowers to default by adversely affecting their ability to refinance due to higher mortgage loan rates;
- A $1.2 million decline in income from loan servicing activities due to an increase in payoff and curtailment interest costs; and
- A $1.4 million increase in operating expense due primarily to a higher number of foreclosed properties, which resulted in a $0.9 million increase in net operation of real estate acquired in settlement of loans.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Net interest income | $ 111,097 | $ 124,752 | $ 129,798 | $ 129,870 | $ 132,021 |
| Provision for credit losses | 9,505 | 617 | 245 | 9,640 | 6,662 |
| Other income | 17,368 | 16,932 | 16,549 | 25,090 | 18,188 |
| Operating expense | 62,060 | 65,275 | 61,995 | 59,801 | 60,652 |
| Net intercompany income (expense) | 19 | 12 | (29 ) | (38 ) | (54 ) |
| Income before income taxes | 56,919 | 75,804 | 84,078 | 85,481 | 82,841 |
| Income taxes | 24,305 | 33,381 | 33,171 | 34,049 | 36,347 |
| Net income | $ 32,614 | $ 42,423 | $ 50,907 | $ 51,432 | $ 46,494 |
| **At period end** | | | | | |
| Assets: | | | | | |
| Loans and mortgage-backed securities, net | $ 12,392,066 | $ 13,210,016 | $ 14,170,750 | $ 15,135,543 | $ 15,938,573 |
| Other | 2,496,685 | 2,015,777 | 2,025,790 | 1,837,714 | 1,517,582 |
| Total assets | 14,888,751 | 15,225,793 | 16,196,540 | 16,973,257 | 17,456,155 |
| Equity | $ 1,464,473 | $ 1,439,463 | $ 1,393,235 | $ 1,344,593 | $ 1,284,085 |

For the first six months of 2007, net income from our banking operations totaled $75.0 million, down $14.0 million from the same period a year ago. The decrease primarily reflected declines in net interest income, gains from sales of loans and mortgage-backed securities and higher operating expenses. Those unfavorable items were partially offset by a decline in provision for credit losses.

The following table sets forth our banking operational results for the year-to-date periods indicated.

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Net interest income | $ 235,849 | $ 257,653 |
| Provision for credit losses | 10,122 | 16,719 |
| Other income | 34,300 | 38,859 |
| Operating expense | 127,335 | 121,449 |
| Net intercompany income | 31 | 33 |
| Income before income taxes | 132,723 | 158,377 |
| Income taxes | 57,686 | 69,367 |
| Net income | $ 75,037 | $ 89,010 |

***Real Estate Investment***

Net income from our real estate investment operations totaled $0.1 million in the current quarter, down from $1.7 million a year ago. The decline primarily reflected a $2.2 million decline in gains from sales, as well as a $0.4 million provision for losses on real estate and joint ventures.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Net interest income | $ 362 | $ 362 | $ 377 | $ 369 | $ 326 |
| Other income | 157 | 756 | 1,685 | 5,579 | 2,842 |
| Operating expense | 300 | 368 | 46 | (1,112 ) | 291 |
| Net intercompany income (expense) | (19 ) | (12 ) | 29 | 38 | 54 |
| Income before income taxes | 200 | 738 | 2,045 | 7,098 | 2,931 |
| Income taxes | 70 | 298 | 837 | 2,910 | 1,201 |
| Net income | $ 130 | $ 440 | $ 1,208 | $ 4,188 | $ 1,730 |
| **At period end** | | | | | |
| Assets: | | | | | |
| Investments in real estate and joint ventures | $ 64,997 | $ 61,663 | $ 59,843 | $ 55,663 | $ 49,237 |
| Other | 27,341 | 28,402 | 28,548 | 28,978 | 31,541 |
| Total assets | 92,338 | 90,065 | 88,391 | 84,641 | 80,778 |
| Equity | $ 78,119 | $ 77,989 | $ 77,549 | $ 76,341 | $ 72,153 |

For the first six months of 2007, our net income from real estate investment operations totaled $0.6 million, down $2.3 million from the same period of 2006. The decline primarily reflected lower gains from sales.

The following table sets forth our real estate investment operational results for the year-to-date periods indicated.

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Net interest income | $ 724 | $ 610 |
| Other income | 913 | 5,381 |
| Operating expense | 668 | 1,026 |
| Net intercompany expense | (31 ) | (33 ) |

| | | | | |
|---|---|---|---|---|
| Income before income taxes | | 938 | | 4,932 |
| Income taxes | | 368 | | 2,021 |
| Net income | $ | 570 | $ | 2,911 |

Our investments in real estate and joint ventures amounted to $65 million at June 30, 2007, up from $60 million at December 31, 2006 and $49 million at June 30, 2006.

For information on valuation allowances associated with real estate and joint venture loans, see Allowance for Credit and Real Estate Losses on page 47.

**FINANCIAL CONDITION**

**Loans and Mortgage-Backed Securities**

Total loans and mortgage-backed securities, including those we hold for sale, declined $818 million during the current quarter to a total of $12.4 billion or 83.2% of total assets at June 30, 2007. Loans held for investment declined $738 million, as loan payoffs exceeded originations and loans held for sale declined $80 million.

Our loan originations, including loans purchased, totaled $1.209 billion in the current quarter, down $862 million or 41.6% from the $2.071 billion we originated in the year-ago second quarter and 4.2% below the $1.261 billion we originated in the first quarter of 2007. Loans originated for sale declined $397 million or 44.5% from a year ago to $495 million, while single family loans originated for portfolio declined $431 million or 38.1% to $699 million. Our prepayment speed, which measures the annualized percentage of loans repaid, for one-to-four unit residential loans held for investment increased from 38% a year ago to 45% in the current quarter and was up slightly from 44% in the first quarter of 2007. During the current quarter, 88% of our residential one-to-four unit originations represented refinance transactions, including new loans to refinance existing loans which we or other lenders originated. This is down from 89% from the first quarter of 2007 but up from 86% in the year-ago second quarter.

We originate one-to-four unit residential mortgage loans both with and without loan origination fees. In mortgage transactions for which we charge no origination fees, we receive a higher interest rate than those for which we charge fees. In addition, a prepayment fee on loans with no origination fees may be 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 $699 million in the current quarter, down from $1.130 billion in the year-ago quarter but up from $603 million in the first quarter of 2007. Of the current quarter total:

- 51% were adjustable fixed for 3-5 years, compared with 35% in the year-ago quarter;
- 41% were adjustable rate loans tied to either the LIBOR index, which typically adjust every six months, or the Constant Maturity Treasury ("CMT") index; and
- 8% were adjustable rate loans tied to either the FHLB Eleventh District Cost of Funds Index ("COFI") or the 12-month moving average of yields on actively traded U.S. Treasury securities adjusted to a constant maturity of one year ("MTA") index and generally have rates that adjust monthly and provide for negative amortization, compared with 55% in the year-ago quarter. Of the current quarter total, loans tied to the COFI index represented 98% of these originations, compared with 99% of originations in the year-ago quarter.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| **Loans originated and purchased** | | | | | |
| Investment portfolio: | | | | | |
| Residential one-to-four units: | | | | | |
| Adjustable by index: | | | | | |
| COFI | $ 55,721 | $ 99,782 | $ 170,394 | $ 339,128 | $ 612,586 |
| MTA | 960 | 6,838 | 44,200 | 11,820 | 3,206 |
| LIBOR | 253,875 | 123,226 | 70,457 | 69,768 | 77,753 |
| CMT | 29,081 | 31,047 | 28,175 | 53,633 | 43,975 |
| Adjustable fixed for 3-5 years | 359,030 | 342,005 | 241,347 | 290,397 | 392,126 |
| Fixed | 285 | - | - | - | 69 |

| | | | | | |
|---|---|---|---|---|---|
| Total residential one-to-four units | 698,952 | 602,898 | 554,573 | 764,746 | 1,129,715 |
| Other | 14,876 | 17,500 | 6,605 | 15,744 | 49,059 |
| Total for investment portfolio | 713,828 | 620,398 | 561,178 | 780,490 | 1,178,774 |
| Sale portfolio [(a)] | 494,871 | 640,669 | 779,002 | 824,072 | 892,314 |
| Total for investment and sale portfolios | $ 1,208,699 | $ 1,261,067 | $ 1,340,180 | $ 1,604,562 | $ 2,071,088 |

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

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

| *(In Thousands)* | *Six Months Ended June 30,* 2007 | 2006 |
|---|---|---|
| **Loans originated and purchased** | | |
| Investment portfolio: | | |
| Residential one-to-four units: | | |
| Adjustable by index: | | |
| COFI | $ 155,503 | $ 1,921,884 |
| MTA | 7,798 | 212,340 |
| LIBOR | 377,101 | 89,149 |
| CMT | 60,128 | 43,975 |
| Adjustable fixed for 3-5 years | 701,035 | 581,511 |
| Fixed | 285 | 224 |
| Total residential one-to-four units | 1,301,850 | 2,849,083 |
| Other | 32,376 | 162,729 |
| Total for investment portfolio | 1,334,226 | 3,011,812 |
| Sale portfolio [a] | 1,135,540 | 1,872,478 |
| Total for investment and sale portfolios | $ 2,469,766 | $ 4,884,290 |

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

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.

| | *June 30, 2007* | | *March 31, 2007* | | *December 31, 2006* | | *September 30, 2006* | | *June 30, 2006* | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* |
| **Loan Investment Portfolio** | | | | | | | | | | |
| Residential one-to-four units: | | | | | | | | | | |
| Adjustable by index: | | | | | | | | | | |
| COFI | $ 7,487,290 | 76 % | $ 8,365,223 | 77 % | $ 9,231,837 | 77 % | $ 10,107,839 | 78 % | 10,770,739 | 77 % |
| MTA | 1,536,480 | 16 | 1,807,965 | 17 | 2,094,828 | 18 | 2,353,639 | 18 | 2,636,804 | 19 |
| LIBOR | 601,083 | 6 | 435,132 | 4 | 364,537 | 3 | 366,907 | 3 | 359,752 | 3 |
| Other, primarily CMT | 228,284 | 2 | 228,260 | 2 | 209,191 | 2 | 191,542 | 1 | 138,488 | 1 |
| | $ 9,853,137 | 100 % | $ 10,836,580 | 100 % | $ 11,900,393 | 100 % | $ 13,019,927 | 100 % | $ 13,905,783 | 100 % |

| Total adjustable loans [(a)] |
|---|

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

Our adjustable rate mortgage loans generally:

- either begin with an incentive interest rate ("start rate"), which is an interest rate below the current market rate, that adjusts to the applicable index plus a defined margin, subject to periodic and lifetime caps, after one, three, six or twelve months, or have a fixed interest rate for a period of three to five years then adjust semi-annually or annually thereafter;
- provide that the maximum interest rate cannot exceed the start rate by more than six to twelve 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.

Our option ARM products have an interest rate that adjusts monthly and a minimum monthly loan payment that adjusts annually. The start rate is lower than the fully-indexed rate and is the effective interest rate for the loan only during the first month. After the first month, interest accrues at the fully-indexed rate. The start rate, however, is used to calculate the required minimum monthly loan payment for the first twelve months. If the borrower chooses to make the required minimum monthly loan payment and the interest accrual, based on the fully-indexed rate, results in monthly interest due exceeding the payment amount, the loan balance will increase by the difference. Payment options, including the required minimum monthly loan payment, are clearly defined in the loan documents signed by the borrower at funding and explained again on the borrower  s monthly statement.

More particularly, our current production of ARM loans:

- limit the maximum loan balance to 110% of the original loan amount if the original loan-to-value ratio (a loan-to-value ratio is the proportion of the principal amount of the loan to the lower of the sales price or appraised value of the property securing the loan at origination) is greater than 75%, 115% if the loan-to-value ratio is 75% or less and up to 120% for certain salable loans;
- have a lifetime interest rate cap, but no periodic cap on interest rate adjustments; and
- include a payment cap that limits the change in required minimum monthly loan payments to 7.5% per year, unless the loan is recast (*i.e.,* a new monthly loan payment is calculated using the fully-indexed interest rate and provides for amortization of the loan balance over the remaining term of the loan). A loan is recast at the earlier of every five years or when the loan balance reaches the maximum level of loan balance permitted.

The maximum home loan we make, except for a limited amount related to Community Reinvestment Act ("CRA") activities, is equal to 97% of a property s appraised value; however, any loan in excess of 80% of appraised value generally requires private mortgage insurance. Typically, this insures the loan down to a 75% loan-to-value ratio, consistent with secondary marketing requirements. A loan-to-value ratio is the proportion of the principal amount of the loan to the lower of the sales price or appraised value of the property securing the loan at origination. If a loan incurs negative amortization, the loan-to-value ratio could rise, which increases credit risk, and the fair value of the underlying collateral could be insufficient to satisfy fully the outstanding loan obligation in the event of a loan default.

Our loan portfolio held for investment contains loans previously originated with a limit on the maximum loan balance of 125% of the original loan amount. At June 30, 2007, loans with the higher 125% limit on the maximum loan balance represented 2% of our one-to-four unit residential loan portfolio, while those with the 115% limit represented 3% and those with the 110% limit represented 71%. We permit adjustable rate mortgage loans to be assumed by qualified borrowers.

While start rates of our loan products fluctuate with the market, we do not use them to qualify a loan applicant. Rather, we qualify an applicant for adjustable rate mortgage loans using a fully-amortizing payment calculated from the higher of the fully-indexed rate or, currently, for our:

- lower risk applicants:
  - 6.00% for owner occupied; or
  - 6.25% for non-owner occupied.
- higher risk applicants:
  - 7.00% for owner occupied; or
  - 7.25% for non-owner occupied.

For interest-only loans, we qualify applicants at the interest-only payment amount based on the interest rate applicable to the fixed rate period of the loan program.



**Navigation Links**

As set forth in the following table, $8.9 billion or 76% of our residential one-to-four unit loans held for investment were subject to negative amortization at June 30, 2007, of which $377 million or 4.2% represented the amount of negative amortization included in the loan balance subject to negative amortization. The amount of negative amortization increased by $20 million during the current quarter, as borrowers took advantage of the flexibility of this product. During the current quarter, approximately 29% of our loan interest income represented negative amortization, down from 31% in the first quarter of 2007 but up from 26% in the year-ago second quarter. At origination, these loans had a weighted average loan-to-value ratio of 73%. In addition, $2.3 billion or 19% of our residential one-to-four unit loans held for investment represented loans requiring interest only payments over the initial terms of the loans, generally the first three to five years.

| *(Dollars in Thousands)* | *Loan Balance* | *% of Total* | *Negative Amortization Included in the Loan Balance* | *Loan to Value Ratio at Origination* | *Current Loan to Value Ratio* [(a)] | *Weighted Average Age (Months)* |
|---|---|---|---|---|---|---|
| **Loan Investment Portfolio** | | | | | | |
| **Residential one-to-four units subject to negative amortization:** | | | | | | |
| At June 30, 2007: | | | | | | |
| With negative amortization: | | | | | | |
| Balance less than or equal to original loan amount | $ 272,216 | 3 % | $ 1,467 | 70 % | 68 % | 36 |
| Balance greater than original loan amount | 7,752,141 | 87 | 375,860 | 74 | 77 | 25 |
| Total with negative amortization | 8,024,357 | 90 | 377,327 | 74 | 77 | 25 |
| Not utilizing negative amortization | 890,091 | 10 | - | 69 | 65 | 53 |
| Total loans subject to negative amortization | $ 8,914,448 | 100 % | $ 377,327 | 73 % | 76 % | 28 |
| As a percentage of total residential one-to-four units | 76 % | | | | | |
| Total loans with interest only payments | $ 2,258,102 | | | 69 % | 68 % | 11 |
| As a percentage of total residential one-to-four units | 19 % | | | | | |
| At December 31 2006: | | | | | | |
| With negative amortization: | | | | | | |
| Balance less than or equal to original loan amount | $ 477,873 | 4 % | $ 1,933 | 70 % | 69 % | 31 |
| Balance greater than original loan amount | 9,320,945 | 83 | 318,533 | 73 | 76 | 20 |
| Total with negative amortization | 9,798,818 | 87 | 320,466 | 73 | 75 | 21 |
| Not utilizing negative amortization | 1,401,052 | 13 | - | 69 | 65 | 41 |
| Total loans subject to negative amortization | $ 11,199,870 | 100 % | $ 320,466 | 73 % | 74 % | 23 |
| As a percentage of total residential one-to-four units | 85 % | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total loans with interest only payments | $ 1,578,202 | | | 69 % | 68 % | 12 |
| As a percentage of total residential one-to-four units | 12 % | | | | | |
| At June 30, 2006: | | | | | | |
| With negative amortization: | | | | | | |
| Balance less than or equal to original loan amount | $ 780,220 | 6 % | $ 2,401 | 70 % | 70 % | 23 |
| Balance greater than original loan amount | 10,352,284 | 78 | 226,651 | 73 | 74 | 16 |
| Total with negative amortization | 11,132,504 | 84 | 229,052 | 73 | 74 | 17 |
| Not utilizing negative amortization | 2,089,180 | 16 | - | 71 | 68 | 31 |
| Total loans subject to negative amortization | $ 13,221,684 | 100 % | $ 229,052 | 73 % | 73 % | 19 |
| As a percentage of total residential one-to-four units | 89 % | | | | | |
| Total loans with interest only payments | $ 1,101,415 | | | 70 % | 69 % | 14 |
| As a percentage of total residential one-to-four units | 7 % | | | | | |

[a] *Based on current loan balance relative to the lower of the appraised value or sales price at time of origination.*



**Navigation Links**

We have other credit risk elements within our real estate loans held for investment besides loans subject to negative amortization or loans with interest-only payments. At June 30, 2007, these other credit risks included:

- 89% of our real estate loans were concentrated and secured by properties located in California, principally in Los Angeles, San Diego, Orange, Santa Clara and Riverside counties;
- 82% of our residential one-to-four unit loans were underwritten based on borrower stated income and asset verification and an additional 8% were underwritten with no verification of either borrower income or assets; and
- the loans are relatively new and unseasoned, as 11% of our residential one-to-four unit loans were originated in 2007, with an additional 28% originated in 2006 and 33% in 2005.

Those risks are mitigated primarily by various minimum borrower credit requirements and maximum loan-to-value limitations. For example, at June 30, 2007, the average loan-to-value ratio at origination of our residential one-to-four unit loan portfolio was 72%. However, even with these requirements and limitations, our risk mitigation strategy is limited by potential defects in the underwriting process as well as potential changes in the loan-to-value ratio due to negative amortization and declines in home values. For example, while residential property values have increased over the past several years thereby further reducing our exposure to credit risk, home value declines emerged in certain markets we lend to in 2006. The uncertainty of future home value changes may materially impact the risk associated with our loan portfolio since 72% of these loans were originated since year-end 2004.

While our historic credit experience has been good, option ARMs can present greater credit risk in sustained periods of rising interest rates, as borrowers may see their loan payments increase significantly when their payments recast to fully-amortizing payments. In addition, credit risk increases if home values decline. In light of continued increases in market interest rates and unfavorable changes in the residential housing market, we increased the start rate on option ARM loans originated for portfolio beginning in March of 2006 in order to reduce the potential for negative amortization. Since our start rate remained higher than that of many of our competitors, our production of option ARM loans for portfolio did not offset loan payoffs for the last year. In September of 2006, we increased the competitiveness of our option ARM pricing by lowering the start rate for borrowers who have high FICO credit scores and low loan-to-value ratios, with the goal of stimulating additional loan production for our portfolio, while at the same time limiting our portfolio credit exposure. However, this pricing change has not resulted in loan production completely offsetting portfolio payoffs.

In September, 2006, the federal banking agencies issued final guidance on non-traditional mortgage loan products that allow borrowers to defer repayment of principal and sometimes interest, including "interest-only" mortgage loans, and "payment option" adjustable rate mortgage loans where a borrower has flexible payment options, including payments that have the potential for negative amortization. While acknowledging that innovations in mortgage lending can benefit some consumers, the final guidance states that management should (1) assess a borrower s ability to repay the loan, including any principal balances added through negative amortization, at the fully indexed rate that would apply after the incentive interest rate period, (2) recognize that certain nontraditional mortgage loans are untested in a stressed environment and warrant strong risk management standards as well as appropriate capital and loan loss reserves, and (3) ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice. We have instituted some disclosure changes and, as of July 1, 2007, our loan underwriting guidelines are in line with regulatory guidance. We continue to closely monitor trends in residential housing and lending markets and will make any other adjustments, as deemed necessary.

We also offer other types of adjustable rate product for portfolio that do not permit negative amortization and do not fall in the scope of the guidance, but those products are currently not as popular with borrowers.



**Navigation Links**

The following table sets forth our investment portfolio of residential one-to-four unit loans by the Fair Isaac Corporation credit score model ("FICO") of the borrower at origination at the dates indicated.

| | *June 30, 2007* | | *March 31, 2007* | | *December 31, 2006* | | *September 30, 2006* | | *June 30, 2006* | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* |
| **Loan Investment Portfolio** | | | | | | | | | | |
| Residential one-to-four units: | | | | | | | | | | |
| FICO score at Origination: | | | | | | | | | | |
| 620 or below | $ 487,877 | 4 % | $ 564,407 | 5 % | $ 645,004 | 5 % | $ 741,310 | 5 % | $ 855,396 | 6 % |
| 621 to 659 | 2,868,183 | 25 | 3,104,677 | 25 | 3,344,594 | 25 | 3,601,342 | 25 | 3,755,084 | 25 |
| 660 to 719 | 4,417,141 | 38 | 4,721,195 | 38 | 5,095,599 | 39 | 5,469,547 | 39 | 5,736,445 | 39 |
| 720 and above | 3,787,318 | 32 | 3,848,112 | 31 | 3,964,348 | 30 | 4,184,865 | 30 | 4,295,868 | 29 |
| Not available | 154,116 | 1 | 165,629 | 1 | 177,459 | 1 | 186,141 | 1 | 196,686 | 1 |
| Total residential one-to-four units | $ 11,714,635 | 100 % | $ 12,404,020 | 100 % | $ 13,227,004 | 100 % | $ 14,183,205 | 100 % | $ 14,839,479 | 100 % |
| Weighted average FICO score for loan investment portfolio of residential one-to-four units | 695 | | 694 | | 692 | | 692 | | 691 | |

The following table sets forth our investment portfolio of residential one-to-four unit loans by original loan-to-value ratio at the dates indicated. For this table, the loan-to-value ratios have been updated to reflect the current loan balance and appraisal if private mortgage insurance has been removed.

| | *June 30, 2007* | | *March 31, 2007* | | *December 31, 2006* | | *September 30, 2006* | | *June 30, 2006* | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* | *Amount* | *% of Total* |
| **Loan Investment Portfolio** | | | | | | | | | | |
| Residential one-to-four units: | | | | | | | | | | |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| 80% or below: | | | | | | | | | | |
| 60% or less | $ 1,751,248 | 15 % | $ 1,839,882 | 15 % | $ 1,940,772 | 15 % | $ 2,048,086 | 14 % | $ 2,148,624 | 14 % |
| 61% to 70% | 2,067,210 | 18 | 2,176,103 | 18 | 2,349,016 | 18 | 2,505,972 | 18 | 2,628,314 | 18 |
| 71% to 80% | 7,311,692 | 62 | 7,763,469 | 63 | 8,271,605 | 62 | 8,877,059 | 63 | 9,225,868 | 62 |
| Total 80% or below | 11,130,150 | 95 | 11,779,454 | 95 | 12,561,393 | 95 | 13,431,117 | 95 | 14,002,806 | 94 |
| 81% to 85%: | | | | | | | | | | |
| With private mortgage insurance | 88,360 | 1 | 90,228 | 1 | 96,683 | 1 | 110,452 | 1 | 124,623 | 1 |
| Without private mortgage insurance | 1,161 | - | 1,210 | - | 1,789 | - | 2,319 | - | 3,293 | - |
| Total 81% to 85% | 89,521 | 1 | 91,438 | 1 | 98,472 | 1 | 112,771 | 1 | 127,916 | 1 |
| 86% to 89%: | | | | | | | | | | |
| With private mortgage insurance | 204,250 | 2 | 218,546 | 2 | 231,471 | 2 | 261,422 | 2 | 291,605 | 2 |
| Without private mortgage insurance | 4,407 | - | 5,005 | - | 5,960 | - | 6,687 | - | 6,603 | - |
| Total 86% to 89% | 208,657 | 2 | 223,551 | 2 | 237,431 | 2 | 268,109 | 2 | 298,208 | 2 |
| 90% and above: | | | | | | | | | | |
| With private mortgage insurance | 257,801 | 2 | 281,334 | 2 | 300,546 | 2 | 341,158 | 2 | 380,351 | 3 |
| Without private mortgage insurance [(a)] | 25,277 | - | 24,948 | - | 25,569 | - | 26,405 | - | 26,491 | - |
| Total 90% and above | 283,078 | 2 | 306,282 | 2 | 326,115 | 2 | 367,563 | 2 | 406,842 | 3 |
| Not available | 3,229 | - | 3,295 | - | 3,593 | - | 3,645 | - | 3,707 | - |
| Total residential one-to-four units | $ 11,714,635 | 100 % | $ 12,404,020 | 100 % | $ 13,227,004 | 100 % | $ 14,183,205 | 100 % | $ 14,839,479 | 100 % |
| Weighted average loan-to-value ratio for loan investment portfolio of residential one-to-four units | | 72 | | 72 | | 72 | | 72 | | 72 |

[(a)] *Primarily related to Community Reinvestment Act activities.*

We continue to originate residential fixed interest rate mortgage loans to meet consumer demand, but we intend to sell the majority of these loans. We expect to sell some of our production of adjustable rate loans into the secondary market to the extent we can do so profitably. We sold $570 million of loans and mortgage-backed securities in the current quarter, down from $714 million in the first quarter of 2007 and $1.028 billion in the year-ago second quarter. All amounts were secured by residential one-to-four unit property, and at June 30, 2007, loans held for sale totaled $188 million.

In addition to single family loans, $15 million of other loans were originated in the current quarter, down from $17 million in the first quarter of 2007 and $49 million in the year-ago quarter.

At June 30, 2007, our unfunded loan application pipeline totaled $709 million. Within that pipeline, we had commitments to borrowers for short-term interest rate locks, before the reduction of expected fallout, of $292 million, of which $159 million were related to residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, at June 30, 2007, we had commitments for undrawn lines of credit of $276 million and loans in process of $41 million. We believe our current sources of funds will be adequate relative to these obligations.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| **Investment Portfolio** | | | | | |
| Loans originated: | | | | | |
| Loans secured by real estate: | | | | | |
| Residential one-to-four units: | | | | | |
| Adjustable | $ 339,637 | $ 260,893 | $ 313,226 | $ 473,072 | $ 729,413 |
| Adjustable fixed for 3-5 years | 359,030 | 342,005 | 241,347 | 290,397 | 392,126 |
| Fixed | 285 | - | - | - | - |
| Total residential one-to-four units | 698,952 | 602,898 | 554,573 | 763,469 | 1,121,539 |
| Home equity loans and lines of credit | 3,365 | 2,812 | 3,018 | 6,388 | 8,313 |
| Residential five or more units adjustable | 750 | 435 | - | 560 | 525 |
| Total residential | 703,067 | 606,145 | 557,591 | 770,417 | 1,130,377 |
| Commercial real estate | 1,350 | - | - | - | - |
| Construction | 2,187 | 12,897 | 1,730 | 7,516 | 4,458 |
| Land | 5,661 | - | 71 | 313 | 33,903 |
| Non-mortgage: | | | | | |
| Commercial | 500 | - | - | - | - |
| Consumer | 1,063 | 1,356 | 1,786 | 967 | 1,860 |
| Total loans originated | 713,828 | 620,398 | 561,178 | 779,213 | 1,170,598 |
| Residential one-to-four unit loans purchased | - | - | - | 1,277 | 8,176 |
| Total loans originated and purchased | 713,828 | 620,398 | 561,178 | 780,490 | 1,178,774 |
| Loan repayments | (1,489,999 ) | (1,560,187 ) | (1,661,536 ) | (1,563,517 ) | (1,596,002 ) |
| Other net changes [(a)] | 38,334 | 74,542 | 95,784 | 74,266 | 70,033 |
| Decrease in loans held for investment, net | (737,837 ) | (865,247 ) | (1,004,574 ) | (708,761 ) | (347,195 ) |

| **Sale Portfolio** | | | | | |
|---|---|---|---|---|---|
| Residential one-to-four unit loans: | | | | | |
| Originated | 494,045 | 631,268 | 778,519 | 823,656 | 890,191 |
| Purchased | 826 | 9,401 | 483 | 416 | 2,123 |
| Loans transferred to the investment portfolio [a] | (658 ) | (16,234 ) | (22,819 ) | (10,722 ) | (6,782 ) |
| Originated whole loans sold | (231,980 ) | (430,739 ) | (474,578 ) | (699,664 ) | (751,702 ) |
| Loans exchanged for mortgage-backed securities | (337,960 ) | (283,691 ) | (239,396 ) | (203,492 ) | (276,292 ) |
| Capitalized basis adjustment [b] | (1,266 ) | (754 ) | (270 ) | 815 | 1,254 |
| Other net changes [c] | (3,117 ) | (4,604 ) | (2,152 ) | (5,272 ) | (2,612 ) |
| Increase (decrease) in loans held for sale, net | (80,110 ) | (95,353 ) | 39,787 | (94,263 ) | (143,820 ) |
| Mortgage-backed securities, net: | | | | | |
| Received in exchange for loans | 337,960 | 283,691 | 239,396 | 203,492 | 276,292 |
| Sold | (337,960 ) | (283,691 ) | (239,396 ) | (203,492 ) | (276,292 ) |
| Repayments | (3 ) | (135 ) | (6 ) | (6 ) | (8 ) |
| Other net changes | - | 1 | - | - | - |
| Decrease in mortgage-backed securities available for sale | (3 ) | (134 ) | (6 ) | (6 ) | (8 ) |
| Increase (decrease) in loans held for sale and mortgage-backed securities available for sale | (80,113 ) | (95,487 ) | 39,781 | (94,269 ) | (143,828 ) |
| Total decrease in loans and mortgage-backed securities, net | $ (817,950 ) | $ (960,734 ) | $ (964,793 ) | $ (803,030 ) | $ (491,023 ) |

[a] *Primarily included changes in undisbursed funds for lines of credit and construction loans, in loss allowances, in net deferred costs and premiums, in interest capitalized on loans (negative amortization), and from loans transferred to real estate acquired in settlement of loans or from (to) the held for sale portfolio.*
[b] *Reflected the change in fair value of the interest rate lock derivative from the date of rate lock to the date of funding.*
[c] *Primarily included repayments and the change in net deferred costs and premiums.*



**Navigation Links**

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

| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|
| **Investment Portfolio** | | | | | |
| Loans secured by real estate: | | | | | |
| Residential one-to-four units: | | | | | |
| Adjustable | $ 9,750,788 | $ 10,715,218 | $ 11,786,038 | $ 12,896,352 | $ 13,774,904 |
| Adjustable fixed for 3-5 years | 1,916,107 | 1,639,381 | 1,397,516 | 1,240,644 | 1,017,059 |
| Fixed | 47,740 | 49,421 | 43,450 | 46,209 | 47,516 |
| Total residential one-to-four units | 11,714,635 | 12,404,020 | 13,227,004 | 14,183,205 | 14,839,479 |
| Home equity loans and lines of credit | 154,980 | 168,442 | 187,939 | 211,713 | 232,746 |
| Residential five or more units: | | | | | |
| Adjustable | 107,416 | 109,330 | 112,580 | 115,174 | 117,060 |
| Fixed | 886 | 898 | 908 | 936 | 1,040 |
| Commercial real estate: | | | | | |
| Adjustable | 24,092 | 23,580 | 23,943 | 24,117 | 24,254 |
| Fixed | 2,675 | 2,716 | 2,757 | 2,793 | 2,837 |
| Construction | 52,699 | 61,955 | 52,922 | 58,157 | 67,609 |
| Land | 64,262 | 58,795 | 58,910 | 59,394 | 59,682 |
| Non-mortgage: | | | | | |
| Commercial | 2,700 | 2,200 | 2,400 | 3,400 | 3,400 |
| Consumer | 6,346 | 6,143 | 6,778 | 6,073 | 6,303 |
| Total loans held for investment | 12,130,691 | 12,838,079 | 13,676,141 | 14,664,962 | 15,354,410 |
| Increase (decrease) for: | | | | | |
| Undisbursed loan funds | (42,486 ) | (43,709 ) | (40,208 ) | (48,635 ) | (58,390 ) |
| Net deferred costs and premiums | 185,102 | 208,425 | 232,294 | 256,315 | 275,797 |
| Allowance for losses | (69,107 ) | (60,758 ) | (60,943 ) | (60,784 ) | (51,198 ) |
| Total loans held for investment, net | 12,204,200 | 12,942,037 | 13,807,284 | 14,811,858 | 15,520,619 |
| **Sale Portfolio** | | | | | |
| Loans held for sale: | | | | | |
| Residential one-to-four units | 189,189 | 266,162 | 358,128 | 318,414 | 411,086 |
| Net deferred costs and premiums | 285 | 2,156 | 4,789 | 4,445 | 6,851 |
| Capitalized basis adjustment [(a)] | (1,722 ) | (456 ) | 298 | 569 | (246 ) |
| Total loans held for sale, net | 187,752 | 267,862 | 363,215 | 323,428 | 417,691 |
| Mortgage-backed securities available for sale: | | | | | |
| Adjustable | 114 | 117 | 251 | 257 | 263 |
| Fixed | - | - | - | - | - |

| | | | | | |
|---|---|---|---|---|---|
| Total mortgage-backed securities available for sale | 114 | 117 | 251 | 257 | 263 |
| Total loans held for sale and mortgage-backed securities available for sale | 187,866 | 267,979 | 363,466 | 323,685 | 417,954 |
| Total loans and mortgage-backed securities, net | $ 12,392,066 | $ 13,210,016 | $ 14,170,750 | $ 15,135,543 | $ 15,938,573 |

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

We carry loans for sale at the lower of cost or fair value. At June 30, 2007, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

We carry mortgage-backed securities available for sale at fair value which, at June 30, 2007, was essentially equal to our cost basis.

**Investment Securities**

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

| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|
| Federal funds | $ - | $ - | $ 1 | $ 1 | $ 2 |
| Investment securities available for sale: | | | | | |
| U.S. Treasury | - | - | - | - | - |
| Government sponsored entities | 1,917,541 | 1,411,196 | 1,433,113 | 1,162,551 | 892,109 |
| Other | 62 | 62 | 63 | 63 | 63 |
| Total investment securities | $ 1,917,603 | $ 1,411,258 | $ 1,433,177 | $ 1,162,615 | $ 892,174 |

The fair value of temporarily impaired investment securities, the amount of unrealized losses and the length of time these unrealized losses existed as of June 30, 2007 are presented in the following table. The $6.3 million unrealized loss on investment securities that have been in a loss position for less than 12 months and the $4.5 million unrealized loss on investment securities that have been in a loss position for more than 12 months are due to changes in market interest rates and are not considered to be other than temporary. We have the intent and ability to hold the securities 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* |
| Investment securities available for sale: | | | | | | |
| U.S. Treasury | $ - | $ - | $ - | $ - | $ - | $ - |
| Government sponsored entities | 1,318,707 | 6,273 | 598,834 | 4,532 | 1,917,541 | 10,805 |
| Other | - | - | - | - | - | - |
| Total temporarily impaired securities | $ 1,318,707 | $ 6,273 | $ 598,834 | $ 4,532 | $ 1,917,541 | $ 10,805 |

The following table sets forth the maturities of our investment securities and their weighted average yields at June 30, 2007.

| | *Amount Due as of June 30, 2007* | | | | |
|---|---|---|---|---|---|
| *(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 | - % | - % | - % | - % | - % |
| Investment securities available for sale: | | | | | |
| U.S. Treasury | - | - | - | - | - |

| | | | | | |
|---|---|---|---|---|---|
| Weighted average yield | - % | - % | - % | - % | - % |
| Government sponsored entities [(a)] | 31,601 | 1,305,973 | 579,967 | - | 1,917,541 |
| Weighted average yield | 5.00 % | 5.58 % | 5.36 % | - % | 5.50 % |
| Other | - | - | - | 62 | 62 |
| Weighted average yield | - % | - % | - % | 6.25 % | 6.25 % |
| Total investment securities | $ 31,601 | $ 1,305,973 | $ 579,967 | $ 62 | $ 1,917,603 |
| Weighted average yield | 5.00 % | 5.58 % | 5.36 % | 6.25 % | 5.50 % |

[(a)] *At June 30, 2007, 21% of our investment securities had step-up provisions that stipulate increases in the coupon rate ranging from 0.50% to 2.00% at various specified dates ranging from August 2007 to December 2012. In addition, at June 30, 2007, all of these investment securities contained call provisions from June 2007 to August 2015. Yields for investment 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.*

**Deposits**

At June 30, 2007, our deposits totaled $11.2 billion, down $641 million or 5.4% from the year-ago level and $538 million or 4.6% from year-end 2006. Compared with the year-ago period, our transaction accounts (*i.e.,* checking, money market and regular passbook) declined $359 million or 12.4% due primarily to a decline of $333 million in regular passbook accounts. Checking accounts declined by $4 million or 0.3% from a year ago. Certificates of deposit declined $282 million or 3.1%.

During the current quarter, one in-store branch was closed due to the closure of the store in which it was located. This brings our total number of branches to 172, of which four were located in Arizona, with the remainder in California. At June 30, 2007, the average deposit size of our 82 traditional branches was $108 million, while the average deposit size of our 90 in-store branches was $26 million.

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

| | *June 30, 2007* | | *March 31, 2007* | | *December 31, 2006* | | *September 30, 2006* | | *June 30, 2006* | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *Weighted Average Rate* | *Amount* | *Weighted Average Rate* | *Amount* | *Weighted Average Rate* | *Amount* | *Weighted Average Rate* | *Amount* | *Weighted Average Rate* | *Amount* |
| Transaction accounts: | | | | | | | | | | |
| Non-interest-bearing checking | - % | $ 767,694 | - % | $ 831,708 | - % | $ 769,086 | - % | $ 776,696 | - % | $ 751,446 |
| Interest-bearing checking [(a)] | 0.27 | 476,884 | 0.28 | 505,975 | 0.28 | 493,620 | 0.28 | 486,226 | 0.29 | 497,313 |
| Money market | 1.04 | 140,143 | 1.05 | 153,291 | 1.04 | 148,448 | 1.04 | 147,812 | 1.05 | 162,213 |
| Regular passbook | 0.95 | 1,151,308 | 0.95 | 1,227,664 | 0.97 | 1,269,420 | 0.98 | 1,355,595 | 1.00 | 1,483,890 |
| Total transaction accounts | 0.54 | 2,536,029 | 0.54 | 2,718,638 | 0.57 | 2,680,574 | 0.58 | 2,766,329 | 0.62 | 2,894,862 |
| Certificates of deposit: | | | | | | | | | | |
| Less than 2.00% | 1.29 | 20,875 | 1.30 | 24,106 | 1.29 | 22,566 | 1.28 | 22,484 | 1.31 | 29,690 |
| 2.00-2.49 | 2.27 | 322 | 2.29 | 686 | 2.29 | 686 | 2.46 | 11,567 | 2.37 | 24,559 |
| 2.50-2.99 | 2.83 | 8,586 | 2.80 | 11,062 | 2.80 | 25,375 | 2.84 | 51,185 | 2.87 | 92,839 |
| 3.00-3.49 | 3.29 | 96,880 | 3.29 | 99,309 | 3.30 | 128,294 | 3.27 | 153,871 | 3.28 | 176,414 |
| 3.50-3.99 | 3.87 | 86,557 | 3.89 | 144,544 | 3.89 | 237,155 | 3.87 | 267,610 | 3.89 | 1,190,947 |
| 4.00-4.49 | 4.26 | 240,373 | 4.25 | 271,609 | 4.31 | 692,386 | 4.26 | 1,574,479 | 4.24 | 3,765,400 |
| 4.50-4.99 | 4.91 | 4,615,314 | 4.90 | 4,235,873 | 4.82 | 2,722,829 | 4.74 | 3,340,812 | 4.72 | 3,408,252 |
| 5.00-5.49 | 5.15 | 3,391,831 | 5.17 | 3,871,787 | 5.19 | 5,008,378 | 5.20 | 3,514,530 | 5.08 | 304,776 |
| 5.50 and greater | 5.55 | 250,039 | 5.55 | 269,817 | 5.54 | 266,626 | 5.54 | 242,891 | - | - |
| Total certificates of deposit | 4.96 | 8,710,777 | 4.97 | 8,928,793 | 4.94 | 9,104,295 | 4.78 | 9,179,429 | 4.36 | 8,992,877 |
| Total deposits | 3.97 % | $ 11,246,806 | 3.94 % | $ 11,647,431 | 3.95 % | $ 11,784,869 | 3.81 % | $ 11,945,758 | 3.45 % | $ 11,887,739 |

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

**Borrowings**

At June 30, 2007, our borrowings totaled $1.9 billion, down $2.1 billion from a year ago and $919 million from year-end 2006. At quarter end, we had borrowed funds through transactions in which securities are sold under agreements to repurchase that totaled $588 million. These repurchase agreements are entered into with selected major securities dealers, using securities of government sponsored entities from our portfolio as collateral.

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

| *(Dollars in Thousands)* | *June 30,* 2007 | *March 31,* 2007 | *December 31,* 2006 | *September 30,* 2006 | *June 30,* 2006 |
|---|---|---|---|---|---|
| Securities sold under agreements to repurchase | $ 587,544 | $ 546,870 | $ 469,971 | $ 463,678 | $ 255,042 |
| Federal Home Loan Bank advances [(a)] | 1,104,373 | 1,298,197 | 2,140,785 | 2,680,546 | 3,499,450 |
| Senior notes | 198,351 | 198,305 | 198,260 | 198,216 | 198,172 |
| Total borrowings | $ 1,890,268 | $ 2,043,372 | $ 2,809,016 | $ 3,342,440 | $ 3,952,664 |
| Weighted average rate on borrowings during the quarter [(a)] | 6.00 % | 5.86 % | 5.77 % | 5.71 % | 5.33 % |
| Total borrowings as a percentage of total assets | 12.68 | 13.41 | 17.33 | 19.68 | 22.63 |

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

**Off-Balance Sheet Arrangements**

We consolidate majority-owned subsidiaries that we control. We account for other affiliates, including joint ventures, in which we do not exhibit significant control or have majority ownership, by the equity method of accounting. For those relationships in which we own less than 20%, we generally carry 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).

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, commitments to purchase loans and mortgage-backed securities for our portfolio and commitments to invest in community development funds. The contract or notional amounts of these instruments reflect the extent of involvement we have in particular classes of financial instruments. For further information, see Asset/Liability Management and Market Risk on page 42 and Note 3 of Notes to the Consolidated Financial Statements on page 9.

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 significant 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.



**Navigation Links**

**Asset/Liability Management and Market Risk**

Market risk is the risk of loss or reduced earnings 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 and frequency 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 in managing interest rate risk is to emphasize the origination for investment of adjustable rate mortgage loans or loans with relatively short maturities. Interest rates on adjustable rate mortgage loans 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 mortgage loans, 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 the use of loan 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 derivative 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. Over time, we may use derivatives or securities to provide an economic hedge against value changes in our MSRs.

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 June 30, 2007, as well as other information regarding the repricing and maturity differences between our interest-earning assets and total deposits and borrowings in future periods. We refer to these differences as gap. We have determined the repricing frequencies by reference to projected maturities, based upon contractual maturities as adjusted for scheduled repayments and repricing mechanisms provisions for changes in the interest and dividend rates of assets and liabilities. We assume prepayment rates on substantially our entire loan portfolio based upon our historical loan prepayment experience to anticipate 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 may not 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.

| | *June 30, 2007* | | | | | |
|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *Within 6 Months* | *After 6 Months Through 12 Months* | *After 1 Year Through 5 Years* | *After 5 Years Through 10 Years* | *Beyond 10 Years* | *Total Balance* |
| Interest-earning assets: | | | | | | |
| Investment securities and stock [(a)] | $ 189,981 | $ 202,621 | $ 1,597,430 | $ - | $ - | $ 1,990,032 |
| Loans and mortgage-backed securities, net: [(b)] | | | | | | |
| Loans secured by real estate: | | | | | | |
| Residential one-to-four units: | | | | | | |
| Adjustable | 10,304,692 | 385,762 | 1,153,344 | - | - | 11,843,798 |
| Fixed | 136,810 | 3,430 | 19,873 | 12,292 | 8,350 | 180,755 |
| Home equity loans and lines of credit | 153,304 | 90 | 563 | 180 | - | 154,137 |
| Residential five or more units: | | | | | | |
| Adjustable | 68,700 | 16,264 | 8,118 | - | - | 93,082 |
| Fixed | 99 | 93 | 455 | 190 | 42 | 879 |
| Commercial real estate | 18,196 | 3,735 | 3,798 | 14 | - | 25,743 |
| Construction | 34,111 | - | - | - | - | 34,111 |
| Land | 52,316 | - | - | - | - | 52,316 |
| Non-mortgage loans: | | | | | | |
| Commercial | 1,087 | - | - | - | - | 1,087 |
| Consumer | 6,038 | 6 | - | - | - | 6,044 |
| Mortgage-backed securities | 114 | - | - | - | - | 114 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total loans and mortgage-backed securities, net | 10,775,467 | 409,380 | 1,186,151 | 12,676 | 8,392 | 12,392,066 |
| Total interest-earning assets | $ 10,965,448 | $ 612,001 | $ 2,783,581 | $ 12,676 | $ 8,392 | $ 14,382,098 |
| Transaction accounts: | | | | | | |
| Non-interest-bearing checking | $ 767,694 | $ - | $ - | $ - | $ - | $ 767,694 |
| Interest-bearing checking [c] | 476,884 | - | - | - | - | 476,884 |
| Money market [d] | 140,143 | - | - | - | - | 140,143 |
| Regular passbook [d] | 1,151,308 | - | - | - | - | 1,151,308 |
| Total transaction accounts | 2,536,029 | - | - | - | - | 2,536,029 |
| Certificates of deposit [e] | 6,690,594 | 1,660,317 | 359,866 | - | - | 8,710,777 |
| Total deposits | 9,226,623 | 1,660,317 | 359,866 | - | - | 11,246,806 |
| FHLB advances and other borrowings | 1,273,544 | - | 418,373 | - | - | 1,691,917 |
| Senior notes | - | - | - | 198,351 | - | 198,351 |
| Impact of swap contracts hedging borrowings | 430,000 | - | (430,000 ) | - | - | - |
| Total deposits and borrowings | $ 10,930,167 | $ 1,660,317 | $ 348,239 | $ 198,351 | $ - | $ 13,137,074 |
| Excess (shortfall) of interest-earning assets | | | | | | |
| over deposits and borrowings | $ 35,281 | $ (1,048,316 ) | $ 2,435,342 | $ (185,675 ) | $ 8,392 | $ 1,245,024 |
| Cumulative gap | 35,281 | (1,013,035 ) | 1,422,307 | 1,236,632 | 1,245,024 | |
| Cumulative gap as a percentage of total assets: | | | | | | |
| June 30, 2007 | 0.24 % | (6.80 )% | 9.54 % | 8.30 % | 8.35 % | |
| December 31, 2006 | 10.86 | 0.92 | 8.29 | 7.14 | 7.18 | |
| June 30, 2006 | 16.02 | 5.45 | 7.74 | 6.68 | 6.73 | |

[(a)] *Includes FHLB stock and is based on contractual maturity and repricing date.*
[(b)] *Based on 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 on contractual maturity and repricing date.*



**Navigation Links**

Our six-month gap at June 30, 2007 was a positive 0.24%. This means more interest-earning assets mature or reprice within six months than total deposits and borrowings. This compares to our positive six-month gap of 10.86% at December 31, 2006 and 16.02% a year ago, which reflected a larger repricing mismatch between interest-earning assets and deposits and borrowings.

We continue to emphasize the origination of adjustable rate mortgages for our investment portfolio. For the twelve months ended June 30, 2007, we originated and purchased for investment $2.7 billion of adjustable rate loans which represented essentially all of the loans we originated and purchased for investment during the period.

At June 30, 2007, December 31, 2006 and June 30, 2006 essentially all of our interest-earning assets mature, reprice or are estimated to prepay within five years. Essentially all of our loans held for investment and mortgage-backed securities portfolios consisted of adjustable rate loans and loans with a due date of five years or less, and totaled $12.1 billion at June 30, 2007, compared with $13.6 billion at December 31, 2006 and $15.3 billion a year ago. During the current quarter, we continued to offer residential fixed rate loan products to our customers primarily for sale in the secondary market. We originate fixed rate loans primarily for sale in the secondary market and price them accordingly to create loan servicing income and to increase opportunities for originating adjustable rate mortgage loans. However, we may originate fixed rate loans for investment if these loans meet specific yield, interest rate risk and other approved guidelines, or to facilitate the sale of real estate acquired through foreclosure.

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

| | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|
| Weighted average yield: (a) | | | | | |
| Loans and mortgage-backed securities | 7.49 % | 7.61 % | 7.59 % | 7.38 % | 6.99 % |
| Investment securities (b) | 5.45 | 5.37 | 5.38 | 5.26 | 4.97 |
| Interest-earning assets yield | 7.22 | 7.40 | 7.38 | 7.22 | 6.88 |
| Weighted average cost: | | | | | |
| Deposits | 3.97 | 3.94 | 3.95 | 3.81 | 3.45 |
| Borrowings: | | | | | |
| Securities sold under agreements to repurchase | 5.30 | 5.29 | 5.30 | 5.27 | 5.30 |
| Federal Home Loan Bank advances (c) | 6.28 | 6.15 | 5.87 | 5.75 | 5.57 |
| Senior notes | 6.50 | 6.50 | 6.50 | 6.50 | 6.50 |
| Total borrowings | 6.00 | 5.95 | 5.82 | 5.73 | 5.60 |
| Combined funds cost | 4.26 | 4.24 | 4.31 | 4.23 | 3.99 |
| Interest rate spread | 2.96 % | 3.16 % | 3.07 % | 2.99 % | 2.89 % |

*(a) Excludes adjustments for non-accrual loans, amortization of net deferred costs to originate loans, premiums and discounts, prepayment and late fees and FHLB stock dividends.*
*(b) Includes the yield on investment securities accounted for on a trade-date basis but for which interest income will not be recognized until settlement. Yields for investment 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.*
*(c) Included the impact of interest rate swap contracts, with notional amounts totaling $430 million of receive-fixed, pay-3-month LIBOR variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.*

The period-end weighted average yield on our loans and mortgage-backed securities was 7.49% at June 30, 2007, down from 7.59% at December 31, 2006 but up from 6.99% a year ago. At June 30, 2007, our adjustable rate mortgage portfolio of single family residential loans, including mortgage-backed securities, totaled $11.7 billion with a weighted average rate of 7.47%, compared with $13.5 billion with a weighted average rate of 7.56% at December 31, 2006, and $15.2 billion with a weighted average rate of 6.94% at June 30, 2006.

**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 and real estate acquired in settlement of loans. Our non-performing assets totaled $227 million at June 30, 2007, up from $110 million at December 31, 2006 and $39 million at June 30, 2006. The increase in our non-performing assets during the current quarter was primarily due to an increase in our residential one-to-four unit category of $76 million and a $7 million construction loan to build single family homes on which no significant loss is expected at this time. The non-performing land category consists of a single loan to develop residential lots. While this loan is deemed collateral dependent and value impaired, no significant loss is anticipated at this time. Of the total non-performing assets, real estate acquired in settlement of loans represented $30 million at June 30, 2007, up from $9 million at December 31, 2006 and up from $1 million at June 30, 2006. Our non-performing assets as a percentage of total assets was 1.53% at June 30, 2007, up from 0.68% at year-end 2006 and 0.23% at June 30, 2006.

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

| *(Dollars in Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|
| Non-accrual loans: | | | | | |
| Residential one-to-four units | $ 178,504 | $ 114,833 | $ 90,218 | $ 60,461 | $ 38,074 |
| Construction | 7,067 | - | - | - | - |
| Land | 11,345 | 11,345 | 11,345 | - | - |
| Other | 525 | 28 | 275 | 306 | - |
| Total non-accrual loans | 197,441 | 126,206 | 101,838 | 60,767 | 38,074 |
| Real estate acquired in settlement of loans | 29,925 | 17,212 | 8,524 | 5,761 | 1,254 |
| Total non-performing assets | $ 227,366 | $ 143,418 | $ 110,362 | $ 66,528 | $ 39,328 |
| Allowance for loan losses: | | | | | |
| Amount | $ 69,107 | $ 60,758 | $ 60,943 | $ 60,784 | $ 51,198 |
| As a percentage of non-accrual loans | 35.00 % | 48.14 % | 59.84 % | 100.03 % | 134.47 % |
| Non-performing assets as a percentage of total assets | 1.53 | 0.94 | 0.68 | 0.39 | 0.23 |

At June 30, 2007, $32 million of our non-performing assets were located outside of California, compared with $10 million a year ago.

***Delinquent Loans***

At June 30, 2007, loans delinquent 30 days or more as a percentage of total loans was 2.11%, up from 1.03% at December 31, 2006 and 0.41% at June 30, 2006. The increase from the prior year-ago quarter occurred primarily in our residential one-to-four unit and land loan classifications. As a percentage of its loan category, delinquent residential one-to-four units increased from 0.41% at June 30, 2006 and 1.05% at December 31, 2006 to 2.08% at June 30, 2007, reflecting the continued weakness in the California residential real estate market. Additionally, a higher incidence of delinquency is expected when the minimum payments on our option ARM and hybrid ARM loans reset, particularly when our option ARM loans reach their maximum loan balance permitted under the terms of the loan. Our land delinquency category consists of a single loan to develop residential lots. While this loan is deemed collateral dependent and value impaired, no significant loss is anticipated at this time. These increases in delinquency are considered when we analyze the adequacy of our loan loss allowance.

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

| | *June 30, 2007* | | | | *March 31, 2007* | | | |
|---|---|---|---|---|---|---|---|---|
| *llars in Thousands)* | *30-59 Days* | *60-89 Days* | *90+ Days* [(a)] | *Total* | *30-59 Days* | *60-89 Days* | *90+ Days* [(a)] | *Total* |
| ns secured by real estate: | | | | | | | | |
| idential: | | | | | | | | |
| ne-to-four units | $ 77,332 | $ 57,065 | $ 113,413 | $ 247,810 | $ 47,770 | $ 31,510 | $ 82,091 | $ 161,371 |
| ome equity loans and lines of credit | 177 | - | 463 | 640 | 256 | 32 | 15 | 303 |
| ve or more units | - | - | - | - | - | - | - | - |
| nmercial real estate | - | - | - | - | - | - | - | - |
| nstruction | - | - | - | - | - | - | - | - |
| d | - | - | 11,345 | 11,345 | - | - | 11,345 | 11,345 |
| tal real estate loans | 77,509 | 57,065 | 125,221 | 259,795 | 48,026 | 31,542 | 93,451 | 173,019 |
| -mortgage: | | | | | | | | |
| nmercial | - | - | - | - | - | - | - | - |
| nsumer | 18 | 11 | 62 | 91 | 6 | 50 | 13 | 69 |
| tal delinquent loans | $ 77,527 | $ 57,076 | $ 125,283 | $ 259,886 | $ 48,032 | $ 31,592 | $ 93,464 | $ 173,088 |
| nquencies as a percentage of total s | 0.63 % | 0.46 % | 1.02 % | 2.11 % | 0.37 % | 0.24 % | 0.71 % | 1.32 % |

| | *December 31, 2006* | | | | *September 30, 2006* | | | |
|---|---|---|---|---|---|---|---|---|
| ns secured by real estate: | | | | | | | | |
| idential: | | | | | | | | |
| ne-to-four units | $ 56,962 | $ 24,100 | $ 62,887 | $ 143,949 | $ 42,522 | $ 20,872 | $ 37,214 | $ 100,608 |
| ome equity loans and lines of credit | 20 | 212 | 259 | 491 | - | 173 | 297 | 470 |
| ve or more units | - | - | - | - | - | - | - | - |
| nmercial real estate | - | - | - | - | - | - | - | - |
| nstruction | - | - | - | - | - | - | - | - |
| d | - | - | - | - | - | - | - | - |
| tal real estate loans | 56,982 | 24,312 | 63,146 | 144,440 | 42,522 | 21,045 | 37,511 | 101,078 |
| -mortgage: | | | | | | | | |
| nmercial | - | - | - | - | - | - | - | - |
| nsumer | 60 | 1 | 16 | 77 | 63 | 10 | 9 | 82 |
| tal delinquent loans | $ 57,042 | $ 24,313 | $ 63,162 | $ 144,517 | $ 42,585 | $ 21,055 | $ 37,520 | $ 101,160 |
| | 0.41 % | 0.17 % | 0.45 % | 1.03 % | 0.28 % | 0.14 % | 0.25 % | 0.68 % |

| nquencies as a percentage of total s | | | | |
|---|---|---|---|---|

| | June 30, 2006 | | | |
|---|---|---|---|---|
| ns secured by real estate: | | | | |
| idential: | | | | |
| ne-to-four units | $ 28,007 | $ 11,877 | $ 23,879 | $ 63,763 |
| ome equity loans and lines of credit | 400 | - | - | 400 |
| ve or more units | - | - | - | - |
| nmercial real estate | - | - | - | - |
| nstruction | - | - | - | - |
| d | - | - | - | - |
| tal real estate loans | 28,407 | 11,877 | 23,879 | 64,163 |
| -mortgage: | | | | |
| nmercial | - | - | - | - |
| nsumer | 13 | 31 | - | 44 |
| tal delinquent loans | $ 28,420 | $ 11,908 | $ 23,879 | $ 64,207 |
| nquencies as a percentage of total s | 0.18 % | 0.08 % | 0.15 % | 0.41 % |

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

***Allowance for Credit and Real Estate Losses***

We maintain a valuation allowance for credit and real estate losses to provide for losses inherent in those portfolios. The allowance for credit losses includes an allowance for loan losses reported as a reduction of loans held for investment and the allowance for loan-related commitments reported in accounts payable and accrued liabilities. Management evaluates the adequacy of the allowance quarterly to maintain the allowance at levels sufficient to provide for inherent losses at the balance sheet date.

We use an internal asset review system and loss allowance methodology designed to provide for timely recognition of problem assets and an adequate allowance to cover asset and loan-related commitment losses. The amount of the allowance is based upon the total of general valuation allowances, allocated allowances and an unallocated allowance. General valuation allowances relate to assets and loan-related commitments with no well-defined deficiency or weakness and take into consideration losses that are imbedded within the portfolio but have not yet been realized. Allocated allowances relate to assets with well-defined deficiencies or weaknesses. If we determine the carrying value of our asset exceeds the net fair value and no alternative payment source exists, then a specific allowance is recorded for the amount of that difference. The previously reported unallocated allowance of $2.8 million that was more subjective and took into consideration estimation errors and economic trends is now taken into account in the general valuation allowance for residential one-to-four unit loans. Prior periods were reclassified for conformity.

Provision for credit losses totaled $9.5 million in the second quarter of 2007, compared with $6.7 million a year ago. The California residential real estate market continued to show signs of weakening, with a decline in prices and an increase in loan defaults. This unfavorable trend was coupled with a shift in the yield curve which increases the probability of certain borrowers to default by adversely affecting their ability to refinance due to higher mortgage loan rates. In addition, capitalized interest balances continued to increase on negative amortizing loans. If this tendency continues, certain borrowers may reach their limit of negative amortization permitted under the terms of their loan, thereby resulting in an increase in their minimum monthly loan payment and the potential for higher delinquencies. In consideration of these trends, an increase in the allowance for loan losses was deemed appropriate. The allowance increased $8.5 million in the current quarter, reflecting a decrease of $5.6 million in the general valuation allowance and an increase of $14.1 million in the allocated allowance. At June 30, 2007, the allowance for credit losses was $70 million, comprised of $69 million for loan losses and $1 million for unfunded loan commitments. That compares to an allowance for credit losses of $62 million at year-end 2006, comprised of $61 million for loan losses and $1 million for loan-related commitments. Unfunded loan commitments are reported on the balance sheet in the category accounts payable and accrued liabilities.

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

| | *Three Months Ended* | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| **Allowance for loan losses** | | | | | |
| Balance at beginning of period | $ 60,758 | $ 60,943 | $ 60,784 | $ 51,198 | $ 44,504 |
| Provision | 9,379 | 507 | 411 | 9,777 | 6,701 |
| Charge-offs | (1,133 ) | (843 ) | (376 ) | (197 ) | (12 ) |
| Recoveries | 103 | 151 | 124 | 6 | 5 |
| Balance at end of period | $ 69,107 | $ 60,758 | $ 60,943 | $ 60,784 | $ 51,198 |
| **Allowance for loan-related commitments** | | | | | |
| Balance at beginning of period | $ 1,165 | $ 1,055 | $ 1,221 | $ 1,358 | $ 1,397 |
| Provision (reduction) | 126 | 110 | (166 ) | (137 ) | (39 ) |
| Balance at end of period | $ 1,291 | $ 1,165 | $ 1,055 | $ 1,221 | $ 1,358 |

| **Total allowance for credit losses** | | | | | |
|---|---|---|---|---|---|
| Balance at beginning of period | $ 61,923 | $ 61,998 | $ 62,005 | $ 52,556 | $ 45,901 |
| Provision | 9,505 | 617 | 245 | 9,640 | 6,662 |
| Charge-offs | (1,133 ) | (843 ) | (376 ) | (197 ) | (12 ) |
| Recoveries | 103 | 151 | 124 | 6 | 5 |
| Balance at end of period | $ 70,398 | $ 61,923 | $ 61,998 | $ 62,005 | $ 52,556 |



Navigation Links

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

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| **Allowance for loan losses** | | |
| Balance at beginning of period | $ 60,943 | $ 34,601 |
| Provision | 9,886 | 16,675 |
| Charge-offs | (1,976 ) | (88 ) |
| Recoveries | 254 | 10 |
| Balance at end of period | $ 69,107 | $ 51,198 |
| **Allowance for loan-related commitments** | | |
| Balance at beginning of period | $ 1,055 | $ 1,314 |
| Provision | 236 | 44 |
| Balance at end of period | $ 1,291 | $ 1,358 |
| **Total allowance for credit losses** | | |
| Balance at beginning of period | $ 61,998 | $ 35,915 |
| Provision | 10,122 | 16,719 |
| Charge-offs | (1,976 ) | (88 ) |
| Recoveries | 254 | 10 |
| Balance at end of period | $ 70,398 | $ 52,556 |

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

| | *Three Months Ended* | | | | | *Six Months Ended* | |
|---|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* | *June 30, 2007* | *2006* |
| **Gross loan charge-offs** | | | | | | | |
| Loans secured by real estate: | | | | | | | |
| Residential: | | | | | | | |
| One-to-four units | $ 1,097 | $ 823 | $ 358 | $ 166 | $ - | $ 1,920 | $ 25 |
| Home equity loans and lines of credit | - | - | - | - | - | - | - |
| Five or more units | - | - | - | - | - | - | - |
| Commercial real estate | - | - | - | - | - | - | - |
| Construction | 20 | - | - | - | - | 20 | - |
| Land | - | - | - | - | - | - | - |
| Non-mortgage: | | | | | | | |
| Commercial | - | - | - | - | - | - | - |
| Consumer | 16 | 20 | 18 | 31 | 12 | 36 | 63 |
| Total gross loan charge-offs | 1,133 | 843 | 376 | 197 | 12 | 1,976 | 88 |
| **Gross loan recoveries** | | | | | | | |
| Loans secured by real estate: | | | | | | | |
| Residential: | | | | | | | |
| One-to-four units | 101 | 150 | 120 | - | - | 251 | - |
| Home equity loans and lines of credit | - | - | - | - | - | - | - |
| Five or more units | - | - | - | - | - | - | - |
| Commercial real estate | - | - | - | - | - | - | - |
| Construction | - | - | - | - | - | - | - |
| Land | - | - | - | - | - | - | - |
| Non-mortgage: | | | | | | | |
| Commercial | - | - | - | - | - | - | - |
| Consumer | 2 | 1 | 4 | 6 | 5 | 3 | 10 |
| Total gross loan recoveries | 103 | 151 | 124 | 6 | 5 | 254 | 10 |
| **Net loan charge-offs (recoveries)** | | | | | | | |
| Loans secured by real estate: | | | | | | | |
| Residential: | | | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| One-to-four units | 996 | 673 | 238 | 166 | - | 1,669 | 25 |
| Home equity loans and lines | | | | | | | |
| of credit | - | - | - | - | - | - | - |
| Five or more units | - | - | - | - | - | - | - |
| Commercial real estate | - | - | - | - | - | - | - |
| Construction | 20 | - | - | - | - | 20 | - |
| Land | - | - | - | - | - | - | - |
| Non-mortgage: | | | | | | | |
| Commercial | - | - | - | - | - | - | - |
| Consumer | 14 | 19 | 14 | 25 | 7 | 33 | 53 |
| Total net loan charge-offs | $ 1,030 | $ 692 | $ 252 | $ 191 | $ 7 | $ 1,722 | $ 78 |
| Net loan charge-offs | | | | | | | |
| as a percentage of average loans | 0.03 % | 0.02 % | 0.01 % | - % | - % | 0.03 % | - % |



Navigation Links

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

| *(Dollars in Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | $ 64,700 | $ 56,731 | $ 56,718 | $ 56,718 | $ 47,318 |
| Home equity loans and lines of credit | 843 | 857 | 999 | 1,124 | 1,192 |
| Five or more units | 992 | 1,006 | 1,030 | 1,049 | 1,064 |
| Commercial real estate | 301 | 266 | 267 | 302 | 304 |
| Construction | 860 | 574 | 581 | 454 | 455 |
| Land | 1,098 | 1,025 | 1,016 | 838 | 570 |
| Non-mortgage: | | | | | |
| Commercial | 11 | 11 | 14 | 14 | 14 |
| Consumer | 302 | 288 | 318 | 285 | 281 |
| Total for loans held for investment | $ 69,107 | $ 60,758 | $ 60,943 | $ 60,784 | $ 51,198 |

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

| *(Dollars in Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | 0.55 % | 0.46 % | 0.43 % | 0.40 % | 0.32 % |
| Home equity loans and lines of credit | 0.54 | 0.51 | 0.53 | 0.53 | 0.51 |
| Five or more units | 0.92 | 0.91 | 0.91 | 0.90 | 0.90 |
| Commercial real estate | 1.12 | 1.01 | 1.00 | 1.12 | 1.12 |
| Construction | 1.63 | 0.93 | 1.10 | 0.78 | 0.67 |
| Land | 1.71 | 1.74 | 1.72 | 1.41 | 0.96 |
| Non-mortgage: | | | | | |
| Commercial | 0.41 | 0.50 | 0.58 | 0.41 | 0.41 |
| Consumer | 4.76 | 4.69 | 4.70 | 4.69 | 4.46 |
| Total for loans held for investment | 0.57 % | 0.47 % | 0.45 % | 0.41 % | 0.33 % |

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

| *(Dollars in Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| Loans secured by real estate: | | | | | |
| Residential: | | | | | |
| One-to-four units | 96.57 % | 96.62 % | 96.71 % | 96.72 % | 96.65 % |
| Home equity loans and lines of credit | 1.28 | 1.31 | 1.37 | 1.44 | 1.51 |
| Five or more units | 0.89 | 0.86 | 0.83 | 0.79 | 0.77 |
| Commercial real estate | 0.22 | 0.20 | 0.20 | 0.18 | 0.18 |
| Construction | 0.44 | 0.48 | 0.39 | 0.40 | 0.44 |
| Land | 0.53 | 0.46 | 0.43 | 0.41 | 0.39 |
| Non-mortgage: | | | | | |
| Commercial | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 |
| Consumer | 0.05 | 0.05 | 0.05 | 0.04 | 0.04 |
| Total for loans held for investment | 100.00 % | 100.00 % | 100.00 % | 100.00 % | 100.00 % |

At June 30, 2007, the recorded investment in loans for which we recognized impairment totaled $19 million, up from $11 million at December 31, 2006 and no loans at June 30, 2006. The allowance for losses related to these loans was $1 million at June 30, 2007 and less than $1 million at December 31, 2006, with no allowance for losses at June 30, 2006. During the current quarter there was no interest recognized from the impaired loan portfolio.



**Navigation Links**

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

| | Three Months Ended | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Balance at beginning of period | $ 657 | $ 601 | $ - | $ - | $ - |
| Provision | 581 | 603 | 601 | - | - |
| Charge-offs | - | (547 ) | - | - | - |
| Recoveries | - | - | - | - | - |
| Balance at end of period | $ 1,238 | $ 657 | $ 601 | $ - | $ - |

The following table summarizes the activity in our allowance for credit losses associated with impaired loans for the year-to-date periods indicated.

| | Six Months Ended June 30, | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Balance at beginning of period | $ 601 | $ - |
| Provision | 1,184 | - |
| Charge-offs | (547 ) | - |
| Recoveries | - | - |
| Balance at end of period | $ 1,238 | $ - |

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

| | Three Months Ended | | | | |
|---|---|---|---|---|---|
| *(In Thousands)* | *June 30, 2007* | *March 31, 2007* | *December 31, 2006* | *September 30, 2006* | *June 30, 2006* |
| Balance at beginning of period | $ 103 | $ 103 | $ 103 | $ 103 | $ 103 |
| Provision | 353 | - | - | - | - |
| Charge-offs | - | - | - | - | - |
| Recoveries | - | - | - | - | - |
| Balance at end of period | $ 456 | $ 103 | $ 103 | $ 103 | $ 103 |

The following table summarizes the activity in our allowance for real estate and joint ventures held for investment for the year-to-date periods indicated.

| | *Six Months Ended June 30,* | |
|---|---|---|
| *(In Thousands)* | *2007* | *2006* |
| Balance at beginning of period | $ 103 | $ 103 |
| Provision | 353 | - |
| Charge-offs | - | - |
| Recoveries | - | - |
| Balance at end of period | $ 456 | $ 103 |

**Capital Resources and Liquidity**

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

Our primary sources of funds generated in the second quarter of 2007 were from:

- principal repayments of $1.270 billion on loans held for investment and mortgage-backed securities available for sale, including prepayments but excluding refinances of our existing loans;
- maturities or calls of $142 million of U.S. Treasury, government sponsored entities and other investment securities available for sale; and
- a net decline of $80 million in our loans held for sale.

We used these funds to:

- originate and purchase $494 million of loans held for investment, excluding refinances of our existing loans;
- absorb a $401 million reduction in deposits;
- purchase $400 million of investment securities of government sponsored entities available for sale; and
- reduce borrowings by $153 million.

Our principal source of liquidity is our ability to utilize borrowings, as needed. Our primary source of borrowings is the FHLB. At June 30, 2007, our FHLB borrowings totaled $1.1 billion, representing 7.4% of total assets. We currently are approved by the FHLB to borrow up to 50% of total assets to the extent we provide qualifying collateral and hold sufficient FHLB stock. That approved limit would have permitted us, as of quarter end, to borrow an additional $6.3 billion. To the extent deposit growth over the remainder of 2007 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 June 30, 2007, we had commitments to borrowers for short-term interest rate locks, before the reduction of expected fallout, of $292 million, of which $159 million were related to residential one-to-four unit loans being originated for sale in the secondary market. We also had undisbursed loan funds and unused lines of credit of $317 million and operating leases of $18 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. As of June 30, 2007, the Bank had the capacity to declare a dividend totaling $400 million subject to filing an application with the Office of Thrift Supervision ( OTS ) at least 30 days prior to the distribution and the OTS approves the dividend. At June 30, 2007, the holding company s liquid assets, including due from Bank interest bearing balances, totaled $98 million down from $108 million at the end of 2006.

Stockholders equity totaled $1.5 billion at June 30, 2007, up $71 million from December 31, 2006 and up $180 million from June 30, 2006.

***Contractual Obligations and Other Commitments***

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

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

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

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

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

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

We enter into derivative financial instruments as part of our interest rate risk management process, including loan forward sale and purchase contracts related to our sale of loans in the secondary market. The associated fair value changes to the notional amount of the derivative instruments are recorded on-balance sheet. The total notional amount of our derivative financial instruments do not represent future cash requirements. For further information, see Asset/Liability Management and Market Risk on page 42 and Note 3 of Notes to the Consolidated Financial Statements on page 9.

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 we made to the investor in connection with the sale. If such a defect is identified, we may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, we have no commitment to repurchase the loan. During the first six months of 2007, we repurchased $10 million of loans and recorded $0.7 million of repurchase or indemnification losses related to defects in the origination process. Included in the repurchased loans was $8 million of one-to-four single family residential loans from Fannie Mae, due to the loans being outside Fannie Mae s underwriting guidelines.

These loan and servicing sale contracts may also 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. We reserved less than $1 million at June 30, 2007, December 31, 2006 and June 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 June 30, 2007, our maximum sales price premium refund would be $5.3 million. See Note 3 of Notes to the Consolidated Financial Statements on page 9.

At June 30, 2007, scheduled maturities of obligations and 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 | $ 8,350,911 | $ 260,079 | $ 99,787 | $ - | $ 8,710,777 |
| Securities sold under agreements to repurchase | 587,544 | - | - | - | 587,544 |
| FHLB advances and other borrowings | 686,000 | 418,373 | - | - | 1,104,373 |
| Senior notes | - | - | - | 198,351 | 198,351 |
| Secondary marketing activities: | | | | | |
| Non-qualifying hedge transactions: | | | | | |
| Interest rate lock commitments [a] | 122,668 | - | - | - | 122,668 |
| Associated loan forward sale contracts [a] | 126,675 | - | - | - | 126,675 |
| Qualifying cash flow hedge transactions: | | | | | |
| Loans held for sale, at lower of cost or fair value | 187,752 | - | - | - | 187,752 |
| Associated loan forward sale contracts [a] | 175,825 | - | - | - | 175,825 |
| Qualifying fair value hedge transactions: | | | | | |
| Designated FHLB advances pay-fixed | - | 430,000 | - | - | 430,000 |
| Associated interest rate swap contracts | | | | | |
| pay-variable, receive-fixed [a] | - | 430,000 | - | - | 430,000 |

| | | | | | |
|---|---|---|---|---|---|
| Commitments to originate adjustable rate loans held | | | | | |
| for investment | 138,510 | - | - | - | 138,510 |
| Undisbursed loan funds and unused lines of credit | 22,412 | 21,641 | 6,277 | 266,601 | 316,931 |
| Operating leases | 5,410 | 8,006 | 3,430 | 687 | 17,533 |

[a] *Amount represents the notional amount of the commitments or contracts. The notional amount for interest rate lock commitments before the reduction of expected fallout was $159 million.*

**Regulatory Capital Compliance**

The Bank s core and tangible capital ratios were both 10.08% and its risk-based capital ratio was 20.86% at June 30, 2007. The Bank s capital ratios compare favorably with the well capitalized standards of 5.00% for core capital and 10.00% for risk-based capital, as defined by regulation.

The following table is a reconciliation of the Bank s stockholder s equity to federal regulatory capital as of June 30, 2007.

| | *Tangible Capital* | | *Core Capital* | | *Risk-Based Capital* | |
|---|---|---|---|---|---|---|
| *(Dollars in Thousands)* | *Amount* | *Ratio* | *Amount* | *Ratio* | *Amount* | *Ratio* |
| Stockholder s equity | $ 1,570,734 | | $ 1,570,734 | | $ 1,570,734 | |
| Adjustments: | | | | | | |
| Deductions: | | | | | | |
| Investment in real estate subsidiary | (77,720 ) | | (77,720 ) | | (77,720 ) | |
| Excess cost over fair value of branch acquisitions | (3,150 ) | | (3,150 ) | | (3,150 ) | |
| Non-permitted mortgage servicing rights | (2,162 ) | | (2,162 ) | | (2,162 ) | |
| Additions: | | | | | | |
| Unrealized losses on investment securities available for sale | 6,068 | | 6,068 | | 6,068 | |
| General loss allowance investment in DSL Service Company | 353 | | 353 | | 353 | |
| Allowance for credit losses, net of specific allowances [a] | - | | - | | 69,312 | |
| Regulatory capital | 1,494,123 | 10.08 % | 1,494,123 | 10.08 % | 1,563,435 | 20.86 % |
| Well capitalized requirement | 222,302 | 1.50 [b] | 741,006 | 5.00 | 749,355 | 10.00 [c] |
| Excess | $ 1,271,821 | 8.58 % | $ 753,117 | 5.08 % | $ 814,080 | 10.86 % |

[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 19.94%.*

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

For information regarding quantitative and qualitative disclosures about market risk, see Asset/Liability Management and Market Risk on page 42.

### ITEM 4. CONTROLS AND PROCEDURES

As of June 30, 2007, Downey carried out an evaluation, under the supervision and with the participation of Downey s management, including Downey s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Downey s disclosure controls and procedures pursuant to Securities and Exchange Commission ( SEC ) rules. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded Downey s disclosure controls and procedures were effective as of the end of the period covered by this report. There have been no significant changes during the most recent quarter in Downey s internal controls over financial reporting or in other factors that could significantly affect these controls subsequent to the evaluation date.

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

# PART II OTHER INFORMATION

### ITEM 1. Legal Proceedings

On 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 complaint seeks unspecified damages for alleged unpaid regular and overtime wages and bonuses, inadequate meal and rest breaks, 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 any time during the four years prior to October 29, 2004. 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.

On June 21, 2005, a former loan underwriting employee brought an action in Contra Costa Superior Court, Case No. C05-01293, entitled "Teresa Sims, et al. v. Downey Savings and Loan Association." The complaint sought unspecified damages for alleged unpaid overtime wages and bonuses, inadequate meal and rest breaks, and related claims. The plaintiff sought class action status to represent all other current and former Downey Savings employees that held the position of loan underwriter, including, but not limited to, the job title of Senior Loan Underwriter within the State of California (a) at any time during the four years prior to June 21, 2005 and/or (b) who was employed by Downey Savings on or about September 30, 2002, when Downey Savings terminated an annual bonus program. During the current quarter, the court granted final approval of a settlement and all amounts due under the court approved settlement have been fully reflected in the financial statements.

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.

**ITEM 1A. Risk Factors**

There have been no other material changes in our risk factors since December 31, 2006, except that the IRS may assert a $9.2 million penalty (including penalty interest) against Downey related to its 2004 tax return. Downey has determined it is unlikely any such penalty would be sustained and it would vigorously contest any penalty that would be proposed. See Note (4) Income Taxes on page 13.

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

None.

**ITEM 3. Defaults Upon Senior Securities**

None.

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

On April 25, 2007, Downey held its annual meeting of shareholders to elect four Class 3 Directors for terms of three years each and to ratify the Board of Directors appointment of KPMG LLP as auditors for the year ending December 31, 2007. The number of votes cast at the meeting as to each matter acted upon was as follows:

1. Election of Directors:

| *Nominees* | *Votes For* | *Votes Withheld* | *Unvoted* |
|---|---|---|---|
| Michael D. Bozarth | 25,306,189 | 436,966 | 2,110,628 |
| James H. Hunter | 23,353,264 | 2,389,891 | 2,110,628 |
| Brent McQuarrie | 25,311,017 | 432,138 | 2,110,628 |
| Jane Wolfe | 24,030,449 | 1,712,706 | 2,110,628 |

The Directors whose terms continued and the years their terms expire are as follows:

| *Continuing Directors* | *Year Term Expires* |
|---|---|
| Gary W. Brummett | 2008 |
| Gerald E. Finnell | 2008 |
| Maurice L. McAlister | 2008 |
| Daniel D. Rosenthal | 2008 |
| Michael B. Abrahams | 2009 |
| Cheryl E. Olson | 2009 |
| Lester C. Smull | 2009 |

2. Ratification of appointment of KPMG LLP as auditors for the year ending December 31, 2007:

| *Votes For* | *Votes Against* | *Abstain* | *Unvoted* |
|---|---|---|---|
| 25,571,536 | 163,615 | 8,004 | 2,110,628 |

**ITEM 5. Other Information**

None.

**ITEM 6. Exhibits**

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

# AVAILABILITY OF REPORTS

Corporate governance guidelines, charters for the audit, compensation, and nominating and corporate governance committees of the Board of Directors and codes of business conduct and ethics are available free of charge from our internet site, www.downeysavings.com 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.

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

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

# SIGNATURES

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

## DOWNEY FINANCIAL CORP.

*/s/ Daniel D. Rosenthal*

Date: August 1, 2007

Daniel D. Rosenthal
President and Chief Executive Officer

*/s/ Brian E. Côté*

Date: August 1, 2007 Brian E. Côté
Chief Financial Officer



**Navigation Links**

# NAVIGATION LINKS


**FORM 10-Q COVER**

## PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ITEM 4. CONTROLS AND PROCEDURES

## PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

ITEM 1A. Risk Factors

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

ITEM 3. Defaults Upon Senior Securities

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

ITEM 5. Other Information

ITEM 6. Exhibits

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AVAILABILITY OF REPORTS

SIGNATURES