DOWNEY FINANCIAL CORP
Form 10-Q
August 09, 2006
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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, 2006**

OR

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

For the transition period from __________ to __________

Commission File Number **1-13578**

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

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

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

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

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

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

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

At June 30, 2006, 27,853,783 shares of the Registrant s Common Stock, $0.01 par value were outstanding.

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DOWNEY FINANCIAL CORP.

June 30, 2006 QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Data)	*June 30, 2006*	*December 31, 2005*	*June 30, 2005*
Assets			
Cash	$ 152,957	$ 190,396	$ 128,670
Federal funds	2	-	30,001
Cash and cash equivalents	152,959	190,396	158,671
U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value	892,172	626,313	504,965
Loans held for sale, at lower of cost or fair value	417,691	464,488	932,248
Mortgage-backed securities available for sale, at fair value	263	277	292
Loans held for investment	15,571,817	15,391,759	14,510,795
Allowance for loan losses	(51,198)	(34,601)	(34,561)
Loans held for investment, net	15,520,619	15,357,158	14,476,234
Investments in real estate and joint ventures	49,237	49,344	58,941
Real estate acquired in settlement of loans	1,254	908	2,201
Premises and equipment	110,537	109,574	105,230
Federal Home Loan Bank stock, at cost	184,796	179,844	265,849
Mortgage servicing rights, net	20,561	20,302	16,833
Other assets	114,691	97,059	92,482
	$ 17,464,780	$ 17,095,663	$ 16,613,946
Liabilities and Stockholders Equity			
Deposits	$ 11,887,739	$ 11,876,848	$ 11,042,072
Securities sold under agreements to repurchase	255,042	-	-
Federal Home Loan Bank advances	3,499,450	3,557,515	4,002,757
Senior notes	198,172	198,087	198,004
Accounts payable and accrued liabilities	201,714	114,527	128,340
Deferred income taxes	132,498	140,467	126,628
Total liabilities	16,174,615	15,887,444	15,497,801
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, 2006, December 31, 2005 and			
June 30, 2005; outstanding 27,853,783 shares at June 30, 2006,			
December 31, 2005 and June 30, 2005	282	282	282
Additional paid-in capital	93,792	93,792	93,792
Accumulated other comprehensive loss	(12,189)	(5,408)	(1,427)
Retained earnings	1,225,072	1,136,345	1,040,290
Treasury stock, at cost, 381,239 shares at June 30, 2006,			
December 31, 2005 and June 30, 2005	(16,792)	(16,792)	(16,792)
Total stockholders equity	1,290,165	1,208,219	1,116,145
	$ 17,464,780	$ 17,095,663	$ 16,613,946

See accompanying notes to consolidated financial statements.

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DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Income

	Three Months Ended June 30,		*Six Months Ended June 30,*	
(Dollars in Thousands, Except Per Share Data)	*2006*	*2005*	*2006*	*2005*
Interest income				
Loans	$ 275,233	$ 206,044	$ 530,578	$ 389,954
U.S. Treasury and government sponsored entities securities	8,930	5,029	16,266	9,867
Mortgage-backed securities	3	3	6	6
Other investment securities	2,243	3,120	4,522	5,658
Total interest income	286,409	214,196	551,372	405,485
Interest expense				
Deposits	99,798	60,962	191,633	109,985
Federal Home Loan Bank advances and other borrowings	50,966	39,572	94,880	73,552
Senior notes	3,298	3,296	6,596	6,591
Total interest expense	154,062	103,830	293,109	190,128
Net interest income	132,347	110,366	258,263	215,357
Provision for credit losses	6,662	583	16,719	2,621
Net interest income after provision for credit losses	125,685	109,783	241,544	212,736
Other income, net				
Loan and deposit related fees	9,171	9,242	17,729	17,846
Real estate and joint ventures held for investment, net	2,553	1,728	4,842	4,308
Secondary marketing activities:				
Loan servicing income (loss), net	452	(2,529)	641	(1,045)
Net gains on sales of loans and mortgage-backed securities	8,619	48,848	20,273	79,463
Net gains on sales of mortgage servicing rights	-	-	-	981
Net gains on sales of investment securities	-	1	-	28
Litigation award	-	1,767	-	1,767
Other	235	339	755	859
Total other income, net	21,030	59,396	44,240	104,207
Operating expense				
Salaries and related costs	40,873	39,042	81,653	78,197

Premises and equipment costs	8,410	7,891	16,948	15,891
Advertising expense	1,879	1,551	3,121	2,901
Deposit insurance premiums and regulatory assessments	1,008	927	2,022	1,854
Professional fees	450	345	1,242	681
Other general and administrative expense	8,295	8,605	17,470	16,997
Total general and administrative expense	60,915	58,361	122,456	116,521
Net operation of real estate acquired in settlement of loans	28	(79)	19	(15)
Total operating expense	60,943	58,282	122,475	116,506
Income before income taxes	85,772	110,897	163,309	200,437
Income taxes	36,232	46,827	69,012	84,628
Net income	$ 49,540	$ 64,070	$ 94,297	$ 115,809
Per share information				
Basic	$ 1.77	$ 2.30	$ 3.38	$ 4.16
Diluted	$ 1.77	$ 2.30	$ 3.38	$ 4.16
Cash dividends declared and paid	$ 0.10	$ 0.10	$ 0.20	$ 0.20
Weighted average shares outstanding				
Basic	27,853,783	27,853,783	27,853,783	27,853,783
Diluted	27,884,281	27,884,276	27,883,751	27,883,058

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)	*2006*	*2005*	*2006*	*2005*
Net income	$ 49,540	$ 64,070	$ 94,297	$ 115,809
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	(5,608)	728	(6,975)	(1,715)
Mortgage-backed securities available for sale, at fair value	-	1	-	1
Reclassification of realized amounts included in net income	-	-	-	(17)
Unrealized gains (losses) on cash flow hedges:				
Net derivative instruments	936	23	1,439	(55)
Reclassification of realized amounts included in net income	(1,321)	(228)	(1,245)	41
Total other comprehensive income (loss), net of income taxes (benefits)	(5,993)	524	(6,781)	(1,745)
Comprehensive income	$ 43,547	$ 64,594	$ 87,516	$ 114,064

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In Thousands)	*Six Months Ended June 30,* 2006	2005
Cash flows from operating activities		
Net income	$ 94,297	$ 115,809
Adjustments to reconcile net income to net cash used for operating activities:		
Depreciation	6,543	6,397
Amortization	56,203	39,751
Provision for losses on loans, loan-related commitments, investments, real estate and joint ventures, mortgage servicing rights, real estate acquired in settlement of loans, and other assets	16,584	4,018
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, investment securities, real estate and other assets	(23,902)	(83,141)
Interest capitalized on loans (negative amortization)	(136,002)	(47,860)
Federal Home Loan Bank stock dividends	(4,513)	(4,875)
Loans originated and purchased for sale	(1,872,478)	(4,947,439)
Proceeds from sales of loans held for sale, including those sold as mortgage-backed securities	1,922,339	5,200,591
Other, net	(52,287)	(61,312)
Net cash provided by operating activities	6,784	221,939
Cash flows from investing activities		
Proceeds from sales of:		
Wholly owned real estate and real estate acquired in settlement of loans	866	1,752
Proceeds from maturities or calls of U.S. Treasury, government sponsored entities and other investment securities available for sale	8,250	26,555
Purchase of:		
U.S. Treasury, government sponsored entities and other investment securities available for sale	(211,220)	(37,528)
Loans held for investment	(20,394)	(29,675)
Premises and equipment	(14,778)	(7,673)
Federal Home Loan Bank stock	(439)	(17,361)
Originations of loans held for investment (net of refinances of $403,664 for the six months ended June 30, 2006 and $336,310 for the six months ended June 30, 2005)	(2,587,754)	(3,068,844)
Principal payments on loans held for investment and mortgage-backed securities available for sale	2,586,310	2,092,954
Net change in undisbursed loan funds	(18,368)	33,621
Investments in real estate held for investment	3,771	(869)

Other, net	7,152	2,559
Net cash used for investing activities	(246,604)	(1,004,509)

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,* 2006	2005
Cash flows from financing activities		
Net increase in deposits	$ 10,891	$ 1,384,094
Proceeds from Federal Home Loan Bank advances and other borrowings	16,271,285	19,078,375
Repayments of Federal Home Loan Bank advances and other borrowings	(16,070,243)	(19,632,875)
Cash dividends	(5,570)	(5,570)
Other, net	(3,980)	(2,285)
Net cash provided by financing activities	202,383	821,739
Net increase (decrease) in cash and cash equivalents	(37,437)	39,169
Cash and cash equivalents at beginning of period	190,396	119,502
Cash and cash equivalents at end of period	$ 152,959	$ 158,671
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 302,257	$ 183,597
Income taxes	68,029	81,426
Supplemental disclosure of non-cash investing:		
Loans transferred to held for investment from held for sale	11,110	19,814
Loans transferred from held for investment to held for sale	488	106
U.S. Treasury, government sponsored entities and other investment securities		
available for sale, purchased and not settled	75,000	-
Loans exchanged for mortgage-backed securities	490,272	480,497
Real estate acquired in settlement of loans	1,077	1,141
Loans to facilitate the sale of real estate acquired in settlement of loans	-	65

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) Basis of Financial Statement Presentation

In the opinion of Downey Financial Corp. and subsidiaries (Downey, we, us and our), the accompanying consolidated financial statements contain all adjustments (consisting of 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, 2006, December 31, 2005 and June 30, 2005, the results of operations and comprehensive income for the three months and six months ended June 30, 2006 and 2005, and changes in cash flows for the six months ended June 30, 2006 and 2005. Certain prior period amounts have been reclassified to conform to the current period presentation.

The accompanying consolidated financial statements have been prepared in accordance with 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, 2005, 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, 2005 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) Reclassification of Prior Period Amounts

During the first quarter of 2006, loan prepayment and late fees were reclassified from loan and deposit related fees to loan interest income to conform with the classification change from prior reporting requirements received from the Office of Thrift Supervision (OTS). Previously reported periods were restated to conform to the current period presentation. The reclassification had no effect on net income or stockholders equity.

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. During the first quarter of 2006, the allowance for losses on loan-related commitments was reclassified from the allowance for loan losses to accounts payable and accrued liabilities. The allowance for losses on loan-related commitments is calculated using the same methodology as that used to determine the allowance for loan losses. Previously reported periods were restated to conform to the current period presentation. The reclassifications had no effect on the provision for credit losses, which continues to be comprised of the sum of the provision for loan losses and the provision for losses on loan-related commitments; thus, there was no effect on net income or stockholders equity.

NOTE (3) 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, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*	*June 30, 2005*
Gross balance at beginning of period	$ 20,420	$ 21,157	$ 20,917	$ 20,626	$ 20,834
Additions	1,285	1,022	1,740	1,858	1,217
Amortization	(1,029)	(1,198)	(1,252)	(1,346)	(1,398)
Sales	-	-	-	(87)	-
Impairment write-down	(11)	(561)	(248)	(134)	(27)
Gross balance at end of period	20,665	20,420	21,157	20,917	20,626
Allowance balance at beginning of period	255	855	1,800	3,793	1,224
Provision for (reduction of) impairment	(140)	(39)	(697)	(1,859)	2,596
Impairment write-down	(11)	(561)	(248)	(134)	(27)
Allowance balance at end of period	104	255	855	1,800	3,793
Total mortgage servicing rights, net	$ 20,561	$ 20,165	$ 20,302	$ 19,117	$ 16,833
As a percentage of associated mortgage loans	0.87 %	0.85 %	0.86 %	0.83 %	0.75 %
Estimated fair value [(a)]	$ 23,644	$ 21,894	$ 20,351	$ 19,139	$ 16,863
Weighted average expected life (in months)	56	51	47	47	40
Custodial account earnings rate	5.39 %	4.90 %	4.46 %	3.99 %	3.45 %
Weighted average discount rate	9.39	9.45	9.32	9.20	9.12
At period end					
Mortgage loans serviced for others:					
Total	$ 6,377,737	$ 5,794,067	$ 5,292,253	$ 11,444,758	$ 10,287,991
With capitalized mortgage servicing rights:[(a)]					
Amount	2,369,543	2,372,534	2,362,539	2,310,726	2,249,030
Weighted average interest rate	5.66 %	5.63 %	5.60 %	5.57 %	5.57 %
Total loans sub-serviced without mortgage					
servicing rights: [(b)]					
Term less than six months	$ 228,455	$ 153,655	$ 123,552	$ 292,480	$ 269,165
Term indefinite	3,760,642	3,248,012	2,785,090	8,818,890	7,744,459

Custodial account balances	$ 147,831	$ 124,324	$ 117,451	$ 326,906	$ 237,722

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

	Six Months Ended June 30,	
(Dollars in Thousands)	*2006*	*2005*
Gross balance at beginning of period	$ 21,157	$ 20,502
Additions	2,307	2,826
Amortization	(2,227)	(2,558)
Sales	-	(14)
Impairment write-down	(572)	(130)
Gross balance at end of period	20,665	20,626
Allowance balance at beginning of period	855	2,538
Provision for (reduction of) impairment	(179)	1,385
Impairment write-down	(572)	(130)
Allowance balance at end of period	104	3,793
Total mortgage servicing rights, net	$ 20,561	$ 16,833

Key assumptions, which vary due to changes in market interest rates and are used to determine the fair value of MSRs, 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. 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. 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, with any associated provision recorded as a component of loan servicing income (loss). 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.

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	$ 1,201	$ 1,139	$ (907)	$ 1,532
Reduction of (increase in) valuation allowance	49	20	(21)	55
Decrease rates 100 basis points: [b]				
Increase (decrease) in fair value	(3,075)	(1,149)	953	(3,840)
Reduction of (increase in) valuation allowance	(1,217)	(58)	11	(1,560)

[a] *The weighted-average expected life of the MSRs portfolio becomes 61 months.*
[b] *The weighted-average expected life of the MSRs portfolio becomes 43 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, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*	*June 30, 2005*
Net cash servicing fees	$ 1,574	$ 1,566	$ 1,743	$ 1,968	$ 1,753
Payoff and curtailment interest cost [a]	(233)	(218)	(250)	(315)	(288)
Amortization of mortgage servicing rights	(1,029)	(1,198)	(1,252)	(1,346)	(1,398)
(Provision for) reduction of impairment of mortgage servicing rights	140	39	697	1,859	(2,596)
Total loan servicing income (loss), net	$ 452	$ 189	$ 938	$ 2,166	$ (2,529)

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

	Six Months Ended June 30,	
(In Thousands)	*2006*	*2005*
Net cash servicing fees	$ 3,140	$ 3,380
Payoff and curtailment interest cost [a]	(451)	(482)
Amortization of mortgage servicing rights	(2,227)	(2,558)
(Provision for) reduction of impairment of mortgage servicing rights	179	(1,385)
Total loan servicing income (loss), net	$ 641	$ (1,045)

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

NOTE (4) 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 to be sold 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 interest rate lock commitments are recorded in current earnings under net gains (losses) 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 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 commitment to the date of funding. At June 30, 2006, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $238 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.

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 loan forward sale contracts not designated as cash flow hedges and the ineffectiveness of hedge transactions that are not perfectly correlated are recorded in net gains (losses) on sales of loans and mortgage-backed securities. Changes in expected future cash flows related to the fair value of the 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) are recognized in the income statement when the hedged forecasted transactions settle. 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 loan forward sale contracts are based on dealer quoted market prices acquired from third parties. At June 30, 2006, the notional amount of loan forward sale contracts amounted to $609 million, with a change in fair value resulting in a gain of $0.7 million, of which $399 million were designated as cash flow hedges. There were no loan forward purchase contracts at June 30, 2006.

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.

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 Downey 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, 2006, swap contracts with a notional amount totaling $430 million were outstanding and had a fair value loss of $22 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, 2006.

(Dollars in Thousands)	*Notional Amount*	*Weighted Average Interest Rate*	*Term*	
Pay Variable (3-month LIBOR)	$ (100,000)	5.23 %	March 2004	October 2008
Receive Fixed	100,000	3.20		
Pay Variable (3-month LIBOR)	(130,000)	5.23	March 2004	October 2008
Receive Fixed	130,000	3.21		
Pay Variable (3-month LIBOR)	(100,000)	5.23	March 2004	November 2008
Receive Fixed	100,000	3.26		
Pay Variable (3-month LIBOR)	(100,000)	5.23	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, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*	*June 30, 2005*
Net gains (losses) on non-qualifying hedge transactions	$ (733)	$ 238	$ 841	$ (1,400)	$ 1,258
Net gains (losses) 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)	(733)	238	841	(1,400)	1,258
Other comprehensive income (loss)	(385)	579	(406)	395	(205)
Notional amount or balance at period end					
Non-qualifying hedge transactions:					

Interest rate lock commitments [a]	$ 237,867	$ 307,635	$ 285,002	$ 513,459	$ 624,604
Associated loan forward sale contracts	209,815	261,359	268,321	402,363	572,977
Qualifying cash flow hedge transactions:					
Loans held for sale, at lower of cost or fair value	417,691	561,511	464,488	501,611	932,248
Associated loan forward sale contracts	398,741	544,141	449,923	489,137	905,373
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] *Amounts are reduced by an anticipated fallout factor for those commitments not expected to fund.*

	Six Months Ended June 30,	
(In Thousands)	*2006*	*2005*
Net gains (losses) on non-qualifying hedge transactions	$ (495)	$ 4,171
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)	(495)	4,171
Other comprehensive income (loss)	194	(14)

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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 a favorable 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 some 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, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*	*June 30, 2005*
Commitments to originate adjustable rate loans					
held for investment	$ 338,222	$ 508,426	$ 390,238	$ 639,249	$ 228,310
Undisbursed loan funds and unused lines of credit	391,395	406,675	409,555	440,257	491,375
Commitments to invest in community development					
funds	-	-	-	-	1,832

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 committed 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 $2 million at June 30, 2006, $1 million at December 31, 2005, and $2 million at June 30, 2005.

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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, 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 2006, Downey recorded a $0.1 million repurchase loss related to defects in the origination process and repurchased $2.3 million of loans. These loan and servicing sale contracts typically contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Downey reserved less than $1 million at June 30, 2006, and December 31, 2005 and $1 million at June 30, 2005 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, 2006, Downey s maximum sales price premium refund would be $7.8 million.

Through the normal course of business, 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 s long-term operating leases are 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, 2006, 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*	*1 3 Years*	*4 5 Years*	*Over 5 Years*	*Total Balance*
Certificates of deposit	$ 8,363,337	$ 463,889	$ 165,651	$ -	$ 8,992,877
FHLB advances and other borrowings	3,346,342	408,150	-	-	3,754,492
Senior notes	-	-	-	198,172	198,172
Operating leases	5,133	7,284	3,432	1,527	17,376
Total other contractual obligations	$ 11,714,812	$ 879,323	$ 169,083	$ 199,699	$ 12,962,917

Litigation

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 seeks unspecified damages for alleged unpaid overtime wages and bonuses, inadequate meal and rest breaks, and related claims. The plaintiff is seeking 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. 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 its operations, cash flows or financial position.

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

NOTE (5) Income Taxes

Downey and its wholly owned subsidiaries file a consolidated federal income tax return and various state income and franchise tax returns on a calendar year basis. The Internal Revenue Service has examined Downey s tax returns for all tax years through 2003, while state taxing authorities have reviewed tax returns through 2002. Downey s management believes it has adequately provided for potential exposure to issues that may be raised by tax auditors in years which remain open to review.

NOTE (6) Employee Stock Option Plans

During 1994, the 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. 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, 2006, options for 52,914 shares were outstanding at a weighted average remaining contractual life of 3 years, 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. At June 30, 2006, 381,239 shares of treasury stock existed that may be used to satisfy the exercise of the options. No other stock based plan exists.

Downey historically measured its employee stock-based compensation arrangements under the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Accordingly, no compensation expense has been recognized for the stock option plan, as stock options were granted at fair value at the date of grant. Had compensation expense for Downey s stock option plan been determined based on the fair value estimated using the Black-Scholes model at the grant date for previous awards, stock-based compensation would have been fully expensed over the vesting period as of December 31, 2002. Therefore, for the three months and six months ended June 30, 2006 and 2005, Downey s net income and income per share would not have been reduced.

NOTE (7) 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,					
	2006			*2005*		
(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	$ 49,540	27,853,783	$ 1.77	$ 64,070	27,853,783	$ 2.30
Effect of dilutive stock options	-	30,498	-	-	30,493	-
Diluted earnings per share	$ 49,540	27,884,281	$ 1.77	$ 64,070	27,884,276	$ 2.30

	Six Months Ended June 30,					
	2006			*2005*		
		Weighted			*Weighted*	

(Dollars in Thousands, Except Per Share Data)	*Net Income*	*Average Shares Outstanding*	*Per Share Amount*	*Net Income*	*Average Shares Outstanding*	*Per Share Amount*
Basic earnings per share	$ 94,297	27,853,783	$ 3.38	$ 115,809	27,853,783	$ 4.16
Effect of dilutive stock options	-	29,968	-	-	29,275	-
Diluted earnings per share	$ 94,297	27,883,751	$ 3.38	$ 115,809	27,883,058	$ 4.16

There were no options excluded from the computation of earnings per share due to anti-dilution.

NOTE (8) 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, 2006				
Net interest income	$ 132,021	$ 326	$ -	$ 132,347
Provision for 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	35,031	1,201	-	36,232
Net income	$ 47,810	$ 1,730	$ -	$ 49,540
At June 30, 2006				
Assets:				
Loans and mortgage-backed securities, net	$ 15,938,573	$ -	$ -	$ 15,938,573
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	$ 1,290,165	$ 72,153	$ (72,153)	$ 1,290,165
Three months ended June 30, 2005				
Net interest income	$ 110,256	$ 110	$ -	$ 110,366
Provision for credit losses	583	-	-	583
Other income	57,365	2,031	-	59,396
Operating expense	58,030	252	-	58,282
Net intercompany income (expense)	(39)	39	-	-
Income before income taxes	108,969	1,928	-	110,897
Income taxes	46,037	790	-	46,827
Net income	$ 62,932	$ 1,138	$ -	$ 64,070
At June 30, 2005				
Assets:				
	$ 15,408,774	$ -	$ -	$ 15,408,774

Loans and mortgage-backed securities, net				
Investments in real estate and joint ventures	-	58,941	-	58,941
Other	1,196,756	17,833	(68,358)	1,146,231
Total assets	16,605,530	76,774	(68,358)	16,613,946
Equity	$ 1,116,145	$ 68,358	$ (68,358)	$ 1,116,145

(In Thousands)	*Banking*	*Real Estate Investment*	*Elimination*	*Totals*
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	66,991	2,021	-	69,012
Net income	$ 91,386	$ 2,911	$ -	$ 94,297
Six months ended June 30, 2005				
Net interest income	$ 215,144	$ 213	$ -	$ 215,357
Provision for loan losses	2,621	-	-	2,621
Other income	99,360	4,847	-	104,207
Operating expense	115,888	618	-	116,506
Net intercompany income (expense)	(77)	77	-	-
Income before income taxes	195,918	4,519	-	200,437
Income taxes	82,776	1,852	-	84,628
Net income	$ 113,142	$ 2,667	$ -	$ 115,809

NOTE (9) Recently Issued Accounting Standards

Financial Accounting Standards Board Interpretation No. 48

In July of 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48, the Interpretation). The Interpretation establishes a more likely than not criterion for financial statement recognition and measurement of certain tax positions that result in differences between an entity s financial statement and tax return income. FIN 48 is effective for fiscal years beginning after December 15, 2006. Management does not believe that adoption of the Interpretation will result in material changes to its financial statements.

Statement of Financial Accounting Standards No. 155

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS 155), which provides the following: 1) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, 2) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, 3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, 4) clarifies that concentrations of credit in the form of subordination are not embedded derivatives, and 5) amends Statement of Financial Accounting Standards No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement 125 to eliminate the prohibition of a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 for accounting for certain hybrid financial instruments is effective for us beginning January 1, 2007. Adoption of SFAS 155 is not expected to have a material impact on Downey.

Statement of Financial Accounting Standards No. 156

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets (SFAS 156), which provides the following: 1) revised guidance on when a servicing asset and servicing liability should be recognized, 2) requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, 3) permits an entity to elect to measure servicing assets and servicing liabilities at fair value each reporting date and report changes in fair value in earnings in the period in which the changes occur, 4) upon initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities for securities which are identified as offsetting the entity s exposure to changes in the fair value of servicing assets or liabilities that a servicer elects to subsequently measure at fair value, and 5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional footnote disclosures. SFAS 156 is effective for us beginning January 1, 2007 with the effects of initial adoption being reported as a cumulative-effect adjustment to retained earnings. The impact to retained earnings as a result of the initial adoption of SFAS 156 is expected to be immaterial.

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

Certain statements under this caption may constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995, which involve risks and uncertainties. Forward-looking statements do not relate strictly to historical information or current facts. Some forward-looking statements may be identified by use of terms such as expects, anticipates, intends, plans, believes, seeks, estimates, o similar meaning, or future or conditional verbs such as will, would, should, could or may. Our actual results may differ significantly fro results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation. For additional information concerning these factors, see Part II Other Information Item 1A. Risk Factors on page 53. 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.

OVERVIEW

Our net income for the second quarter of 2006 totaled $49.5 million or $1.77 per share on a diluted basis, down 22.7% from $64.1 million or $2.30 per share in the second quarter of 2005.

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

- A $40.2 million decline in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans sold and a lower gain per dollar of loan sold;
- A $6.1 million increase in provision for credit losses;
- A $2.6 million or 4.4% increase in general and administrative expense; and
- A $1.8 million unfavorable change in income from a litigation award, as the year-ago second quarter included an award associated with an other real estate owned asset that had suffered damage from earth movement.

Those unfavorable factors were partially offset by:

- A $22.0 million or 19.9% increase in net interest income reflecting both a higher level of average interest-earning assets and effective interest rate spread; and
- A $3.0 million favorable change in loan servicing activities due to a favorable change in the valuation allowance for mortgage servicing rights.

For the first six months of 2006, our net income totaled $94.3 million or $3.38 per share on a diluted basis, down 18.6% from the $115.8 million or $4.16 per share for the first six months of 2005. The decrease primarily reflected declines in gains from sales of loans and mortgage-backed securities, an increase in provision for credit losses and higher operating expenses. Those unfavorable items were partially offset by higher net interest income and loan servicing income.

For the second quarter, our return on average assets was 1.12%, down from 1.51% a year ago, while our return on average equity was 15.60%, down from 23.62% a year ago. For the first six-month periods, our return on average assets declined from 1.40% a year ago to 1.07%, while our return on average equity declined from 21.90% to 15.10%.

At June 30, 2006, assets totaled $17.465 billion, up 5.1% from a year ago and up 2.2% from year-end 2005. During the current quarter, assets declined $338 million due primarily to declines of $347 million in loans held for investment and $144 million in loans held for sale. Those declines were partially offset by a $162 million increase in securities available for sale. Included within loans held for investment at quarter end were $13.222 billion of one-to-four unit adjustable rate mortgages subject to negative amortization, down $644 million from March 31, 2006. The amount of negative amortization

included in loan balances increased $47 million during the current quarter to $229 million or 1.73% of loans subject to negative amortization. During the current quarter, approximately 26% of loan interest income represented negative amortization, up from 25% in the first quarter of 2006 and 14% in the year-ago second quarter. At origination, these loans had a weighted average loan-to-value ratio of 73%.

Loan originations (including purchases) totaled $2.071 billion in the current quarter, down 49.9% from $4.133 billion a year ago. Loans originated for sale declined $1.874 billion to $892 million, while single family loans originated for portfolio declined $143 million to $1.130 billion. Of the current quarter total originated for portfolio, $18 million represented subprime credits. At quarter end, the subprime portfolio totaled $826 million, with an average loan-to-value ratio at origination of 70% and, of the total, 97% represented Alt. A and A- credits. In addition to single family loans, $49 million of other loans were originated in the current quarter. For the first six months of 2006, loan originations totaled $4.884 billion, down 41.7% from $8.382 billion in the same period a year ago.

Deposits totaled $11.888 billion at quarter end, up 7.7% from a year ago but virtually unchanged from year-end 2005. At quarter end, the number of branches totaled 171, of which 91 were in-store and four were located in Arizona, down two from March 31, 2006, as two in-store branches were closed due to the closure of the stores in which they were located. The deposits from the two closed locations have been transferred to nearby branches. A year ago, we had 172 branches, of which 92 were in-store and four were located in Arizona.

Our non-performing assets were virtually unchanged during the quarter at $39 million and represented 0.23% of total assets, compared to 0.21% at year-end 2005 and 0.15% a year ago.

At June 30, 2006, Downey Savings and Loan Association, F.A. (the Bank), our primary subsidiary, exceeded all regulatory capital requirements, with capital-to-asset ratios of 7.91% for both tangible and core capital and 15.77% for risk-based capital. These capital levels are significantly above the well capitalized standards defined by the federal banking regulators of 5% for core capital and 10% for risk-based capital.

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CRITICAL ACCOUNTING POLICIES

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey s Annual Report on Form 10-K for the year ended December 31, 2005. 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, 2006, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $238 million, with a change in fair value resulting in a loss of $0.3 million, compared to a notional amount of interest rate lock commitments of $625 million with a change in fair value resulting in a gain of $0.1 million at June 30, 2005. For further information, see Note 4 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. On March 31, 2006, we reclassified to accounts payable and accrued liabilities our allowance for loan-related commitments which was previously included with the allowance for loan losses. 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 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 review all loans under $5 million by analyzing their performance and the composition of their collateral as a whole because of the relatively homogeneous nature of the loans. This allowance is determined by applying against asset and loan-related commitment balances the associated loss factors for each major credit type that consider past loss experience and asset duration, or loss statistics against current classified credit balances. Those amounts may be adjusted based upon an analysis of macro-economic and other trends 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 $53 million at June 30, 2006, compared to $38 million at June 30, 2005. For further information, see Allowance for Credit and Real Estate Losses on page 45.
- 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 mortgages. 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). During the first quarter of 2006, the coupon rate strata was reduced, which did not have a significant impact on the valuation allowance. At June 30, 2006, the MSR valuation allowance totaled less than $1 million, compared to $4 million at June 30, 2005. For further information, see Note 3 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 sales contracts typically contain provisions to refund sale price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Loan and MSR sales reserves are estimated using the prepayment experience of similar products. The estimates are updated during the 120 day period for actual payoffs. The reserve was less than $1 million at June 30, 2006 and $1 million at June 30, 2005. For further information, see Note 3 on page 7 and Note 4 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 $132.3 million in the second quarter of 2006, up $22.0 million or 19.9 % from a year ago. The increase reflected both a higher level of average interest-earning assets and effective interest rate spread. Interest-earning assets averaged $17.259 billion in the current quarter, up 4.3% from the same period a year ago. The effective interest rate spread averaged 3.07% in the current quarter, up from 2.67% a year ago and 2.97% in the first quarter of 2006. The improvement in the effective interest rate spread between second quarters primarily reflected two items. First, our interest-earning assets in the current quarter were funded with a higher proportion of interest free funds (non-interest-bearing checking accounts and the excess of interest-earning assets over deposits and borrowings), and the value of those funds was worth more due to higher interest rate levels. Second, loan prepayment fees in the current quarter covered a higher proportion of the deferred loan origination costs that were written-off as a result of those payoffs. For further information regarding a reclassification of certain prior period amounts, see Note 2 on page 6 of Notes to Consolidated Financial Statements.

For the first six months of 2006, net interest income totaled $258.3 million, up $42.9 million from a year ago. The increase was due to higher interest-earning asset levels and a higher effective interest rate spread.

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

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

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

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

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

	Three Months Ended June 30,					
	2006			2005		
(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		$ 25,888	0.64 %		$ 15,743	0.40 %
Write-off of deferred costs and premiums from loan payoffs		(26,019)	(0.64)		(18,774)	(0.48)
All other		275,364	6.76		209,075	5.31
Total loans	$ 16,283,301	275,233	6.76	$ 15,761,341	206,044	5.23
Mortgage-backed securities	267	3	4.49	294	3	4.08
Investment securities [a]	975,373	11,173	4.59	778,672	8,149	4.20
Total interest-earnings assets	17,258,941	$ 286,409	6.64 %	16,540,307	$ 214,196	5.18 %
Non-interest-earning assets	426,727			412,604		
Total assets	$ 17,685,668			$ 16,952,911		
Transaction accounts:						
Non-interest-bearing checking	$ 744,440	$ -	- %	$ 699,998	$ -	- %
Interest-bearing checking [b]	508,205	439	0.35	537,003	480	0.36
Money market	161,537	421	1.05	157,761	411	1.04
Regular passbook	1,563,990	3,940	1.01	2,289,652	6,129	1.07
Total transaction accounts	2,978,172	4,800	0.65	3,684,414	7,020	0.76
Certificates of deposit	9,033,473	94,998	4.22	6,921,807	53,942	3.13
Total deposits	12,011,645	99,798	3.33	10,606,221	60,962	2.31
FHLB advances and other borrowings [c]	3,886,870	50,966	5.26	4,827,696	39,572	3.29
Senior notes	198,157	3,298	6.66	197,988	3,296	6.66
Total deposits and borrowings	16,096,672	154,062	3.84	15,631,905	103,830	2.66
Other liabilities	319,055			236,109		
Stockholders equity	1,269,941			1,084,897		
Total liabilities and stockholders equity	$ 17,685,668			$ 16,952,911		

Net interest income/interest rate spread		$ 132,347	2.80 %		$ 110,366	2.52 %
Excess of interest-earning assets over						
deposits and borrowings	$ 1,162,269			$ 908,402		
Effective interest rate spread			3.07			2.67

[a] Yields for securities available for sale are calculated using historical cost balances and do not give effect to changes in fair value that are reflected as a component of stockholders equity.
[b] Included amounts swept into money market deposit accounts.
[c] 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.

	Six Months Ended June 30,					
	2006			2005		
(Dollars in Thousands)	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
Average balance sheet data						
Interest-earning assets:						
Loans:						
Loan prepayment fees		$ 47,359	0.58 %		$ 25,998	0.34 %
Write-off of deferred costs and premiums from loan payoffs		(48,063)	(0.59)		(31,796)	(0.41)
All other		531,282	6.55		395,752	5.13
Total loans	$ 16,210,406	530,578	6.55	$ 15,421,287	389,954	5.06
Mortgage-backed securities	272	6	4.41	298	6	4.03
Investment securities [(a)]	911,916	20,788	4.60	759,588	15,525	4.12
Total interest-earnings assets	17,122,594	$ 551,372	6.44 %	16,181,173	$ 405,485	5.01 %
Non-interest-earning assets	422,893			398,562		
Total assets	$ 17,545,487			$ 16,579,735		
Transaction accounts:						
Non-interest-bearing checking	$ 722,205	$ -	- %	$ 656,971	$ -	- %
Interest-bearing checking [(b)]	511,861	874	0.34	534,710	956	0.36
Money market	162,875	844	1.04	158,126	821	1.05
Regular passbook	1,645,512	8,324	1.02	2,462,755	13,295	1.09
Total transaction accounts	3,042,453	10,042	0.67	3,812,562	15,072	0.80
Certificates of deposit	8,968,856	181,591	4.08	6,469,258	94,913	2.96
Total deposits	12,011,309	191,633	3.22	10,281,820	109,985	2.16
FHLB advances and other borrowings [(c)]	3,788,128	94,880	5.05	4,809,754	73,552	3.08
Senior notes	198,135	6,596	6.66	197,969	6,591	6.66
Total deposits and borrowings	15,997,572	293,109	3.69	15,289,543	190,128	2.51
Other liabilities	298,948			232,652		
Stockholders equity	1,248,967			1,057,540		
Total liabilities and stockholders equity	$ 17,545,487			$ 16,579,735		

Net interest income/interest rate spread		$ 258,263	2.75 %		$ 215,357	2.50 %
Excess of interest-earning assets over						
deposits and borrowings	$ 1,125,022			$ 891,630		
Effective interest rate spread			3.02			2.66

[a] *Yields for securities available for sale are calculated using historical cost balances and do not give effect to changes in fair value that are reflected as a component of stockholders equity.*
[b] *Included amounts swept into money market deposit accounts.*
[c] *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, 2006 Versus 2005 Changes Due To				*Six Months Ended June 30, 2006 Versus 2005 Changes Due To*			
(In Thousands)	*Volume*	*Rate*	*Rate/ Volume*	*Net*	*Volume*	*Rate*	*Rate/ Volume*	*Net*
Interest income:								
Loans	$ 6,823	$ 60,367	$ 1,999	$ 69,189	$ 19,954	$ 114,796	$ 5,874	$ 140,624
Mortgage-backed securities	-	-	-	-	(1)	1	-	-
Investment securities	2,058	771	195	3,024	3,112	1,791	360	5,263
Change in interest income	8,881	61,138	2,194	72,213	23,065	116,588	6,234	145,887
Interest expense:								
Transaction accounts:								
Interest-bearing checking	(26)	(16)	1	(41)	(41)	(43)	2	(82)
Money market	10	-	-	10	25	(2)	-	23
Regular passbook	(1,942)	(361)	114	(2,189)	(4,413)	(837)	279	(4,971)
Total transaction accounts	(1,958)	(377)	115	(2,220)	(4,429)	(882)	281	(5,030)
Certificates of deposit	16,456	18,850	5,750	41,056	36,673	36,069	13,936	86,678
Total interest-bearing deposits	14,498	18,473	5,865	38,836	32,244	35,187	14,217	81,648
FHLB advances and other borrowings	(7,713)	23,732	(4,625)	11,394	(15,623)	46,916	(9,965)	21,328
Senior notes	3	(1)	-	2	6	(1)	-	5
Change in interest expense	6,788	42,204	1,240	50,232	16,627	82,102	4,252	102,981
Change in net interest income	$ 2,093	$ 18,934	$ 954	$ 21,981	$ 6,438	$ 34,486	$ 1,982	$ 42,906

Provision for Credit Losses

Provision for credit losses totaled $6.7 million in the second quarter of 2006, up $6.1 million from a year ago. During the current quarter, California residential real estate markets continued to show signs of slower sales and flattening home values. In addition, the amount of negative amortization associated with option ARM loans continued to increase and may result in certain borrowers reaching 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.

For the first six months of 2006, provision for credit losses totaled $16.7 million, and net charge-offs were $0.1 million. That compares to a $2.6 million provision for credit losses and net charge-offs of $1.0 million in the year-ago period. For further information, see Allowance for Credit and Real Estate Losses on page 45.

Other Income

Our total other income was $21.0 million in the current quarter, down $38.4 million from a year ago. Contributing to the decline between second quarters was:

- a $40.2 million decline in net gains from sales of loans and mortgage-backed securities; and
- a $1.8 million unfavorable change in income from a litigation award, as the year-ago second quarter included an award associated with an other real estate owned asset that had suffered damage from earth movement.

Those unfavorable items were partially offset by:

- a $3.0 million favorable change in loan servicing activities; and
- a $0.8 million increase in income from real estate investment activities.

For the first six months of 2006, other income totaled $44.2 million, down $60.0 million from the same period a year ago. The decline primarily reflected lower 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

Loan and deposit related fees totaled $9.2 million in the current quarter, essentially unchanged from a year ago. Loan related fees were down $0.4 million or 28.0% and deposit related fees were up $0.3 million or 4.1%. Within deposit related fees, automated teller machine fees declined 13.4% primarily reflecting the removal of 200 standalone machines in the fourth quarter of 2005, while other fees increased 13.7%. For further information regarding a reclassification of certain prior period amounts, see Note 2 on page 6 of Notes to Consolidated Financial Statements.

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