DOWNEY FINANCIAL CORP
Form 10-K
March 05, 2004

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Securities And Exchange Commission
Washington, D.C. 20549

Form 10-K

(Mark One)

þ Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2003.

¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ______________ to ______________.

Commission File Number 1-13578

DOWNEY FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

3501 Jamboree Road, Newport Beach, California	92660
(Address of principal executive offices)	(Zip Code)

I.R.S. Employer Identification No.: 33-0633413

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

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

Title of each class	Name of each exchange
Common Stock, $0.01 par value	New York Stock Exchange
	Pacific Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).
Yes þ No ¨

The aggregate market value of the registrant s outstanding Common Stock held by non-affiliates on June 30, 2003, based upon the closing sale price on that date of $41.30, as quoted on the New York Stock Exchange, was $875,744,239.

At February 29, 2004, 27,953,747 shares of the Registrant's Common Stock, $0.01 par value, were outstanding.

Documents Incorporated by Reference: Portions of the Registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of Stockholders to be held April 28, 2004 are incorporated by reference in Part III hereof.

Page **Navigation Links**

TABLE OF CONTENTS

TABLE OF CONTENTS

Navigation Links

PART I

Certain matters discussed in this Annual Report may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and, as such, may involve risks and uncertainties. These forward-looking statements relate to, among other things, expectations of the business environment in which Downey Financial Corp. ("Downey," "we," "us" and "our") operates, projections of future performance, perceived opportunities in the market and statements regarding our mission and vision. Some forward-looking statements may be identified by use of terms such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could" or "may." Our actual results, performance or achievements may differ significantly from the results, performance or achievements expressed or implied in such forward-looking statements. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. For additional information concerning these factors, see Factors That May Affect Future Results Of Operations on page 17.

ITEM 1. BUSINESS

GENERAL

We were incorporated in Delaware on October 21, 1994. On January 23, 1995, after we obtained necessary stockholder and regulatory approvals, we acquired 100% of the issued and outstanding capital stock of Downey Savings and Loan Association ("Bank") and the Bank s stockholders became holders of our stock. Downey was thereafter funded by the Bank and presently operates as the Bank s holding company. Our stock is traded on the New York Stock Exchange and Pacific Exchange under the trading symbol "DSL." Corporate governance guidelines, charters for the audit, compensation, and nominating and corporate governance committees of the Board of Directors and code of business conduct and ethics are available (or will be available by April 28, 2004) free of charge from our internet site, www.downeysavings.com by clicking on "Investor Relations" on our home page and proceeding to "Corporate Governance." Annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are posted on our internet site as soon as reasonably practical after we file them with the SEC and available free of charge under "Corporate Filings" on our "Investor Relations" page.

The Bank was formed in 1957 as a California-licensed savings and loan association and converted to a federal charter in 1995. As of December 31, 2003, it conducts its business through 172 retail deposit branches, including 100 full-service, in-store branches. Residential loans are originated or purchased:

- by branch managers and loan officers in our branches;
- by loan officers who solicit loans from realtors and other business sources, including the internet;
- by wholesale loan representatives who obtain loans submitted by mortgage brokers; and
- by purchases of loans from correspondent banking institutions and mortgage bankers.

The Bank is regulated or affected by the following governmental entities and laws:

- As a federally chartered savings association, the Bank s activities and investments are generally governed by the Home Owners Loan Act, as amended, and regulations and policies of the Office of Thrift Supervision ("OTS").
- The Bank and Downey are subject to the primary regulatory and supervisory jurisdiction of the OTS.
- As a federally insured depository institution, the Bank is regulated and supervised by the Federal Deposit Insurance Corporation ("FDIC") with respect to some of its activities and investments.
- The Bank is a member of the Federal Home Loan Bank ("FHLB") of San Francisco, which is one of the 12 regional banks for federally insured depository institutions comprising the FHLB System.
- The Bank s savings deposits are insured through the Savings Association Insurance Fund ("SAIF") of the FDIC, an instrumentality of the United States government.

Page 1 **Navigation Links**

- The Bank is regulated by the Federal Reserve with respect to reserves the Bank is required to maintain against deposits and other matters.

General economic conditions, the monetary and fiscal policies of the federal government and the regulatory policies of governmental authorities significantly influence our operations. Additionally, interest rates on competing investments and general market interest rates influence our deposit flows and the costs we incur on interest-bearing liabilities, which represents our cost of funds. Similarly, market interest rates and other factors that affect the supply of and demand for housing and the availability of funds affect our loan volume, our yields on loans and mortgage-backed securities as well as the valuation of our mortgage servicing rights associated with the portfolio of loans we service for others.

Our primary business is banking and we are also involved in real estate investments, each of which we discuss further below.

BANKING ACTIVITIES

Our primary business is banking. Our banking activities focus on:

- attracting funds from the general public and institutions and obtaining borrowings; and
- originating and investing in loans, primarily residential real estate mortgage loans, investment securities and mortgage-backed securities.

These mortgage-backed securities include mortgage pass-through securities issued by other entities and securities issued or guaranteed by government-sponsored enterprises like the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association.

Our primary sources of revenue from our banking business are:

- interest we earn on loans, investment securities and mortgage-backed securities;
- fees we earn in connection with loans and deposits;
- gains on sales of our loans, investment securities and mortgage-backed securities; and
- income we earn on loans and mortgage-backed securities we service for investors.

Our principal expenses in connection with our banking business are:

- interest we incur on our interest-bearing liabilities, including deposits and borrowings; and
- general and administrative costs.

Our primary sources of funds from our banking business are:

- deposits;
- principal and interest payments on our loans, investment securities and mortgage-backed securities;
- proceeds from sales of our loans, investment securities and mortgage-backed securities; and
- borrowings.

Scheduled payments we receive on our loans and mortgage-backed securities and certain fees from loans and deposits are a relatively stable source of funds. However, the funds we receive from the prepayment of loans and mortgage-backed securities vary widely. Below is a detailed discussion of our banking activities.

Lending Activities

Historically, our lending activities have primarily emphasized our origination of first mortgage loans secured by residential properties and retail neighborhood shopping centers. To a lesser extent, our lending activities have emphasized our origination of real estate loans secured by multi-family and commercial properties, including land and other properties with income producing capabilities and consumer loans, primarily home equity loans and

home equity lines of credit. In addition, we have provided construction loan financing for single family and multi-family residential properties and commercial retail neighborhood shopping center projects. These construction loan financings have included loans to joint ventures, which were being engaged in by DSL Service Company, a wholly owned subsidiary of the Bank, with other participants. We also originate loans to businesses.

Our primary focus continues to be our origination of adjustable rate single family mortgage loans for portfolio, including subprime loans which carry higher interest rates. In addition, we will originate for portfolio other loans including:

- multi-family loans;
- commercial real estate loans;
- construction and land loans to developers;
- loans to individuals for the construction and permanent financing of single family homes; and
- consumer loans.

We will also continue our secondary marketing activities of originating and selling single family mortgage loans to various investors.

For more information, see Secondary Marketing and Loan Servicing Activities on page 5. For additional information on the composition of our loan and mortgage-backed securities portfolio, see Loans and Mortgage-Backed Securities on page 34.

Loan and Mortgage-Backed Securities Portfolio

We carry loans receivable held for investment at cost. Our net loans receivable are adjusted for unamortized premiums and unearned discounts, which are amortized into interest income using the interest method. Our investments in mortgage-backed securities represent participating interests in pools of first mortgage loans originated and serviced by the issuers of the securities. We carry mortgage-backed securities held to maturity at unpaid principal balances, which are adjusted for unamortized premiums and unearned discounts. We amortize premiums and discounts on mortgage-backed securities by using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments.

We identify loans that may be sold before their maturity. In our balance sheets, we classify these as loans held for sale and record them at the lower of cost or fair value. The cost includes a basis adjustment to the loan at funding resulting from the change in the fair value of the associated interest rate lock derivative from the date of commitment to the date of funding. We recognize net unrealized losses on these loans, if any, in a valuation allowance by making charges to our income.

We carry mortgage-backed securities available for sale at fair value. In stockholders equity, we report net unrealized gains or losses on these securities, net of income taxes, as accumulated other comprehensive income until realized, unless the security is deemed other than temporarily impaired. If the security is determined to be other than temporarily impaired, we charge the amount of the impairment to operations.

Residential Real Estate Lending

Our primary lending activity is our origination of mortgage loans secured by single family residential properties consisting of one-to-four units located primarily in California. We provide these loans for borrowers to purchase residences or to refinance their existing mortgages and typically have contractual maturities at origination of 15 to 40 years. To limit the interest rate risk associated with these 15- to 40-year maturities, we, among other things, principally originate adjustable rate mortgages for our own loan portfolio. For more information, see Asset/Liability Management on page 8. We also originate residential fixed rate mortgage loans to meet consumer demand, but we sell the majority of these loans in the secondary market, rather than hold them in our portfolio. We may, however, place residential fixed rate loans in our portfolio of loans held for investment if these fixed rate loans are funded with long-term funds to mitigate interest rate risk. In addition, we originate a small volume of fixed rate loans for our own investment if they meet specific yield and other approved guidelines, or to facilitate our sale of real estate acquired in settlement of loans. The average term of these fixed rate mortgage loans we originate for our own portfolio historically has been significantly shorter than their contractual maturity as a result of home sales or refinancings and prepayments. For more information, see Secondary Marketing and Loan Servicing Activities on page 5.

Page 3 **Navigation Links**

Our adjustable rate mortgages:

- generally either begin with an incentive interest rate, which is an interest rate below the current market rate, that adjusts to the applicable index plus a defined spread, subject to periodic and lifetime caps, after one, three, six or twelve months, or are fixed for a period of three to five years then adjust semi-annually or annually thereafter;
- generally provide that the maximum interest rate cannot exceed the incentive rate by more than six to nine percentage points, depending on the type of loan and the initial rate offered; and
- limit interest rate adjustments, for loans that adjust both the interest rate and payment amount simultaneously, to 1% per adjustment period for those that adjust semi-annually and 2% per adjustment period for those that adjust annually.

Most of our adjustable rate mortgages adjust the interest rate monthly and the payment amount annually. These monthly adjustable rate mortgages:

- have a lifetime interest rate cap, but no specified periodic interest rate adjustment cap;
- have a periodic cap on changes in required monthly payments; and
- allow for negative amortization, which is the addition to loan principal of accrued interest that exceeds the required monthly loan payments.

If a loan incurs significant negative amortization, the loan-to-value ratio could increase which also increases credit risk, as the fair value of the underlying collateral could be insufficient to satisfy fully the outstanding principal and interest. A loan-to-value ratio is the ratio of the principal amount of the loan to the lower of the sales price or appraised value of the property securing the loan at origination. We currently impose a limit on the amount of negative amortization. The principal plus the negative amortization cannot exceed 125% of the original loan amount, except for subprime loans and loans with loan-to-value ratios of greater than 80% where the borrower has obtained private mortgage insurance to reduce the effective loan-to-value ratio to between 67% and 80%. In those two instances, the principal plus negative amortization cannot exceed 110% of the original loan amount. At year-end 2003, loans with the higher 125% limit on negative amortization represented 28% of our adjustable rate one-to-four unit residential portfolio, while those with the 110% limit represented 45%. We permit adjustable rate mortgages to be assumed by qualified borrowers.

During 2003, approximately 72% of our one-to-four unit residential real estate loans were originated or purchased through outside mortgage brokers. These mortgage brokers do not operate from our offices and are not our employees. Our branch managers and residential loan officers originated approximately 28% of our one-to-four unit residential loans during 2003.

We require that our residential real estate loans be approved at various levels of management, depending upon the amount of the loan. On a single family residential loan we originate for our portfolio, the maximum amount we generally will lend is $2 million. Our average loan size, however, is much lower. In 2003, our average loan size was $354,000. We generally make loans with loan-to-value ratios not exceeding 80%. We will make loans with loan-to-value ratios of over 80%, if the borrower obtains private mortgage insurance to reduce the effective loan-to-value ratio to between 67% and 80%, consistent with secondary marketing requirements. In addition, we require that borrowers obtain hazard insurance for all residential real estate loans covering the lower of the loan amount or the replacement value of the residence.

In our approval process for the loans we originate or purchase, we assess both the value of the property securing the loan and the applicant s ability to repay the loan. Qualified appraisers on our staff or approved outside appraisers establish the value of the collateral through appraisals or alternative valuation formats that meet regulatory requirements. Appraisal reports prepared by outside appraisers are selectively reviewed by our staff appraisers or by approved fee appraisers. We generally obtain information about the applicant s income, financial condition, employment and credit history. Typically, we will verify an applicant s credit information for loans originated by our retail loan representatives. For loans submitted from outside mortgage brokers, we require the mortgage broker to obtain, review and verify the applicant s credit information and employment.

We offer one-to-four unit residential loans to borrowers who have or, in the case of purchases, will have equity in their homes but whose credit rating contains exceptions which preclude them from qualifying for lower or better market interest rates and terms. We refer to these lower rated credits, which we characterize as "A-," "B" and "C" loans, as subprime loans in our loan portfolio. Our subprime loans are characterized by lower loan-to-

value ratios and higher average interest rates than higher credit grade prime loans or "A" loans. We believe these lower credit rated borrowers represent an opportunity for us to earn a higher net return for the risks we assume. For further information, see Regulatory Capital Requirements on page 11.

We currently qualify applicants of our adjustable rate mortgages at the higher of the fully-indexed rate or:

- for prime borrowers:
  - 5.25% for owner occupied; or
  - 5.50% for non-owner occupied.
- for subprime borrowers:
  - 6.25% for owner occupied; or
  - 6.50% for non-owner occupied.

Secondary Marketing and Loan Servicing Activities

As part of our secondary marketing activities, we originate residential real estate adjustable rate mortgages and fixed rate mortgages that we intend to sell. Accordingly, we classify these loans as held for sale and carry them at the lower of cost or fair value. The cost includes a basis adjustment to the loan at funding resulting from the change in the fair value of the associated interest rate lock derivative from the date of commitment to the date of funding. These loans are primarily secured by first liens on one-to-four unit residential properties and generally have maturities of 30 years or less.

We believe that servicing loans for others can be an important asset/liability management tool because it produces operating results which, in response to changes in market interest rates, tend to move opposite to changes in net interest income. Because yields on adjustable rate mortgages take longer to adjust to market interest rates than their funding sources, net interest income associated with these loans is expected to decline in periods of rising interest rates and increase in periods of falling rates. In contrast, the value of a loan servicing portfolio normally:

- increases as interest rates rise and loan prepayments decrease; and

- declines as interest rates fall and loan prepayments increase.

In addition, increased levels of servicing activities and the opportunity to offer our other financial services in servicing loans for others can provide us with additional income with minimal additional overhead costs.

Depending upon market pricing for servicing, we sell loans either servicing retained or servicing released. When we sell loans servicing retained, we record gains or losses from these loans at the time of sale. We calculate gains or losses from our sale as the difference between the net sales proceeds and the allocated basis of the loans sold. We capitalize mortgage servicing rights we acquire through either our purchase or origination of mortgage loans we have sold with servicing rights retained. We allocate the total cost of the mortgage loans sold to both the mortgage servicing rights and to the mortgage loans without mortgage servicing rights based on their relative fair values. We disclose our mortgage servicing rights in our financial statements and include them as a component of the gain on sale of loans. We recognize impairment losses on the mortgage servicing rights through a valuation allowance and record any associated provision as a component of loan servicing income (loss), net category. For further information, see Note 1 on page 72 and Note 11 on page 88 of Notes to the Consolidated Financial Statements.

Generally, we use hedging programs to manage the interest rate risk of our secondary marketing activities. For further information, see Asset/Liability Management and Market Risk on page 45.

We may exchange loans we originate for sale with government-sponsored agencies for mortgage-backed securities collateralized by these loans. Our cost for the exchange, a monthly guaranty fee, is expressed as a percentage of the unpaid principal balance and is deducted from interest income. The securities we receive can be used to collateralize various types of our borrowings at rates that frequently are more favorable than rates on other types of liabilities and also carry a lower risk-based capital requirement than whole loans. We carry these mortgage-backed securities available for sale at fair value. However, we record no gain or loss on the exchange

in our statement of income until the securities are sold to a third party, usually that same day. Before we sell these securities to third parties, we show all changes in fair value as a separate component of stockholders equity as accumulated other comprehensive income, net of income taxes.

Multi-Family and Commercial Real Estate Lending

We have provided permanent loans secured by multi-family and retail neighborhood shopping center properties. Our major loan officers conduct our multi-family and commercial real estate lending activities.

Multi-family and commercial real estate loans generally entail additional risks as compared to single family residential mortgage lending. We subject each loan, including loans to facilitate the sale of real estate we own, to our underwriting standards, which generally include:

- our evaluation of the creditworthiness and reputation of the borrower; and
- the amount of the borrower s equity in the project as determined on the basis of appraisal, sales and leasing information on the property and cash flow projections.

To protect the value of the security for our loan, we require borrowers to maintain casualty insurance for the loan amount or replacement cost. In addition, for non-residential loans in excess of $500,000, we require the borrower to obtain comprehensive general liability insurance. All commercial real estate loans we originate must be approved by at least two of our officers, one of whom must be the originating loan account officer and the other a designated officer with appropriate loan approval authority.

Construction Lending

We have provided construction loan financing for single family and multi-family residential properties and commercial real estate projects, like retail neighborhood shopping centers. Our major loan officers principally originate these loans. We generally make construction loans at floating interest rates based upon the prime or reference rate of a major commercial bank. Generally, we require a loan-to-value ratio of 75% or less on construction lending and we subject each loan to our underwriting standards.

Construction loans involve risks different from completed project lending because we advance loan funds based upon the security of the completed project under construction. If the borrower defaults on the loan, then we may have to advance additional funds to finance the project s completion before the project can be sold. Moreover, construction projects are affected by uncertainties inherent in estimating:

- construction costs;
- potential delays in construction time;
- market demand; and
- the accuracy of the value on the completed project.

When providing construction loans, we require the general contractor to, among other things, carry contractor s liability insurance equal to specific prescribed minimum amounts, carry builder s risk insurance and have a blanket bond against employee misappropriation.

Commercial Lending

We maintain traditional private banking credit products and services for our existing high net worth, relationship based customers. Our portfolio emphasis is toward secured, floating rate credit facilities. We also provide commercial deposit account products and services to meet the needs of business relationships maintained at the Bank.

Consumer Lending

The Bank originates home equity loans and home equity lines of credit, and other consumer loan products. Before we make a consumer loan, we assess the applicant s ability to repay the loan and, if applicable, the value of the collateral securing the loan. The risk involved with home equity loans and home equity lines of credit is similar to the risk involved with residential real estate loans. We offer customers a credit card through a third party, who extends the credit and services the loans made to our customers.

Investment Activities

As a federally chartered savings association, the Bank s ability to make securities investments is prescribed under the OTS regulations and the Home Owners Loan Act. The Bank s authorized officers make investment decisions within guidelines established by the Bank s Board of Directors. The Bank manages these investments in an effort to produce the highest yield, while at the same time maintaining safety of principal, minimizing interest rate risk and complying with applicable regulations.

We carry securities held to maturity at amortized cost. We adjust these costs for amortization of premiums and accretion of discounts, which we recognize in interest income using the interest method. We carry securities available for sale at fair value. We exclude unrealized holding gains and losses, or valuation allowances established for net unrealized losses, from our earnings and report them as a separate component of our stockholders equity as accumulated other comprehensive income, net of income taxes, unless the security is deemed other than temporarily impaired. If the security is determined to be other than temporarily impaired, we charge the amount of the impairment to operations. For further information on the composition of our investment portfolio, see Investment Securities on page 39.

Deposit Activities

We prefer to use deposits raised through our retail branch system as our principal source of funds for supporting our lending activities, because the cost of these funds generally is less than that of borrowings or other funding sources with comparable maturities. We traditionally have obtained our deposits primarily from areas surrounding the Bank s branch offices. However, we occasionally raise some retail deposits from institutions through Wall Street activities.

General economic conditions affect deposit flows. Funds may flow from depository institutions such as savings associations into direct vehicles like government and corporate securities or other financial intermediaries. Our ability to attract and retain deposits will continue to be affected by money market conditions, prevailing interest rates and available competing investment vehicles. Generally, state or federal regulation does not restrict interest rates we pay on deposits.

For further information, see Deposits on page 42.

Borrowing Activities

Besides deposits, we have utilized other sources to fund our loan origination and other business activities. We have at times relied upon our borrowings from the FHLB of San Francisco or the issuance of corporate debt as an additional source of funds. The FHLB of San Francisco makes advances to us through several different credit programs it offers.

From time to time, we obtain additional sources of funds by selling some of our securities and mortgage loans under agreements to repurchase. These reverse repurchase agreements are generally short-term and are collateralized by our mortgage-backed and investment securities or our mortgage loans. We only deal with investment banking firms that are recognized as primary dealers in U.S. government securities or major commercial banks in connection with these reverse repurchase agreements. In addition, we limit the amounts of our borrowings from any single institution.

Another source of funds has come from the issuance of junior subordinated debentures to Downey Financial Capital Trust I ("Trust"), a wholly owned, special purpose entity, whose sole purpose was to raise money through the sale of capital securities.

For further information, see Borrowings on page 43.

Earnings Spread

Our primary source of earnings comes from our net interest income. We determine our net interest income or the interest rate spread by calculating the difference between:

- the yield we earn on our interest-earning assets like loans, mortgage-backed securities and investment securities; and

- the cost we pay on our interest-bearing liabilities like deposits and borrowings.

Our net interest income is also determined by the relative dollar amounts of our interest-earning assets and interest-bearing liabilities.

Our effective interest rate spread, which reflects the relative level of our interest-earning assets to our interest-bearing liabilities, equals:

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

For information regarding our net income and the components thereof and for management s analysis of our financial condition and results of operations, see Management s Discussion and Analysis of Financial Condition and Results of Operations beginning on page 23. For information regarding the return on our assets and other selected financial data, see Selected Financial Data on page 21.

Asset/Liability Management

Savings institutions are affected by interest rate risks to the degree that their interest-bearing liabilities, consisting principally of customer deposits, FHLB advances and other borrowings, mature or reprice on a different basis than their interest-earning assets, which consist predominantly of intermediate or long-term real estate loans. While having liabilities that on average mature or reprice more frequently than assets may be beneficial in times of declining interest rates, this asset/liability structure may result in declining net earnings during periods of rising interest rates. Our principal objectives are to actively monitor and manage the effects of adverse changes in interest rates on our net interest income while maintaining our asset quality. To improve the rate sensitivity and maturity balance of our interest-earning assets and liabilities, we have emphasized the origination of loans with adjustable interest rates or relatively short maturities. Loans with adjustable interest rates have the beneficial effect of allowing the yield on our assets to increase during periods of rising interest rates, although these loans have contractual limitations on the frequency and extent of interest rate adjustments.

For further information, see Lending Activities on page 2 and Asset/Liability Management and Market Risk on page 45.

Insurance Agency Activities

Downey Affiliated Insurance Agency was incorporated on January 25, 1995, as Downey s wholly owned subsidiary. We capitalized Downey Affiliated Insurance Agency on February 24, 1995 with $400,000. In the 1995 second quarter, Downey Affiliated Insurance Agency commenced operations at which time representatives of Downey Affiliated Insurance Agency were available in our branches to offer annuity products. During 1996, Downey Affiliated Insurance Agency began offering forced-placed casualty insurance policies on mortgage loans and stopped offering annuity products. The offering of forced-placed casualty insurance policies ceased in April 1999.

REAL ESTATE INVESTMENT ACTIVITIES

In addition to our primary business of banking, which has been described above, we are also involved in real estate investment activities, which are conducted primarily through DSL Service Company, a wholly owned subsidiary of the Bank. DSL Service Company is a diversified real estate development company which was established in 1966 as a neighborhood shopping center and residential tract developer. Today its capabilities include development, construction and property management activities relating to its portfolio of projects primarily within California, but also in Arizona. In addition, DSL Service Company associates with other qualified developers to engage in joint ventures. The primary revenue sources of our real estate investment activities include net rental income and gains from the sale of real estate investments. The primary expenses of our real estate investment activities are interest expense and general and administrative expense.

Due to federal law, the Bank is prohibited from making new investments in real estate development and joint venture operations and is required to deduct the full amount of its investment in DSL Service Company in calculating its applicable ratios under the core, tangible and risk-based capital standards. Savings associations generally may invest in service corporation subsidiaries, like DSL Service Company, to the extent of 2% of the

association s assets, plus up to an additional 1% of assets for investments which serve primarily community, inner-city or community development purposes. In addition, "conforming loans" by the Bank to DSL Service Company joint venture partnerships are limited to 50% of the Bank s risk-based capital. "Conforming loans" are those generally limited to 80% of appraised value, bear a market rate of interest and require payments sufficient to amortize the principal balance of the loan. We are in compliance with each of these investment limitations.

To the extent Downey or a subsidiary of Downey, other than the Bank or its subsidiaries, makes real estate investments, the above-mentioned capital deductions and limitations do not apply, as they only pertain to the specific investments by savings associations or their subsidiaries.

For further information, see Investments in Real Estate and Joint Ventures on page 40.

COMPETITION

We face competition both in attracting deposits and in making loans. Our most direct competition for deposits has historically come from other savings institutions and from commercial banks located in our principal market areas, including many large financial institutions based in other parts of the country or their subsidiaries. In addition, we face additional significant competition for investors funds from short-term money market securities and other corporate and government securities. Our ability to attract and retain savings deposits depends, generally, on our ability to provide a rate of return, liquidity and risk comparable to that offered by competing investment opportunities and the appropriate level of customer service.

We experience competition for real estate loans principally from other savings institutions, commercial banks, mortgage banking companies and insurance companies. We compete for loans principally through our interest rates and loan fees we charge and our efficiency and quality of services we provide borrowers and real estate brokers.

EMPLOYEES

At December 31, 2003, we had 2,355 full-time employees and 649 part-time employees. We provide our employees with health and welfare benefits and a retirement and savings plan. Additionally, we offer qualifying employees participation in our stock purchase plan. Our employees are not represented by any union or collective bargaining group, and we consider our employee relations to be good.

REGULATION

General

Federal and state law extensively regulate savings and loan holding companies and savings associations. This regulation is intended primarily to protect our depositors and the SAIF and is not for the benefit of our stockholders. Below we describe some of the regulations applicable to us and the Bank. We do not claim this discussion is complete and qualify our discussion by reference to applicable statutory or regulatory provisions.

Regulation of Downey

General

We are a savings and loan holding company and are subject to regulatory oversight by the OTS. We are required to register and file reports with the OTS and are regulated and examined by the OTS. The OTS has enforcement authority over us, which also permits the OTS to restrict or prohibit our activities that it determines to be a serious risk to the Bank.

Activities Restrictions

As a savings and loan holding company with only one savings and loan association subsidiary, we generally are not limited by OTS activity restrictions, provided the Bank satisfies the qualified thrift lender test or meets the definition of a domestic building and loan association in the Internal Revenue Code. If we acquire control of another savings association as a separate subsidiary of Downey, we would become a multiple savings and loan holding company. As a multiple savings and loan holding company, our activities, other than the activities of the Bank or any other SAIF-insured savings association, would become subject to restrictions applicable to bank holding companies unless these other savings associations were acquired in a supervisory acquisition and each also satisfies the qualified thrift lender test or meets the definition of a domestic building and

loan association. Furthermore, if in the future we sold control of the Bank to any other company, such company would not succeed to our grandfathered status as a unitary thrift holding company and would be subject to the same business activity restrictions as a bank holding company. For more information, see Qualified Thrift Lender Test on page 13.

Restrictions on Acquisitions

We must obtain approval from the appropriate bank regulatory agencies before acquiring control of any insured depository institution. The OTS generally prohibits these types of acquisitions if they result in a multiple savings and loan holding company controlling savings associations in more than one state. However, the OTS permits interstate acquisitions if the acquisition is authorized by specific state authorization or a supervisory acquisition of a failing savings association.

Federal law generally provides that no "person," acting directly or indirectly or through or in concert with one or more other persons, may acquire "control" of a federally insured savings association unless the person gives at least 60 days written notice to the OTS. The OTS then has the opportunity to disapprove the proposed acquisition. In addition, no company may acquire control of this type of an institution without prior OTS approval. These provisions also prohibit, among other things, any director or officer of a savings and loan holding company, or any individual who owns or controls more than 25% of the voting shares of a savings and loan holding company, from acquiring control of any savings association not a subsidiary of the savings and loan holding company, unless the acquisition is approved by the OTS.

The Sarbanes-Oxley Act of 2002

On July 30, 2002, the Sarbanes-Oxley Act was signed into law. This new legislation and subsequent regulations address accounting oversight and corporate governance matters, including:

- the creation of a five-member oversight board appointed by the Securities and Exchange Commission ("SEC") that will set standards for accountants and have investigative and disciplinary powers;
- the prohibition of accounting firms from providing various types of consulting services to public clients and requiring accounting firms to rotate partners among public client assignments every five years;
- increased penalties for financial crimes;
- expanded disclosure of corporate operations and internal controls and certification of financial statements;
- increased requirements for board audit committees and their members;
- enhanced controls on and reporting of insider trading; and

- statutory separations between investment bankers and analysts.

The new legislation and its implementing regulations will result in increased costs of compliance, including certain outside professional costs.

Regulation of the Bank

General

The OTS and the FDIC extensively regulate the Bank because the Bank is a federally chartered, SAIF-insured savings association. The Bank must ensure that its lending activities and its other investments comply with various statutory and regulatory requirements. The Bank is also regulated by the Federal Reserve.

The OTS, in conjunction with the FDIC, regularly examines the Bank and prepares reports for the Bank s Board of Directors to consider with respect to any deficiencies the OTS or the FDIC finds in the Bank s operations. Federal and state laws also regulate the relationship between the Bank and its depositors and borrowers, especially in matters regarding the ownership of savings accounts and the documents used by the Bank.

The Bank must file reports with the OTS and the FDIC concerning its activities and financial condition. In addition, the Bank must obtain regulatory approvals before entering into some transactions like mergers with or acquisitions of other financial institutions. This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily to protect the SAIF and our depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies regarding the classification of assets and adequate loan loss reserves for regulatory purposes. Any change in regulations,

whether by the OTS, the FDIC, the Federal Reserve or the Congress, could have a material adverse impact on us, the Bank and our operations.

Insurance of Deposit Accounts

The SAIF, as administered by the FDIC, insures the Bank s deposit accounts up to the maximum amount permitted by law. The FDIC may terminate insurance of deposits upon a finding that the institution:

- has engaged in unsafe or unsound practices;
- is in an unsafe or unsound condition to continue operations; or
- has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or the OTS.

The FDIC charges an annual assessment for the insurance of deposits based on the risk a particular institution poses to its deposit insurance fund. Under this system during 2003, SAIF members paid within a range of 0% to 0.27% of insured domestic deposits, depending upon the institution s risk classification. This risk classification is based on an institution s capital group and supervisory subgroup assignment.

The Bank also pays, in addition to its normal deposit insurance premium as a member of the SAIF, assessments towards the retirement of the Financing Corporation Bonds (known as FICO Bonds) issued in the 1980s to assist in the recovery of the savings and loan industry. These assessments will continue until the FICO Bonds mature in 2017. For the fourth quarter of 2003, this assessment was equal to 0.0154% of insured deposits.

Regulatory Capital Requirements

The Bank must meet regulatory capital standards to be deemed in compliance with OTS capital requirements. OTS capital regulations require savings associations to meet the following three capital standards:

- tangible capital equal to 1.5% of total adjusted assets;
- leverage capital, or "core capital," equal to 3% of total adjusted assets for institutions such as the Bank; and
- risk-based capital equal to 8.0% of total risk-based assets.

The OTS views its capital regulation requirements as minimum standards, and it expects most institutions to maintain capital levels well above the minimum. In addition, the OTS regulations provide that the OTS may establish minimum capital levels higher than those provided in the regulations for individual savings associations, upon a determination that the savings association s capital is or may become inadequate in view of its circumstances. The OTS regulations provide that higher individual minimum regulatory capital requirements may be appropriate in circumstances where, among others, a savings association:

- has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration of credit risk, other risks arising from nontraditional activities, or similar risks or a high proportion of off-balance sheet risk;
- is growing, either internally or through acquisitions, at a rate that presents supervisory issues; or
- may be adversely affected by activities or the condition of its holding company, affiliates, subsidiaries or other persons, or savings associations with which it has significant business relationships.

The Bank is not required to meet any individual minimum regulatory capital requirement. At December 31, 2003, the Bank s regulatory capital exceeded all minimum regulatory capital requirements.

As a result of a number of federally insured financial institutions extending their lending risk selection standards to attract lower credit quality borrowers due to their loans having higher interest rates and fees, the federal banking regulatory agencies jointly issued Interagency Guidelines on Subprime Lending. Subprime lending involves extending credit to individuals with less than perfect credit histories.

The guidelines consider subprime lending a high-risk activity that is unsafe and unsound if the risks associated with subprime lending are not properly controlled. Specifically, the 2002 guidelines direct examiners to

expect regulatory capital one and one-half to three times higher than that typically set aside for prime assets for institutions that:

- have subprime assets equal to 25% or higher of Tier 1 capital, or
- have subprime portfolios experiencing rapid growth or adverse performance trends, are administered by inexperienced management, or have inadequate or weak controls.

Our subprime portfolio, pursuant to our definition, represented 107% of Tier 1 capital as of year-end 2003. The OTS notified us that as of March 31, 2003, we were required to risk weight our subprime residential loans at 75% versus their current 50% risk weighting. This change increased the required regulatory capital associated with our subprime loans by one and one-half times that of prime residential loans.

The Home Owners Loan Act permits savings associations not in compliance with the OTS capital standards to seek an exemption from penalties or sanctions for noncompliance. The OTS will grant an exemption only if the savings association meets strict requirements. In addition, the OTS must deny the exemption in some circumstances. If the OTS does grant an exemption, the savings association still may be exposed to enforcement actions for other violations of law or unsafe or unsound practices or conditions.

Prompt Corrective Action

The OTS s prompt corrective action regulation requires the OTS to take mandatory actions and authorizes the OTS to take discretionary actions against a savings association that falls within undercapitalized capital categories specified in the regulation.

The regulation establishes five categories of capital classification:

- "well capitalized;"
- "adequately capitalized;"
- "undercapitalized;"
- "significantly undercapitalized;" and
- "critically undercapitalized."

The regulation uses an institution s risk-based capital, leverage capital and tangible capital ratios to determine the institution s capital classification. At December 31, 2003, the Bank exceeded the capital requirements of a well capitalized institution under applicable OTS regulations.

Predatory Lending

The term "predatory lending," much like the terms "safety and soundness" and "unfair and deceptive practices," is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower s ability to repay an obligation ("asset-based lending");
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); and/or
- engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Federal Reserve Bank regulations aimed at curbing such lending significantly widen the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that requires extra disclosures and consumer protections to borrowers. The following triggers coverage under the act:

- interest rates for first lien mortgage loans in excess of 8 percentage points above comparable Treasury securities;

- subordinate-lien loans of 10 percentage points above Treasury securities; and
- fees such as optional insurance and similar debt protection costs paid in connection with the credit transaction, when combined with points and fees if deemed excessive.

In addition, the act bars loan flipping by the same lender or loan servicer within a year. Lenders also will be presumed to have violated the law which says loans shouldn t be made to people unable to repay them unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid.

We do not expect these rules and potential state action in this area to have a material impact on our financial condition or results of operation. State action in this area, however, could impact our operations.

Loans-to-One-Borrower

Savings associations generally are subject to the lending limits applicable to national banks. With limited exceptions, the maximum amount that a savings association or a national bank may lend to any borrower, including some related entities of the borrower, at one time may not exceed:

- 15% of the unimpaired capital and surplus of the institution, plus
- an additional 10% of unimpaired capital and surplus if the loans are fully secured by readily marketable collateral.

Savings associations are additionally authorized to make loans to one borrower, for any purpose:

- in an amount not to exceed $500,000; or
- by order of the Director of OTS, in an amount not to exceed the lesser of $30 million or 30% of unimpaired capital and surplus to develop residential housing, provided:
    - the purchase price of each single-family dwelling in the development does not exceed $500,000;
    - the savings association is in compliance with its capital requirements;
    - the loans comply with applicable loan-to-value requirements; and
    - the aggregate amount of loans made under this authority does not exceed 15% of unimpaired capital and surplus.

At December 31, 2003, the Bank s loans-to-one-borrower limit was $147 million based upon the 15% of unimpaired capital and surplus measurement, or $245 million for loans secured by readily marketable collateral. The Bank s largest lending relationship consisted of nine loans to one of the Bank s directors totaling a commitment of $20 million, of which $19 million had been disbursed as of December 31, 2003. All such loans are performing in accordance with their loan terms, which are substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other non-related parties.

Qualified Thrift Lender Test

The OTS requires savings associations to meet a qualified thrift lender test. The test may be met either by maintaining a specified level of assets in qualified thrift investments as specified in the Home Owners Loan Act or by meeting the definition of a "domestic building and loan association." Qualified thrift investments are primarily residential mortgages and related investments, including some mortgage-related securities. The required percentage of investments under the Home Owners Loan Act is 65% of assets while the Internal Revenue Code requires investments of 60% of assets. An association must be in compliance with the qualified thrift lender test or the definition of domestic building and loan association on a monthly basis in nine out of every twelve months. Associations failing to meet the qualified thrift lender test are generally allowed only to engage in activities permitted for both national banks and savings associations.

The FHLB also relies on the qualified thrift lender test. A savings association will only enjoy full borrowing privileges from an FHLB if the savings association is a qualified thrift lender. As of December 31, 2003, the Bank was in compliance with its qualified thrift lender test requirement and met the definition of a domestic building and loan association.

Affiliate Transactions

The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of, any affiliates, the purchase of, or investments in, stock or other securities thereof, the taking of such securities as collateral for loans, and the purchase of assets of any affiliates. Such restrictions prevent any affiliates from borrowing from us unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by us to or in any affiliate are limited, individually, to 10% of the Bank s capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20% of the Bank s capital and surplus. Some entities included in the definition of an affiliate are parent companies, sister banks, sponsored and advised companies, investment companies whereby the bank its affiliate serves as investment advisor, and financial subsidiaries of the Bank. Additional restrictions on transactions with affiliates may be imposed on us under the prompt corrective action provisions of federal law. See Prompt Corrective Action on page 12.

Capital Distribution Limitations

A savings association that is a subsidiary of a savings and loan holding company, such as the Bank, must file an application or a notice with the OTS at least 30 days before making a capital distribution. Savings associations are not required to file an application for permission to make a capital distribution and need only file a notice if the following conditions are met:

- they are eligible for expedited treatment under OTS regulations;
- they would remain adequately capitalized after the distribution;
- the annual amount of capital distribution does not exceed net income for that year to date added to retained net income for the two preceding years; and
- the capital distribution would not violate any agreements between the OTS and the savings association or any OTS regulations.

Any other situation would require an application to the OTS. The OTS may disapprove an application or notice if the proposed capital distribution would:

- make the savings association undercapitalized, significantly undercapitalized or critically undercapitalized;
- raise safety or soundness concerns; or
- violate a statute, regulation or agreement with the OTS (or with the FDIC), or a condition imposed in an OTS approved application or notice.

Privacy

Federal banking regulations limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to those rules, financial institutions must provide:

- initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- annual notices of their privacy policies to current customers; and
- a reasonable method for customers to "opt out" of disclosures to nonaffiliated third parties.

These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

Interagency Guidance on Response Programs to Protect Against Identity Theft

On August 12, 2003, the Federal bank and thrift regulatory agencies requested public comment on proposed guidance that would require financial institutions to develop programs to respond to incidents of unauthorized access to customer information, including procedures for notifying customers under certain circumstances. The proposed guidance:

- interprets previously issued interagency customer information security guidelines that require financial institutions to implement information security programs designed to protect their customers information; and

- describes the components of a response program and sets a standard for providing notice to customers affected by unauthorized access to or use of customer information that could result in substantial harm or inconvenience to those customers, thereby reducing the risk of losses due to fraud or identity theft.

USA Patriot Act of 2001

The USA Patriot Act and its implementing regulations significantly expanded anti-money laundering and financial transparency laws, including:

- due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts or correspondent accounts for non-US persons;
- standards for verifying customer identification at account opening and maintaining expanded records;
- rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering;
- the filing of reports by non-financial businesses filed with the Treasury Department s Financial Crimes Enforcement Network for cash transactions exceeding $10,000; and
- the filing of suspicious activities reports by securities brokers and dealers if they believe a customer may be violating U.S. laws and regulations.

Activities of Subsidiaries

A savings association seeking to establish a new subsidiary, acquire control of an existing company or conduct a new activity through a subsidiary must provide 30 days prior notice to the FDIC and the OTS and conduct any activities of the subsidiary in compliance with regulations and orders of the OTS. The OTS may require a savings association to divest any subsidiary or terminate any activity conducted by a subsidiary that the OTS determines to pose a serious threat to the financial safety, soundness or stability of the savings association or to be otherwise inconsistent with sound banking practices.

Community Reinvestment Act and the Fair Lending Laws

Savings associations have a responsibility under the Community Reinvestment Act and related OTS regulations to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. An institution s failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in regulatory restrictions on its activities and the denial of applications. In addition, an institution s failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in the OTS, other federal regulatory agencies as well as the Department of Justice taking enforcement actions.

Federal Home Loan Bank System

The Bank is a member of the FHLB system. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB.

As an FHLB member, the Bank is required to own capital stock in an FHLB in an amount equal to the greater of:

- 1% of its aggregate outstanding principal amount of its residential mortgage loans, home purchase contracts and similar obligations at the beginning of each calendar year; or
- 5% of its FHLB advances or borrowings.

At December 31, 2003, the Bank had $123 million of FHLB stock, an amount in excess of our required investment of $106 million.

A new capital plan of the FHLB of San Francisco was approved by the Federal Housing Finance Board and will be implemented on April 1, 2004. The new capital plan incorporates a single class of stock with a par value of $100 per share, and may be issued, exchanged, redeemed, and repurchased only at par value. Each member is

 Navigation Links

required to own stock in amount equal to the greater of:

- a membership stock requirement with an initial cap of $25 million (100% of "membership asset value" as defined), or
- an activity based stock requirement (based on percentage of outstanding advances).

The new capital stock is redeemable on five years written notice, subject to certain conditions.

We do not believe that the initial implementation of the FHLB of San Francisco new capital plan as approved will have a material impact upon our financial condition, cash flows, or results of operations. Based on December 31, 2003 data, the required investment in FHLB stock under the new plan would be $100 million, which we exceed and we could be required to sell the excess to the FHLB San Francisco at their discretion. In addition, the Bank could be required to purchase as much as 50% additional capital stock or sell as much as 50% of its proposed capital stock requirement at the discretion of the FHLB of San Francisco.

Federal Reserve System

The Federal Reserve requires all depository institutions to maintain non-interest-bearing reserves at specified levels against their transaction accounts and non-personal time deposits. These transaction accounts include checking, NOW and Super NOW checking accounts. These reserves may also be used to satisfy the OTS s liquidity requirements. At December 31, 2003, the Bank was in compliance with these requirements.

Proposed Legislation

From time to time, new laws are proposed that could have an effect on the financial institutions industry. For example, legislation is currently being considered in the U.S. House of Representatives Financial Institutions Subcommittee which would:

- merge the Bank Insurance Fund ("BIF") and the SAIF;
- increase the current deposit insurance coverage limit for insured deposits to $130,000 and index future coverage limits to inflation;
- increase deposit insurance coverage limits for municipal deposits;
- double deposit insurance coverage limits for individual retirement accounts; and
- smooth out bank deposit insurance premiums to avoid sharp increases during times of recession.

While we cannot predict whether such proposals will eventually become law, they could have an effect on our operations and the way we conduct business.

Regulation of DSL Service Company

DSL Service Company is licensed as a real estate broker under the California Real Estate Law and as a contractor with the Contractors State License Board. Thus, the real estate investment activities of DSL Service Company, including development, construction and property management activities relating to its portfolio of projects, are governed by a variety of laws and regulations. Changes occur frequently in the laws and regulations or their interpretation by agencies and the courts. DSL Service Company must comply with various federal, state and local laws, ordinances, rules and regulations concerning zoning, building design, construction, hazardous waste and similar matters. Environmental laws and regulations also affect the operations of DSL Service Company, including regulations pertaining to availability of water, municipal sewage treatment capacity, land use, protection of endangered species, population density and preservation of the natural terrain and coastlines. These and other requirements could become more restrictive in the future, resulting in additional time and expense in connection with DSL Service Company s real estate activities.

With regard to environmental matters, the construction products industry is regulated by federal, state and local laws and regulations pertaining to several areas including human health and safety and environmental compliance. The Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended by the Superfund Amendments and Reauthorization Act of 1986, as well as analogous laws in some states, create joint and several liability for the cost of cleaning up or correcting releases to the environment of designated hazardous substances. Among those who may be held jointly and severally liable are:

- those who generated the waste;

- those who arranged for disposal;
- those who owned or operated the disposal site or facility at the time of disposal; and
- current owners.

In general, this liability is imposed in a series of governmental proceedings initiated by the government s identification of a site for initial listing as a "Superfund site" on the National Priorities List or a similar state list and the government s identification of potentially responsible parties who may be liable for cleanup costs. None of the DSL Service Company s project sites is listed as a "Superfund site."

In addition, California courts have imposed warranty-like responsibility upon developers of new housing for defects in structure and the housing site, including soil conditions. This responsibility is not necessarily dependent upon a finding that the developer was negligent.

As a licensed entity, DSL Service Company is also examined and supervised by the California Department of Real Estate and the Contractors State License Board.

TAXATION

Federal

Savings institutions are taxed like other corporations for federal income tax purposes, and are required to comply with income tax statutes and regulations similar to those applicable to large commercial banks. The Bank s bad debt deduction is determined under the specific charge-off method, which allows the Bank to take an income tax deduction for loans determined to be wholly or partially worthless.

In addition to the regular income tax, corporations are also subject to an alternative minimum tax. This tax is computed at 20% of the corporation s regular taxable income, after taking certain adjustments into account. The alternative minimum tax applies to the extent that it exceeds the regular income tax liability.

A corporation that incurs alternative minimum tax generally is entitled to take this tax as a credit against its regular tax liability in later years to the extent that the regular tax liability in these later years exceeds the alternative minimum tax.

State

The Bank uses California s financial corporation income tax rate to compute its California franchise tax liability. This rate is higher than the California non-financial corporation income tax rate because the financial corporation rate reflects an amount "in lieu" of local personal property and business license taxes that are paid by non-financial corporations, but not by banks or other financial corporations. The financial corporation income tax rate was 10.84% for both 2003 and 2002.

The Bank files a California franchise tax return on a combined reporting basis. Other income and franchise tax returns are filed on a separate-entity basis in various other states. The Bank anticipates that additional state income and franchise tax returns will be required in future years as its lending business expands nationwide.

The Internal Revenue Service and various state taxing authorities have examined the Bank s tax returns for all tax years through 1997. Management believes it has adequately provided for potential exposure to issues that may be raised by tax auditors in the years subsequent to 1997, which remain open to review.

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

In addition to the other information contained in this report, the following risks may affect us. If any of these risks occur, our business, financial condition or operating results could be adversely affected.

Our California business focus and economic conditions in California could adversely affect our operations.

Downey is headquartered in and its operations are concentrated in California. As a result of this geographic concentration, our results depend largely upon economic and business conditions in this state.

 Navigation Links

Deterioration of economic conditions in California could have a material adverse impact on the quality of our loan and real estate portfolios and the demand for our products and services.

Significant changes in interest rates could adversely affect our performance and results of operations.

If interest rates vary substantially from present levels, our results may differ materially from recent levels. Changes in interest rates will influence the growth of loans, investments, deposits and borrowings and affect the rates received on loans and investment securities and paid on deposits and borrowings. Changes in interest rates also affect the value of our recorded mortgage servicing rights on loans we service for others, generally increasing in value as interest rates rise and declining as interest rates fall. If interest rates were to increase significantly, the economic feasibility of real estate investment activities also could be adversely affected.

We are subject to government regulation and federal monetary policy that could limit or restrict our activities, which could adversely affect our operations.

The financial services industry is subject to extensive federal and state supervision and regulation. Significant new laws or changes in, or repeals of, existing laws may cause our results to differ materially. Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects credit conditions for Downey, primarily through open market operations in United States government securities, the discount rate for borrowings and reserve requirements. A material change in these conditions would be likely to have a material impact on our results.

Competition may adversely affect our performance.

The banking and financial services business in our market areas is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the expectation of continued consolidation among financial services providers. Increasing levels of competition in the banking and financial services businesses may reduce our market share or cause the prices we charge for our products to decline. Our results may differ in future periods depending on the nature or level of competition.

If a significant number of borrowers, guarantors and related parties fail to perform as required by the terms of their loans, we will sustain losses.

A significant source of risk arises from the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. While we have adopted underwriting and loan quality monitoring systems, procedures and credit policies, including the establishment and review of the allowance for loan losses, such policies and procedures may not prevent unexpected losses that could materially affect our results.

Because Downey operates as a holding company, changes in the ability of the Bank to pay dividends may adversely affect Downey s ability to pay dividends.

Although we have been paying regular quarterly dividends, our ability to pay dividends to our stockholders depends to a large extent upon the dividends we receive from the Bank. Dividends paid by the Bank are subject to restrictions under various federal and state banking laws. In addition, the Bank must maintain certain capital levels, which may restrict the ability of the Bank to pay dividends to us. The Bank s regulators have the authority to prohibit the Bank or us from engaging in unsafe or unsound practices in conducting our business. As a consequence, the Bank regulators could deem the payment of dividends by the Bank to be an unsafe or unsound practice, depending on the Bank s financial condition or otherwise, and prohibit such payments. If the Bank were unable to pay dividends to us, we might cease paying or reduce the rate or frequency at which we pay dividends to stockholders until such time that the Bank could again pay us dividends.

ITEM 2. PROPERTIES

BRANCHES

The corporate offices of Downey, the Bank and DSL Service Company are owned by the Bank and located at 3501 Jamboree Road, Newport Beach, California 92660. Part of that corporate facility houses a branch office of the Bank. Certain departments (warehousing, record retention, etc.) are located in other owned and leased facilities in Orange County, California. The majority of our administrative operations, however, are located in our corporate headquarters.

At December 31, 2003, we had 172 branches. We owned the building and land occupied by 61 of our branches, we owned one branch building on leased land and we had one branch under construction. We operate branches in 110 locations (including 100 in-store locations) with leases or licenses expiring at various dates through August 2011, with options to extend the term.

The net book value of our owned branches, including the one on leased land, totaled $81 million at December 31, 2003, and the net book value of our leased branch offices totaled $3 million at December 31, 2003. The net book value of our furniture and fixtures, including electronic data processing equipment, was $26 million at December 31, 2003.

For additional information regarding our offices and equipment, see Note 1 on page 72 and Note 8 on page 87 of Notes to Consolidated Financial Statements.

ELECTRONIC DATA PROCESSING

We utilize a mainframe computer system and use various internally developed and third-party vendors software for retail deposit operations, loan servicing, accounting and loan origination functions, including our operations conducted over the Internet. The net book value of our electronic data processing equipment, including personal computers and software, was $13 million at December 31, 2003.

ITEM 3. LEGAL PROCEEDINGS

We have been named as a defendant in legal actions arising in the ordinary course of business, none of which, in the opinion of management, is material.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to stockholders during the fourth quarter of 2003.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the New York Stock Exchange ("NYSE") and the Pacific Exchange ("PCX") under the trading symbol "DSL." At February 29, 2004, we had approximately 699 stockholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 27,953,747 outstanding shares of common stock.

The following table sets forth for the quarters indicated the range of high and low sale prices per share of our common stock as reported on the NYSE Composite Tape.

	2003				*2002*			
	4th Quarter	*3rd Quarter*	*2nd Quarter*	*1st Quarter*	*4th Quarter*	*3rd Quarter*	*2nd Quarter*	*1st Quarter*
High	$50.15	$48.68	$45.25	$41.41	$41.55	$49.25	$55.56	$48.83
Low	45.50	40.19	40.15	37.59	31.32	33.34	46.70	41.84
End of period	49.30	46.73	41.30	39.41	39.00	34.25	47.30	45.60

During 2003 and 2002, we paid quarterly cash dividends of $0.09 per share, or $0.36 per share annually. Total cash dividends were $10.1 million in both 2003 and 2002. On February 26, 2004, we paid a $0.10 per share quarterly cash dividend, representing an increase of 11.1% and aggregating $2.8 million.

We may pay additional dividends out of funds legally available therefor at such times as the Board of Directors determines that dividend payments are appropriate. The Board of Directors policy is to consider the declaration of dividends on a quarterly basis.

The payment of dividends by the Bank to Downey is subject to OTS regulations. For further information regarding these regulations, see Capital Distribution Limitations on page 14.

On July 24, 2002, our Board of Directors authorized a share repurchase program of up to $50 million of our common stock. To fund this program, the Bank paid a special $50 million dividend to the holding company. The shares are being repurchased from time-to-time in open market transactions. The timing, volume and price of purchases will be made at our discretion, and will also be contingent upon our overall financial condition, as well as market conditions in general. Since July 25, 2002, 306,300 shares of our common stock have been repurchased at an aggregate cost of $39.73 per share. No shares were reissued during the year, leaving $38 million available for future purchases.

There were no shares repurchased during 2003. Common stock repurchases were as follows:

	Common Stock Repurchased		
	Number of Shares	*Average Price*	*Available Repurchases*
Authorized a share repurchase program July 24, 2002	-	$ -	$ 50,000,000
August 2002	212,300	41.04	41,287,128
November 2002	94,000	36.78	37,829,808
Balance at December 31, 2003	306,300	$ 39.73	$ 37,829,808

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in Thousands, Except Per Share Data)	*2003*	*2002*	*2001*	*2000*	*1999*
Income statement data					
Total interest income	$ 522,450	$ 633,038	$ 808,381	$ 784,360	$ 533,751
Total interest expense	233,837	318,012	503,183	522,257	326,428
Net interest income	288,613	315,026	305,198	262,103	207,323
Provision for (reduction of) loan losses	(3,718)	939	2,564	3,251	11,270
Net interest income after provision for (reduction of) loan losses	292,331	314,087	302,634	258,852	196,053
Other income, net:					
Loan and deposit related fees	53,076	47,220	50,486	30,089	20,097
Real estate and joint ventures held for investment, net	9,835	10,250	3,885	8,798	19,302
Secondary marketing activities:					
Loan servicing income (loss), net	(27,060)	(39,629)	(11,373)	(3,628)	1,672
Net gains on sales of loans and mortgage-backed securities	61,436	45,860	22,432	3,297	14,806
Net gains on sales of mortgage servicing rights	23	331	934	-	-
Net losses on trading securities	(10,449)	-	-	-	-
Net gains (losses) on sales of investment securities	8	219	329	(106)	288
Gain on sale of subsidiary [(a)]	-	-	-	9,762	-
Litigation award	2,851	-	-	-	-
Other	1,222	2,803	2,215	2,714	3,268
Total other income, net	90,942	67,054	68,908	50,926	59,433

Operating expense:					
General and administrative expense	207,999	186,644	162,496	136,189	144,382
Net operation of real estate acquired in settlement of					
loans	(929)	11	239	818	19
Amortization of excess cost over fair value of branch					
acquisitions [b]	-	-	457	462	474
Total operating expense	207,070	186,655	163,192	137,469	144,875
Net income [a]	$ 101,741	$ 112,293	$ 120,181	$ 99,251	$ 63,804
Per share data					
Earnings per share Basic [a]	$ 3.64	$ 3.99	$ 4.26	$ 3.52	$ 2.27
Earnings per share Diluted [a]	3.64	3.99	4.25	3.51	2.26
Book value per share at end of period	32.83	29.47	26.01	22.15	18.91
Stock price at end of period	49.30	39.00	41.25	55.00	20.19
Cash dividends paid	0.36	0.36	0.36	0.36	0.35
Selected financial ratios					
Effective interest rate spread	2.61 %	2.91 %	2.91 %	2.65 %	2.88 %
Efficiency ratio [c]	56.70	50.23	43.93	46.23	58.41
Return on average assets [a]	0.89	1.00	1.11	0.97	0.85
Return on average equity [a]	11.65	14.42	17.81	17.17	12.70
Dividend payout ratio	9.88	9.02	8.45	10.22	15.44
Loan activity					
Loans originated	$ 10,548,675	$ 10,445,978	$ 8,128,285	$ 5,217,421	$ 7,132,486
Loans and mortgage-backed securities purchased	706,949	1,497,645	216,214	19,775	49,669
Loans and mortgage-backed securities sold	6,581,856	7,103,861	4,553,944	1,662,600	2,386,958

[a] In 2000, a $5.6 million after-tax gain was recognized from the sale of Downey Auto Finance Corp. Excluding the gain, 2000 net income would have been $93.6 million or $3.33 per share on a basic basis and $3.32 per share on a diluted basis, the return on average assets would have been 0.92% and the return on average equity would have been 16.20%.
[b] During the fourth quarter of 2002, we adopted SFAS 147, which required us to cease the amortization of goodwill as of January 1, 2002.
[c] The amount of general and administrative expense incurred for each $1 of net interest income plus other income, except for income associated with real estate held for investment and securities gains or losses.

ITEM 6. SELECTED FINANCIAL DATA (CONTINUED)

(Dollars in Thousands, Except Per Share Data)	*2003*	*2002*	*2001*	*2000*	*1999*
Balance sheet summary (end of period)					
Total assets	$ 11,645,980	$ 11,981,878	$ 11,108,757	$ 10,897,590	$ 9,411,267
Loans and mortgage-backed securities	10,396,510	10,976,942	10,132,413	10,084,353	8,746,063
Investments, cash and cash equivalents	803,514	590,092	551,823	439,968	299,698
Deposits	8,293,758	9,238,350	8,619,566	8,082,689	6,562,761
Borrowings	2,253,022	1,747,795	1,646,423	2,102,283	2,246,491
Stockholders equity	917,018	823,104	733,896	624,636	532,418
Loans serviced for others	9,313,948	8,316,236	5,805,811	3,964,462	2,923,778
Average balance sheet data					
Assets	$ 11,458,956	$ 11,234,112	$ 10,854,441	$ 10,221,129	$ 7,502,821
Loans	10,445,684	10,336,951	10,033,155	9,514,978	6,937,342
Deposits	8,787,851	8,768,204	8,701,424	7,290,850	5,697,292
Stockholders equity	873,051	778,463	674,972	577,979	502,412
Capital ratios					
Average stockholders equity to average assets	7.62 %	6.93 %	6.22 %	5.65 %	6.70 %
Bank only end of period: [(a)]					
Core and tangible capital	7.96	6.92	7.10	6.42	6.27
Risk-based capital	15.55	14.08	14.53	12.94	12.14
Selected asset quality data (end of period)					
Total non-performing assets	$ 48,631	$ 79,814	$ 92,632	$ 54,974	$ 39,194
Non-performing assets as a percentage of total assets	0.42 %	0.67 %	0.83 %	0.50 %	0.42 %
Allowance for loan losses:					
Amount	$ 30,330	$ 34,999	$ 36,120	$ 34,452	$ 38,342
As a percentage of non-performing loans	70.82 %	51.89 %	46.76 %	76.63 %	116.25 %

[(a)] *For more information regarding these ratios, see Regulatory Capital Compliance on page 62.*

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements under this caption may constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995, which involve risks and uncertainties. Forward-looking statements do not relate strictly to historical information or current facts. Some forward-looking statements may be identified by use of terms such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could" or "may." Our actual results may differ significantly from the results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. For additional information concerning these factors, see Factors That May Affect Future Results Of Operations on page 17.

OVERVIEW

Our net income for 2003 totaled $101.7 million or $3.64 per share on a diluted basis, down from last year s $112.3 million or $3.99 per share.

The decline in our net income between years primarily reflected the following:

- a $26.4 million decline in net interest income reflecting a decline in the effective interest rate spread;
- a $21.4 million increase in general and administrative expense due to higher costs associated with the increased number of branch locations and higher loan origination activity; and
- a $10.4 million loss from trading securities that were sold in July and were intended to enhance net interest income and serve as a partial economic hedge against mortgage servicing rights.

Those unfavorable items were partially offset by the following:

- a $15.6 million increase in net gains on sales of loans due to both a higher volume of loan sales and a higher gain per dollar of loan sold;
- a $12.6 million improvement in loan servicing activities due primarily to a smaller addition to the valuation allowance for mortgage servicing rights;
- a $5.9 million increase in loan and deposit related fees;
- a $4.7 million improvement in provision for loan losses; and
- a $2.9 million litigation award.

For 2003, our return on average assets was 0.89% and our return on average equity was 11.65%. These compare to our 2002 returns of 1.00% on average assets and 14.42% on average equity.

Our single family loan originations, including purchases, increased from $10.7 billion in 2002 to a record $10.9 billion in 2003, of which $6.2 billion were originated for sale in the secondary market. Of the 2003 total, $4.7 billion represented originations of loans for portfolio, of which $318 million were subprime credits. In addition to single family loans, we originated $377 million of other loans during the year, including $100 million of construction and land loans.

Our assets declined $336 million or 2.8% during 2003 to $11.6 billion at year end, following a 7.9% increase during 2002. The decline was primarily in loans held for investment, as the low interest rate environment throughout 2003 resulted in our loan repayments exceeding our portfolio originations. Deposits declined $945 million or 10.2% to a year-end level of $8.3 billion, following a 7.2% increase during 2002. Since deposits declined more than assets, our borrowings increased $505 million during 2003 to $2.3 billion at year end.

Non-performing assets totaled $49 million at December 31, 2003, down from $80 million a year ago. The decrease was due primarily to a decline in our residential non-performers. When measured as a percentage of total assets, our non-performing assets dropped to 0.42% at year-end 2003 from 0.67% at year-end 2002.

At December 31, 2003, the Bank exceeded all regulatory capital tests, with capital-to-asset ratios of 7.96% for both tangible and core capital and 15.55% for risk-based capital. These capital levels are significantly above the "well capitalized" standards defined by the federal banking regulators of 5% for core and tangible capital and 10% for risk-based capital. For further information, see Insurance of Deposit Accounts on page 11, Investments in Real Estate and Joint Ventures on page 40 and Regulatory Capital Compliance on page 62.

On October 11, 2003, grocery store workers from Albertsons, Vons, Pavilions and Ralphs went on strike or were locked out by grocery store management. The grocery stores have remained open during the labor dispute. Downey operates 85 full-service, in-store branches with 85 automated teller machines ("ATMs") and 142 stand-alone ATMs in these grocery stores. At December 31, 2003, we had $1.2 billion in deposits or 15% of total deposits associated with these branches. There has been no material change to deposit volumes and the impact to our financial results has been minimal.

Page 24 **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 Note 1 of Notes to the Consolidated Financial Statements beginning on page 72. Certain accounting policies require us to make significant estimates and assumptions which have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and our results of operations for the reporting periods. Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors.

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

- Allowance for mortgage servicing rights ("MSRs") losses. MSRs are reviewed for impairment based on their fair value. The fair value of the MSRs, for the purposes of impairment, is measured using a discounted cash flow analysis based on available market quotes, market-adjusted discount rates and anticipated prepayment speeds. Market sources are used to determine prepayment speeds, the net cost of servicing per loan, inflation rate, and default and interest rates for mortgages. We capitalize and measure MSR impairment on a disaggregated basis based on the following predominant risk characteristics of the underlying mortgage loans: fixed-rate mortgage loans by loan term and coupon rate (less than 7%, 150 basis point increments between 7% and 10%, and greater than 10%), and loan term for adjustable rate mortgages. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income (loss). At December 31, 2003, the allowance totaled $13 million, compared to the prior year-end allowance of $33 million. For further information, see Note 1 on page 72 and Note 11 on page 88 of Notes to the Consolidated Financial Statements.
- Valuation of expected interest rate lock commitments. We enter into commitments to make loans that we intend to sell to investors whereby the interest rate on the loan is set prior to funding. These interest rate lock commitments are considered to be derivatives and are recorded at fair value. This value is calculated using market sources, adjusted by an anticipated fallout factor for interest rate lock commitments that are not expected to fund. At December 31, 2003, an asset was recorded for interest rate lock derivatives of $0.1 million, compared to the prior year-end asset balance of $5.4 million. For further information, see Interest Rate Lock Derivatives on page 63 and Note 1 on page 72 and Note 22 on page 100 of Notes to the Consolidated Financial Statements.
- Allowance for losses on loans and real estate. The allowance for losses on loans and real estate are maintained at an amount management deems adequate to cover inherent losses. We have implemented and use an internal asset review system and loan loss allowance methodology designed to provide for the detection of problem assets and an adequate allowance to cover loan losses. In determining the allowance for loan losses related to specific large loans (loans over $5 million), we evaluate the allowance on an individual loan basis, including an analysis of the creditworthiness, cash flows and financial status of the borrower, and the condition and the estimated value of the collateral. Generally, we review all loans under $5 million by analyzing their performance and composition of their collateral as a whole because of the relatively homogeneous nature of the portfolios, unless an individual loan or borrower relationship warrants separate analysis. The allowance is determined by applying factors that take into consideration past loss experience and asset duration for each major asset type to the associated asset balance or loss statistics against current classified asset balances to determine the amount of the allowances. At December 31, 2003, these allowances totaled $32 million, compared to the prior year-end allowances of $36 million. For further information, see Allowance for Losses on Loans and Real Estate on page 54 and Note 1 of Notes to the Consolidated Financial Statements on page 72.

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 $288.6 million in 2003, down $26.4 million or 8.4% from 2002 and $16.6 million or 5.4% lower than 2001. The decline during 2003 reflected a lower effective interest rate spread, as our average interest-earning assets increased by $222 million or 2.1% to $11.1 billion. Our effective interest rate spread averaged 2.61% in 2003, down from 2.91%, the average for both 2002 and 2001. The decline in 2003 was due to our yield on interest-earning assets declining more rapidly than our cost of funds. The more rapid decline primarily reflected our positive interest rate gap (i.e., more interest-earning assets reprice to market interest rates within one year than do interest-bearing liabilities). In addition, the decline in our effective interest rate spread also reflected a higher proportion of lower yielding investment securities, a higher proportion of adjustable rate mortgages tied to the 12-month moving average of annual yields on actively traded U.S. Treasury securities to a constant maturity of one year ("MTA") that currently have lower fully-indexed yields than those tied to the FHLB Eleventh District Cost of Funds Index ("COFI") and a lower percentage of higher yielding subprime loans.

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

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

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

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

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

	2003			*2002*			*2001*		
llars in Thousands)	*Average Balance*	*Interest*	*Average Yield/ Rate*	*Average Balance*	*Interest*	*Average Yield/ Rate*	*Average Balance*	*Interest*	*Average Yield/ Rate*
erest-earning assets:									
ans	$ 10,445,684	$ 504,480	4.83 %	$ 10,336,951	$ 612,762	5.93 %	$ 10,033,155	$ 782,784	7.80 %
ortgage-backed securities	1,714	61	3.56	76,250	3,637	4.77	13,747	726	5.28
ading and investment curities	608,256	17,909	2.94	420,142	16,639	3.96	443,386	24,871	5.61

otal interest-earning assets	11,055,654	522,450	4.73	10,833,343	633,038	5.84	10,490,288	808,381	7.71
n-interest-earning assets	403,302			400,769			364,153		
tal assets	$ 11,458,956			$ 11,234,112			$ 10,854,441		
nsaction accounts:									
on-interest-bearing checking	$ 415,995	$ -	- %	$ 306,890	$ -	- %	$ 302,628	$ -	- %
erest-bearing checking [(a)]	446,582	1,164	0.26	421,590	1,391	0.33	406,666	2,057	0.51
oney market	131,134	1,485	1.13	113,862	1,929	1.69	93,964	2,436	2.59
egular passbook	3,958,567	53,109	1.34	3,042,839	69,113	2.27	1,118,287	34,553	3.09
otal transaction accounts	4,952,278	55,758	1.13	3,885,181	72,433	1.86	1,921,545	39,046	2.03
tificates of deposit	3,835,573	106,067	2.77	4,883,023	172,108	3.52	6,779,879	385,809	5.69
tal deposits	8,787,851	161,825	1.84	8,768,204	244,541	2.79	8,701,424	424,855	4.88
LB advances and real ate notes	1,492,034	59,477	3.99	1,410,762	60,936	4.32	1,219,484	65,793	5.40
ior subordinated bentures	123,711	12,535	10.13	123,711	12,535	10.13	123,711	12,535	10.13
tal deposits and borrowings	10,403,596	233,837	2.25	10,302,677	318,012	3.09	10,044,619	503,183	5.01
er liabilities	182,309			152,972			134,850		
ckholders equity	873,051			778,463			674,972		
tal liabilities and ockholders equity	$ 11,458,956			$ 11,234,112			$ 10,854,441		
interest income/interest e spread		$ 288,613	2.48 %		$ 315,026	2.75 %		$ 305,198	2.70 %
cess of interest-earning ets over posits and borrowings	$ 652,058			$ 530,666			$ 445,669		
ective interest rate spread			2.61			2.91			2.91

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

Navigation Links

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

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

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

	2003 Versus 2002 Changes Due To				2002 Versus 2001 Changes Due To			
housands)	Volume	Rate	Rate/ Volume	Net	Volume	Rate	Rate/ Volume	Net
est income:								
ns	$ 6,446	$ (113,534)	$ (1,194)	$ (108,282)	$ 23,702	$ (188,031)	$ (5,693)	$ (170,022)
tgage-backed securities	(3,556)	(923)	903	(3,576)	3,301	(70)	(320)	2,911
ding and investment urities	7,450	(4,269)	(1,911)	1,270	(1,304)	(7,311)	383	(8,232)
ange in interest income	10,340	(118,726)	(2,202)	(110,588)	25,699	(195,412)	(5,630)	(175,343)
est expense:								
nsaction accounts:								
erest-bearing checking [a]	82	(292)	(17)	(227)	75	(715)	(26)	(666)
ney market	293	(640)	(97)	(444)	516	(844)	(179)	(507)
gular passbook	20,798	(28,289)	(8,513)	(16,004)	59,465	(9,153)	(15,752)	34,560
tal transaction accounts	21,173	(29,221)	(8,627)	(16,675)	60,056	(10,712)	(15,957)	33,387
tificates of deposit	(36,919)	(37,075)	7,953	(66,041)	(107,941)	(146,844)	41,084	(213,701)
al interest-bearing posits	(15,746)	(66,296)	(674)	(82,716)	(47,885)	(157,556)	25,127	(180,314)
B advances and real te es	3,403	(4,770)	(92)	(1,459)	10,320	(13,119)	(2,058)	(4,857)
or subordinated entures	-	-	-	-	-	-	-	-
ange in interest expense	(12,343)	(71,066)	(766)	(84,175)	(37,565)	(170,675)	23,069	(185,171)
nge in net interest me	$ 22,683	$ (47,660)	$ (1,436)	$ (26,413)	$ 63,264	$ (24,737)	$ (28,699)	$ 9,828

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

Provision for Loan Losses

During 2003, $3.7 million of provision for loan losses was reversed, compared to an expense of $0.9 million in 2002 and $2.6 million in 2001. The current year reversal reflected both an improvement in our credit quality and a decline in our loan portfolio.

For further information, see Allowance for Losses on Loans and Real Estate on page 54.

Other Income

Our total other income was $90.9 million in 2003, up from $67.1 million in 2002 and $68.9 million in 2001. The $23.9 million increase from 2002 primarily reflected:

- a $15.6 million increase from gains on sales of loans;
- a $12.6 million improvement in loan servicing activities;
- a $ 5.9 million increase in loan and deposit related fees; and
- a $2.9 million litigation award, related to an other real estate owned asset that suffered damage from earth movement.

Page 28 **Navigation Links**

Those favorable items were partially offset by a $10.4 million loss from trading securities and a $1.6 million decline in our other income category.

Total other income declined $1.9 million during 2002 due primarily to a $28.3 million higher loss from our loan servicing activities. That unfavorable item was partially offset by increases of $23.4 million in net gains on sales of loans and mortgage-backed securities and $6.4 million in income from real estate held for investment.

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

Loan and Deposit Related Fees

Loan and deposit related fees totaled $53.1 million in 2003, up $5.9 million from 2002 and $2.6 million higher than 2001. Our deposit related fees increased $3.9 million during 2003, primarily due to higher fees from our checking accounts, while our loan related fees increased $2.0 million.

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

(In Thousands)	*2003*	*2002*	*2001*
Loan related fees:			
Prepayment fees	$ 16,780	$ 15,999	$ 23,839
Other fees	10,479	9,258	8,764
Deposit related fees:			
Automated teller machine fees	8,925	7,328	6,524
Other fees	16,892	14,635	11,359
Total loan and deposit related fees	$ 53,076	$ 47,220	$ 50,486

Real Estate and Joint Ventures Held for Investment

Income from our real estate and joint ventures held for investment totaled $9.8 million in 2003, $0.4 million below 2002, but $6.0 million higher than 2001. The current year decline was primarily attributed to a $1.0 million unfavorable change in provision for losses on real estate and joint ventures and a $0.9 million decline in net rental operations due to fewer properties owned. Those unfavorable items were partially offset by a $0.8 million increase in gains from sales to $7.2 million (a $2.1 million increase in gains from sales of wholly owned real estate more than offset a $1.3 million decline in gains related to joint venture projects reported within equity in net income from joint ventures) and a $0.4 million increase in interest from joint ventures.

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

(In Thousands)	*2003*	*2002*	*2001*

Rental operations, net of expenses	$ 1,213	$ 2,102	$ 2,245
Net gains on sales of wholly owned real estate	3,317	1,200	129
Equity in net income from joint ventures	4,379	5,476	736
Interest from joint venture advances	1,454	1,024	468
(Provision for) reduction of losses on real estate and joint ventures	(528)	448	307
Total income from real estate and joint ventures held for investment, net	$ 9,835	$ 10,250	$ 3,885

For additional information, see Investments in Real Estate and Joint Ventures on page 40, Allowance for Losses on Loans and Real Estate on page 54 and Note 6 of Notes to Consolidated Financial Statements on page 84.

Secondary Marketing Activities

A loss of $27.1 million was recorded in loan servicing from our portfolio of loans serviced for others during 2003, which was $12.6 million below the 2002 loss but $15.7 million higher than the loss in 2001. In each of the three years, the fair value of our mortgage servicing rights declined due to the drop in long-term interest rates that resulted in an increase in the actual and projected rate loans we service for others prepay, thereby shortening their expected average life. Those declines in the fair value required us to record a provision for impairment in each year. However, the addition in 2003 of $11.9 million was $24.7 million below the addition made in 2002 and was

primarily responsible for the lower loss from our servicing activities. Also contributing to the improvement in 2003 was a $4.7 million increase in net cash servicing fees due to the growth in the servicing portfolio. Those positive factors were partially offset by increases of $10.3 million in the amortization of mortgage servicing rights and $6.5 million in payoff and curtailment interest cost, both of which were adversely impacted by high prepayments. When a loan we service for others prepays, most of our loan servicing agreements require us to pay interest to the investor up to the date we remit funds to them. That additional interest cost is what we call payoff and curtailment interest cost. However, we benefit from the use of those proceeds from the time of repayment until we are required to remit the funds to the investor. That benefit results in a reduction of our borrowing costs within net interest income.

At December 31, 2003, we serviced $9.3 billion of loans for others, compared to $8.3 billion at December 31, 2002 and $5.8 billion at December 31, 2001.

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

(In Thousands)	*2003*	*2002*	*2001*
Net cash servicing fees	$ 21,215	$ 16,536	$ 11,702
Payoff and curtailment interest cost [(a)]	(11,611)	(5,117)	(2,674)
Amortization of MSRs	(24,774)	(14,435)	(9,813)
Provision for impairment of MSRs	(11,890)	(36,613)	(10,588)
Total loan servicing loss, net	$ (27,060)	$ (39,629)	$ (11,373)

[(a)] *Represents contractual obligation to pay interest at the investor s rate from the date the loan is repaid until the funds are remitted to the investor. This does not include the benefit of the use of repaid loan funds to reduce borrowings and its associated interest expense, which is reported in net interest income.*

Sales of loans and mortgage-backed securities we originated increased in 2003 to a record $6.6 billion from $6.0 billion in 2002 and $4.6 billion in 2001. Net gains associated with these sales totaled $61.4 million in 2003, up from $45.8 million in 2002 and $22.4 million in 2001. Included in the current year was a $0.9 million loss associated with the SFAS 133 impact of valuing derivatives associated with the sale of loans, compared to $6.1 million of income in 2002 and a loss of $6.0 million in 2001. Excluding the SFAS 133 impact, a gain of $62.4 million or 0.95% of loans sold was realized, up from 0.66% in 2002 and 0.62% in 2001. The higher gain as a percentage of loans sold in 2003 reflected improved pricing in the secondary markets which is unlikely to continue as borrower demand for fixed rate loans declines and competition for the lower volume intensifies. Net gains included capitalized mortgage servicing rights of $61.1 million in 2003, compared to $53.2 million in 2002 and $44.4 million in 2001.

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

(In Thousands)	*2003*	*2002*	*2001*
Mortgage servicing rights	$ 61,110	$ 53,236	$ 44,391
All other components excluding SFAS 133 [(a)]	1,264	(13,474)	(15,995)
SFAS 133	(938)	6,098	(5,964)
Total net gains on sales of loans and mortgage-backed securities	$ 61,436	$ 45,860	$ 22,432
Secondary marketing gain excluding SFAS 133 as a percentage of associated sales	0.95 %	0.66 %	0.62 %

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

For additional information concerning mortgage servicing rights, see Note 11 of Notes to Consolidated Financial Statements on page 88.

Trading Securities

In May 2003, the Federal Reserve announced a change in their bias towards economic weakness and the potential for further declines in market interest rates. Following that announcement, we purchased trading securities to enhance net interest income and to also serve as a partial economic hedge against further declines in the value of our mortgage servicing rights. The initial purchase of trading securities was approximately $230

million. When long-term interest rates began to rise in July 2003, the trading securities were sold and we have not made any further purchases. We incurred a loss from the trading securities totaling $10.4 million. That loss was offset by an increase during the same period in the value of our mortgage servicing rights that resulted in a recapture of previously provided provisions to the associated valuation allowance.

Operating Expense

Our operating expense totaled $207.1 million in 2003, up from $186.7 million in 2002 and $163.2 million in 2001. The current year increase was due to higher general and administrative expense, which increased by $21.4 million or 11.4%. That increase was primarily due to higher costs associated with an increased number of branch locations and higher loan origination activity.

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

(In Thousands)	*2003*	*2002*	*2001*

Salaries and related costs	$ 134,610	$ 119,514	$ 99,935
Premises and equipment costs	32,261	30,694	26,016
Advertising expense	3,712	4,418	4,410
SAIF insurance premiums and regulatory assessments	3,205	3,078	3,051
Professional fees	2,383	1,435	5,452
Other general and administrative expense	31,828	27,505	23,632
Total general and administrative expense	207,999	186,644	162,496
Net operation of real estate acquired in settlement of loans	(929)	11	239
Amortization of excess cost over fair value of branch acquisitions [a]	-	-	457
Total operating expense	$ 207,070	$ 186,655	$ 163,192

[a] *During the fourth quarter of 2002, Downey adopted SFAS 147, which required us to cease the amortization of goodwill as of January 1, 2002 and to subject this asset to annual impairment testing.*

Provision for Income Taxes

Our effective tax rate was 42.3% for 2003, unchanged from 2002 and 2001. See Note 1 on page 72 and Note 18 on page 94 of Notes to the Consolidated Financial Statements for a further discussion of income taxes and an explanation of the factors which impact our effective tax rate.

Business Segment Reporting

The previous discussion and analysis of the Results of Operations pertained to our consolidated results. This section discusses and analyzes the results of operations of our two business segments banking and real estate investment. For a description of these business segments and the accounting policies used, see Business on page 1 and Note 1 on page 72 and Note 24 on page 106 of Notes to Consolidated Financial Statements.

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

(In Thousands)	*2003*	*2002*	*2001*
Banking net income	$ 95,459	$ 106,074	$ 119,454
Real estate investment net income	6,282	6,219	727
Total net income	$ 101,741	$ 112,293	$ 120,181

Banking

Net income from our banking operations totaled $95.5 million in 2003, down from $106.1 million in 2002 and $119.5 million in 2001. The current year decline was primarily due to the following:

- a $26.2 million decline in net interest income reflecting a decline in the effective interest rate spread;
- a $20.3 million increase in operating expense due to higher costs associated with the increased number of branch locations and higher loan origination activity; and
- a $10.4 million loss from trading securities that were sold in July and were intended to enhance net interest income and serve as a partial economic hedge against mortgage servicing rights.

Those unfavorable items were partially offset by the following:

- a $15.6 million increase in net gains on sales of loans due to both a higher volume of sales and a higher gain per dollar of loan sold;
- a $12.6 million improvement in loan servicing activities due primarily to a smaller addition to the valuation allowance for mortgage servicing rights;
- a $5.2 million increase in loan and deposit related fees;
- a $4.7 million improvement in provision for loan losses; and
- a $2.9 million litigation award.

During 2002, net income from our banking operations declined $13.4 million. The decrease was primarily due to a $28.3 million higher loss from loan servicing activities, a $26.3 million increase in operating expense and a $7.3 million decline in loan related fees. These unfavorable items were partially offset by a $23.4 million increase in net gains on sales of loans and mortgage-backed securities, a $9.8 million increase in net interest income, a $4.1 million increase in deposit related fees and a $1.6 million decline in provision for loan losses.

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

(In Thousands)	*2003*	*2002*	*2001*
Net interest income	$ 288,740	$ 314,981	$ 305,201
Provision for (reduction of) loan losses	(3,718)	939	2,564
Other income	79,084	55,423	63,712
Operating expense	206,142	185,859	159,604
Net intercompany income	169	343	369
Income before income taxes	165,569	183,949	207,114
Income taxes	70,110	77,875	87,660
Net income	$ 95,459	$ 106,074	$ 119,454
At period end			
Assets:			
Loans and mortgage-backed securities	$ 10,396,510	$ 10,976,942	$ 10,132,413
Other	1,237,858	999,197	970,669
Total assets	11,634,368	11,976,139	11,103,082
Equity	$ 917,018	$ 823,104	$ 733,896

Real Estate Investment

Net income from our real estate investment operations totaled $6.3 million in 2003, virtually unchanged from 2002 and up from $0.7 million in 2001. Higher gains from sales and interest from joint ventures in 2003 were essentially offset by an unfavorable change in provision for losses on real estate and joint ventures and lower net rental income.

During 2002, net income from our real estate investment operations increased $5.5 million primarily due to higher gains from sales and lower operating expenses, as 2001 included expense pertaining to litigation matters associated with certain joint venture partners.

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

(In Thousands)	*2003*	*2002*	*2001*
Net interest income (loss)	$ (127)	$ 45	$ (3)
Other income	11,858	11,631	5,196
Operating expense	928	796	3,588
Net intercompany expense	169	343	369
Income before income taxes	10,634	10,537	1,236
Income taxes	4,352	4,318	509
Net income	$ 6,282	$ 6,219	$ 727
At period end			
Assets:			
Investments in real estate and joint ventures	$ 35,716	$ 33,890	$ 38,185
Other [(a)]	3,503	14,174	2,003
Total assets	39,219	48,064	40,188
Equity	$ 27,607	$ 42,325	$ 34,513

[(a)] *Cash held in the Bank was approximately $11 million higher at year-end 2002 than in the other reported periods.*

For a further discussion regarding income from real estate investment, see Real Estate and Joint Ventures Held For Investment on page 29, and for information regarding related assets, see Investments in Real Estate and Joint Ventures on page 40.

FINANCIAL CONDITION

Loans and Mortgage-Backed Securities

Total loans and mortgage-backed securities, including those we hold for sale, declined $580 million or 5.3% from year-end 2002 to a total of $10.4 billion or 89.3% of assets at December 31, 2003. The decline occurred in both loans held for sale and loans held for investment. Loans held for sale declined $372 million as the volume of new single family fixed rate applications fell due to the rise in mortgage interest rates beginning in the third quarter of 2003, while loans held for investment declined $206 million as repayments exceeded originations. Our prepayment speed during 2003 was 51%, compared to 39% during 2002 and 37% during 2001.

Our loan originations, including loans purchased, totaled a record $11.3 billion in 2003, up from $10.9 billion in 2002 and $8.2 billion in 2001. This current year increase primarily reflects record originations of one-to-four unit residential loans of $10.9 billion, of which approximately $4.7 billion or 43% were for portfolio, with the balance for sale in the secondary market. Our origination of subprime loans totaled $318 million in 2003, down from $520 million in 2002. Refinancing activities related to residential one-to-four unit loans, including new loans to refinance existing loans which we or other lenders originated, constituted 83% of originations during 2003 compared to 78% during 2002 and 75% during 2001. Refinancing activities increased from $8.3 billion in 2002 to $9.1 billion in 2003, as a lower interest rate environment existed throughout most of the year.

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

The table below presents information regarding interest rates and loan origination costs, net of fees collected on loans originated during the years indicated.

(Dollars in Thousands)	*2003*	*2002*	*2001*	*2000*	*1999*
Average interest rate on new loans	4.43 %	5.43 %	6.18 %	6.10 %	5.92 %
Total loan origination costs (net of fees) and premiums					
(net of discounts) deferred during the year [(a)]	$ 96,115	$ 75,420	$ 36,497	$ 34,797	$ 53,181

[(a)] *The change in the amount of net deferred loan costs in each year primarily reflects changes in the volume of new loan originations.*

Originations of adjustable rate residential one-to-four unit loans for portfolio, including loans purchased, totaled $4.6 billion in 2003, up from $4.4 billion in 2002 and $3.2 billion in 2001. Of the 2003 total:

- 62% were monthly adjustable loans tied to either the COFI or MTA index and provide for negative amortization. During 2003, there was greater borrower preference for monthly adjustable loans tied to MTA, as those loans had a lower fully-indexed rate than did those tied to COFI. MTA-related monthly adjustable loans represented 63% of monthly adjustable originations, compared to only 29% in 2002.
- 29% were adjustable rate loans where the initial rate is fixed for the first three or five years. At the conclusion of the initial fixed rate period, those loans then adjust to the change in either the weekly average on one-year U.S. Treasury securities adjusted to a constant maturity ("CMT"), or the London Inter-Bank Offered Rate ("LIBOR").
- 9% were adjustable loans that typically adjust every six or twelve months.

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

(In Thousands)	*2003*	*2002*	*2001*	*2000*	*1999*
Loans originated and purchased					
Investment portfolio:					

Residential one-to-four units:					
Adjustable by index:					
COFI	$ 1,077,726	$ 2,264,065	$ 2,041,962	$ 3,179,126	$ 3,762,022
MTA	1,795,628	890,814	169,909	17,040	433,656
LIBOR	405,080	3,903	12,683	6,254	36,477
Adjustable fixed for 3-5 years	1,353,320	1,288,389	978,713	37,366	79,824
Fixed	22,647	40,375	21,199	14,661	297,773
Total residential one-to-four units	4,654,401	4,487,546	3,224,466	3,254,447	4,609,752
Other	377,355	269,407	180,498	253,529	530,129
Total for investment portfolio	5,031,756	4,756,953	3,404,964	3,507,976	5,139,881
Sale portfolio[a]	6,223,868	6,172,572	4,823,938	1,729,220	2,042,274
Total for investment and sale portfolios	$ 11,255,624	$ 10,929,525	$ 8,228,902	$ 5,237,196	$ 7,182,155

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

At December 31, 2003, $7.0 billion of our one-to-four unit adjustable rate mortgages were subject to negative amortization, of which $48 million represented the amount of negative amortization included in the loan balance. The amount of negative amortization declined $64 million during 2003 as loans were repaid or as borrowers repaid previously capitalized interest due to loans becoming fully amortizing. For further information, see Residential Real Estate Lending on page 3.

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

	December 31,									
	2003		*2002*		*2001*		*2000*		*1999*	
(Dollars in Thousands)	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*
Investment Portfolio										
Residential one-to-four units:										
Adjustable by index:										
COFI	$ 4,819,852	61 %	$ 6,831,649	85 %	$ 7,244,336	92 %	$ 8,096,156	92 %	$ 6,354,068	89 %
MTA	2,503,336	32	1,090,646	13	612,867	8	635,503	7	450,379	6
LIBOR	403,450	5	25,296	-	37,254	-	50,126	1	51,730	1
Other, primarily CMT	185,437	2	136,230	2	4,248	-	5,734	-	315,675	4
	$ 7,912,075	100 %	$ 8,083,821	100 %	$ 7,898,705	100 %	$ 8,787,519	100 %	$ 7,171,852	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.*

Origination of loans secured by multi-family properties, including loans purchased, totaled $85 million in 2003, up from $3 million in 2002 and less than $1 million in 2001. Our origination of commercial real estate loans, including loans purchased, totaled $4 million in 2003, compared to $1 million in 2002 and $7 million in 2001.

During 2003, we originated $80 million of construction loans, principally for entry level and first time move-up residential tracts. This compares to $124 million in 2002 and $102 million in 2001. Our origination of land development loans totaled $20 million in 2003, compared to $56 million in 2002 and $16 million in 2001.

Origination of non-mortgage commercial loans totaled $3 million in 2003, down from $14 million in 2002 and $18 million in 2001. A substantial majority of these originations represented secured loans.

Origination of automobile loans totaled less than $1 million in 2003, the same as in 2002 but below the $5 million in 2001.

During 2002, we purchased $1.0 billion of 30-year fixed rate mortgage-backed securities due to a net interest spread of over 3% given the steepness in the yield curve. These securities were sold in the fourth quarter

Page 35 **Navigation Links**

of 2002 due to interest rate volatility and the potential adverse impact market interest rate changes could have on the carrying value of the investment. Approximately $1.0 million was earned on the securities while owned.

At December 31, 2003, our unfunded loan application pipeline totaled $1.7 billion. Within that pipeline, we had commitments to borrowers for short-term interest rate locks, not including expected fallout, of $740 million, of which $211 million were related to residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, we had commitments for undrawn lines of credit of $185 million and loans in process of $55 million. We believe our current sources of funds will enable us to meet these obligations.

Page 36 **Navigation Links**

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

(In Thousands)	*2003*	*2002*	*2001*	*2000*	*1999*
Investment Portfolio					
Loans originated:					
Loans secured by real estate:					
Residential one-to-four units:					
Adjustable	$ 2,958,976	$ 2,648,302	$ 1,800,777	$ 2,798,592	$ 3,100,154
Adjustable subprime	301,938	466,086	423,777	392,794	1,105,384
Adjustable fixed for 3-5 years	692,635	818,417	890,704	33,004	2,656
Adjustable fixed for 3-5 years subprime	11,683	47,794	-	3,117	77,168
Total adjustable residential one-to-four units	3,965,232	3,980,599	3,115,258	3,227,507	4,285,362
Fixed	20,447	40,245	16,443	9,167	262,923
Fixed subprime	1,468	-	4,708	-	12,238
Residential five or more units:					
Adjustable	46,774	2,806	-	-	247

Fixed	-	-	125	678	-
Total residential	4,033,921	4,023,650	3,136,534	3,237,352	4,560,770
Commercial real estate	3,847	1,157	133	23,720	10,063
Construction	80,201	124,168	101,716	98,330	149,143
Land	19,589	56,362	16,242	16,530	56,851
Non-mortgage:					
Commercial	2,585	13,671	17,581	18,504	24,948
Automobile	118	855	4,825	56,576	233,948
Other consumer	185,608	70,388	32,953	38,136	54,489
Total loans originated	4,325,869	4,290,251	3,309,984	3,489,148	5,090,212
Real estate loans purchased:					
One-to-four units	664,363	460,263	88,057	9,178	36,317
One-to-four units subprime	2,891	6,439	-	8,595	12,912
Other [(a)]	38,633	-	6,923	1,055	440
Total real estate loans purchased	705,887	466,702	94,980	18,828	49,669
Total loans originated and purchased	5,031,756	4,756,953	3,404,964	3,507,976	5,139,881
Loan repayments	(5,212,106)	(3,911,209)	(3,715,163)	(1,981,802)	(1,823,585)
Other net changes [(b)]	(25,768)	(37,515)	2,029	(291,935)	(36,794)
Net increase (decrease) in loans held for investment	(206,118)	808,229	(308,170)	1,234,239	3,279,502
Sale Portfolio					
Residential one-to-four units:					
Originated whole loans	6,219,652	6,155,727	4,818,301	1,641,099	2,028,402
Originated whole loans subprime	-	-	-	87,174	13,872
Loans purchased	1,062	16,845	5,637	947	-
Loans transferred from (to) the investment portfolio	(9,983)	(2,928)	(7,454)	54,993	42,570
Originated whole loans sold	(936,664)	(919,211)	(737,773)	(687,512)	(999,594)
Loans exchanged for mortgage-backed securities	(5,642,483)	(5,104,433)	(3,816,171)	(970,319)	(1,387,364)
Other net changes	(5,254)	(5,386)	(4,762)	(10,815)	(9,263)
Capitalized basis adjustment [(c)]	(1,816)	12,414	(10,326)	-	-
Non-mortgage loans, net	3,091	-	-	-	-
Net increase (decrease) in loans held for sale	(372,395)	153,028	247,452	115,567	(311,377)
Mortgage-backed securities, net:					
Received in exchange for loans	5,642,483	5,104,433	3,816,171	970,319	1,387,364
Sold	(5,642,483)	(6,184,650)	(3,816,171)	(975,088)	(1,387,364)
Purchased	-	1,014,098	115,597	-	-
Repayments	(1,882)	(51,956)	(6,523)	(7,031)	(9,936)
Other net changes	(37)	1,347	(296)	284	(491)
Net increase (decrease) in mortgage-backed securities available for sale	(1,919)	(116,728)	108,778	(11,516)	(10,427)

Net increase (decrease) in loans held for sale and mortgage-backed securities available for sale	(374,314)	36,300	356,230	104,051	(321,804)
Total net increase (decrease) in loans and mortgage-backed securities	$ (580,432)	$ 844,529	$ 48,060	$ 1,338,290	$ 2,957,698

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

 Navigation Links

At December 31, 2003, approximately 95% of our real estate loans were secured by real estate located in California, principally in Los Angeles, Santa Clara, Orange, San Diego and Contra Costa counties.

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

	December 31,				
(In Thousands)	*2003*	*2002*	*2001*	*2000*	*1999*
Investment Portfolio					
Loans secured by real estate:					
Residential one-to-four units:					
Adjustable	$ 6,945,106	$ 6,739,243	$ 6,365,149	$ 7,098,689	$ 5,554,332
Adjustable subprime	940,655	1,297,280	1,424,656	1,633,917	1,532,780
Adjustable fixed for 3-5 years	1,687,323	1,697,953	999,528	101,711	90,551
Adjustable fixed for 3-5 years subprime	42,952	81,421	66,760	92,609	87,844
Fixed	105,042	210,001	334,384	454,838	510,516
Fixed subprime	4,432	7,412	15,303	17,388	18,777
Total residential one-to-four units	9,725,510	10,033,310	9,205,780	9,399,152	7,794,800

Residential five or more units:					
Adjustable	91,024	6,964	6,055	14,203	15,889
Fixed	1,904	3,676	5,124	5,257	5,166
Commercial real estate:					
Adjustable	36,142	40,373	40,900	37,374	37,419
Fixed	13,144	31,042	71,609	127,230	110,908
Construction	105,706	103,547	84,942	118,165	176,487
Land	16,855	53,538	22,028	26,880	67,631
Non-mortgage:					
Commercial	4,975	15,021	22,017	21,721	26,667
Automobile [(a)]	3,823	11,641	24,529	39,614	399,789
Other consumer	95,319	56,782	50,908	60,653	49,344
Total loans held for investment	10,094,402	10,355,894	9,533,892	9,850,249	8,684,100
Increase (decrease) for:					
Undisbursed loan funds	(56,543)	(95,002)	(61,280)	(72,328)	(125,159)
Net deferred costs and premiums	108,990	96,744	77,916	79,109	67,740
Allowance for losses	(30,330)	(34,999)	(36,120)	(34,452)	(38,342)
Total loans held for investment, net	10,116,519	10,322,637	9,514,408	9,822,578	8,588,339
Sale Portfolio, Net					
Loans held for sale:					
Residential one-to-four units	276,295	649,964	509,350	251,572	136,005
Non-mortgage	3,090	-	-	-	-
Capitalized basis adjustment [(b)]	272	2,088	(10,326)	-	-
Total loans held for sale	279,657	652,052	499,024	251,572	136,005
Mortgage-backed securities available for sale:					
Adjustable	334	2,253	101,562	6,050	7,700
Fixed	-	-	17,419	4,153	14,019
	334	2,253	118,981	10,203	21,719

Total mortgage-backed securities available for sale					
Total loans held for sale and mortgage-backed securities available for sale	279,991	654,305	618,005	261,775	157,724
Total loans and mortgage-backed securities	$ 10,396,510	$ 10,976,942	$ 10,132,413	$ 10,084,353	$ 8,746,063

[(a)] *The decline during 2000 primarily reflected the sale of subsidiary.*
[(b)] *Reflected the change in fair value of the interest rate lock derivatives from the date of commitment to the date of funding.*

We carry loans for sale at the lower of cost or fair value. At December 31, 2003, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

At December 31, 2003, our residential one-to-four units subprime portfolio consisted of approximately 91% "A-" credit, 8% "B" credit and 1% "C" credit loans. The average loan-to-value ratio at origination for these loans was approximately 73%.

We carry mortgage-backed securities available for sale at fair value which, at December 31, 2003, reflected an unrealized gain of $7,000. The 2003 year-end unrealized gain, less the associated tax effect, is reflected as a separate component in stockholders equity as accumulated other comprehensive income (loss) until realized.

The table below sets forth the scheduled contractual maturities, including principal amortization, of our loan and mortgage-backed securities portfolio at December 31, 2003.

(In Thousands)	*Within 1 Year*	*1-2 Years*	*2-3 Years*	*3-5 Years*	*5-10 Years*	*10-15 Years*	*Beyond 15 Years*	*Total*
Loans secured by real estate:								
Residential:								
One-to-four units:								
Adjustable by index:								
COFI	$ 73,383	$ 76,668	$ 80,471	$ 173,114	$ 513,749	$ 654,451	$ 3,248,562	$ 4,820,398

MTA	43,226	44,793	46,417	97,944	277,677	331,803	1,659,553	2,501,413
6-Month LIBOR	25,517	26,794	28,134	60,560	179,981	229,730	1,092,062	1,642,778
Other, primarily CMT	10,940	11,592	12,284	26,810	82,335	110,004	487,136	741,101
Fixed	4,734	5,049	5,384	11,851	38,456	51,712	179,201	296,387
Five or more units:								
Adjustable	3,036	3,189	3,347	7,200	21,374	20,811	32,067	91,024
Fixed	75	81	87	197	515	544	405	1,904
Commercial real estate:								
Adjustable	2,994	3,183	3,382	7,415	15,900	3,268	-	36,142
Fixed	1,196	1,300	1,412	3,200	6,036	-	-	13,144
Construction	105,706	-	-	-	-	-	-	105,706
Land	12,136	4,246	114	261	98	-	-	16,855
Non-mortgage:								
Commercial	3,426	181	193	425	750	-	-	4,975
Automobile	1,823	2,000	-	-	-	-	-	3,823
Other consumer [(a)]	2,660	2,869	3,095	2,480	87,305	-	-	98,409
Total loans	290,852	181,945	184,320	391,457	1,224,176	1,402,323	6,698,986	10,374,059
Mortgage-backed securities, net	10	9	10	20	58	70	157	334
Total loans and mortgage-backed securities	$ 290,862	$ 181,954	$ 184,330	$ 391,477	$ 1,224,234	$ 1,402,393	$ 6,699,143	$ 10,374,393

[(a)] *Included home equity loans, which are interest only, with balances due at the end of the term. All or part of the outstanding balances may be paid off at any time during the term without penalty.*

At December 31, 2003, the maximum amount the Bank could have loaned to any one borrower, and related entities, under regulatory limits was $147 million, or $245 million for loans secured by readily marketable collateral, compared to $135 million or $225 million for loans secured by readily marketable collateral at year-end 2002. We do not expect that these regulatory limitations will adversely impact our proposed lending activities during 2004.

Investment Securities

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

	December 31,				
(In Thousands)	2003	2002	2001	2000	1999
Federal funds	$ 1,500	$ 2,555	$ 37,001	$ 19,601	$ 1
U.S. Treasury and agency securities available for sale	690,281	457,797	356,910	284,102	171,823
Corporate bonds available for sale	-	-	45,445	21,513	-
Other investment securities available for sale	66	67	68	69	100
Municipal securities held to maturity	-	6,149	6,320	6,481	6,628
Total trading and investment securities	$ 691,847	$ 466,568	$ 445,744	$ 331,766	$ 178,552

Navigation Links

The fair value of temporarily impaired securities, the amount of unrealized losses and the length of time these unrealized losses existed as of December 31, 2003 are as follows:

	Less than 12 months		12 months or longer		Total	
(In Thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury and agency securities	$ 47,550	$ 170	$ -	$ -	$ 47,550	$ 170
Other investment securities	-	-	-	-	-	-
Total temporarily impaired securities	$ 47,550	$ 170	$ -	$ -	$ 47,550	$ 170

The following table sets forth the maturities of our investment securities and their weighted average yields at December 31, 2003.

	1 Year or Less		After 1 Year Through 5 Years		After 5 Years		Total	
(Dollars in Thousands)	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield	Amount	Weighted Average Yield

Federal funds	$ 1,500	0.75 %	$ -	- %	$ -	- %	$ 1,500	0.75 %
U.S. Treasury and agency securities								
available for sale [a]	-	-	89,605	2.45	600,676	3.11	690,281	3.02
Other investment securities	-	-	-	-	66	6.25	66	6.25
Total investment securities	$ 1,500	0.75 %	$ 89,605	2.45 %	$ 600,742	3.11 %	$ 691,847	3.02 %

[a] *Includes within the category of maturities after five years, $426 million with yields that adjust every three months based on movements of 3-month LIBOR.*

Investments in Real Estate and Joint Ventures

DSL Service Company participates as an owner of, or a partner in, a variety of real estate development projects, principally retail neighborhood shopping centers and residential developments, most of which are located in California. For additional information regarding these real estate investments, see Note 6 of Notes to the Consolidated Financial Statements on page 84. We have substantially completed and leased most of the neighborhood shopping center projects with a weighted average occupancy rate of 84% at December 31, 2003. At December 31, 2003, the Bank had no loan commitments to the joint ventures.

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

As of December 31, 2003, DSL Service Company was involved with one joint venture partner. This partner was the operator of two residential housing development projects. DSL Service Company had five wholly owned retail neighborhood shopping centers located in California and Arizona.

Our investment in real estate and joint ventures amounted to $36 million at December 31, 2003, compared to $34 million at December 31, 2002 and $38 million at December 31, 2001. The increase during 2003 was primarily attributed to a $6 million investment in existing shopping centers, a $5 million investment in a new joint venture and our share of joint venture profits of $3 million. Those increases were partially offset by a $7 million return of capital from one of our existing joint ventures and the sale of wholly owned projects with a carrying value of $5 million. During 2002, we sold wholly owned projects with a carrying value of $22 million. That decline was partially offset by a $17 million investment in a residential joint venture and a $1 million investment in a shopping center development.

The following table sets forth the condensed balance sheet of DSL Service Company s residential joint ventures at December 31, 2003, on a historical cost basis.

(Dollars in Thousands)

Assets

Cash	$ 6,915
Projects under development	37,945
Other assets	4,581
	$ 49,441
Liabilities and Equity	
Liabilities:	
Notes payable	$ 22,244
Other	4,412
Equity:	
DSL Service Company [(a)]	18,232
Other partners [(b)]	4,553
Net equity	22,785
	$ 49,441
Number of joint venture projects	2

[(a)] We included in this amount interest-bearing joint venture advances with priority interest payments from joint ventures to DSL Service Company.
[(b)] The aggregate other partners equity of $5 million represents their equity interest in the accumulated retained earnings of the respective joint ventures. Those results include the net profit on sales and the operating results of the real estate assets, net of depreciation and funding costs. Except for any secured financing which has been obtained, DSL Service Company has provided all other financing. As part of our internal asset review process, we compare the fair value of the joint venture real estate assets to the secured notes payable to the Bank and DSL Service Company s equity investment. To the extent the fair value of the real estate assets is less than the aggregate of those amounts, we make a provision to create a valuation allowance. No valuation allowance was required at December 31, 2003.

The following table sets forth by property type our investments in real estate and related allowances for losses at December 31, 2003. For further information regarding the establishment of loss allowances, see Allowance for Losses on Loans and Real Estate on page 54.

(Dollars in Thousands)	*Residential*	*Retail Neighborhood Shopping Centers*	*Land*	*Total*
Investment in wholly owned projects [(a)]	$ -	$ 17,617	$ 291	$ 17,908
Investment in Affordable Housing Funds	1,012	-	-	1,012
Allowance for losses	-	(1,333)	(103)	(1,436)
Net investment in real estate projects	$ 1,012	$ 16,284	$ 188	$ 17,484
Number of projects	4	5	3	12

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

Real estate investments entail risks similar to those our construction and commercial lending activities present. In addition, California courts have imposed warranty-like responsibility upon developers of new housing for defects in structure and the housing site, including soil conditions. This responsibility is not necessarily dependent upon a finding that the developer was negligent. Owners of real property also may incur liabilities with respect to environmental matters, including financial responsibility for clean-up of hazardous waste or other conditions, under various federal and state laws.

Deposits

Our deposits declined $945 million or 10.2% in 2003 and totaled $8.3 billion at December 31, 2003. Compared to the year-ago period, our certificates of deposit declined $1.4 billion or 31.0%, which was partially offset by an increase of $501 million or 11.0% in our lower-rate transaction accounts i.e., checking, money market and regular passbook. Depositors continued to be more interested in liquidity given the relatively low level of interest rates, and moved monies from certificates of deposit to transaction accounts, primarily regular passbook accounts. When interest rates rise, we would expect the reverse to occur. At December 31, 2003, the average deposit size of our 72 traditional branches was $97 million, while the average deposit size of our 100 in-store branches was $13 million.

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

	December 31,					
	2003		*2002*		*2001*	
(Dollars in Thousands)	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*
Transaction accounts:						
Non-interest-bearing checking	- %	$ 429,743	- %	$ 388,376	- %	$ 263,165
Interest-bearing checking [a]	0.21	462,733	0.25	422,417	0.35	423,776
Money market	1.05	142,418	1.37	120,105	2.01	108,747
Regular passbook	1.12	4,036,464	1.70	3,639,798	2.46	2,131,048
Total transaction accounts	0.94	5,071,358	1.41	4,570,696	1.92	2,926,736
Certificates of deposit:						
Less than 2.00%	1.17	1,548,398	1.57	919,864	1.94	99,654
2.00-2.49	2.23	338,763	2.28	401,657	2.30	556,075
2.50-2.99	2.73	222,436	2.79	528,557	2.74	315,125
3.00-3.49	3.27	305,258	3.38	1,188,078	3.20	458,511
3.50-3.99	3.78	106,861	3.89	700,250	3.84	532,634
4.00-4.49	4.27	240,459	4.25	374,424	4.22	892,517
4.50-4.99	4.83	420,262	4.80	473,399	4.76	555,885
5.00 and greater	5.59	39,963	5.63	81,425	5.94	2,282,429

Total certificates of deposit	2.44	3,222,400	3.19	4,667,654	4.54	5,692,830
Total deposits	1.52 %	$ 8,293,758	2.31 %	$ 9,238,350	3.65 %	$ 8,619,566

(a) *Included amounts swept into money market deposit accounts.*

The following table shows at December 31, 2003 our certificates of deposit maturities by interest rate category.

(Dollars in Thousands)	*Less Than 2.50%*	*2.50% - 2.99%*	*3.00% - 3.49%*	*3.50% - 3.99%*	*4.00% - 4.99%*	*5.00% and Greater*	*Total (a)*	*Percent of Total*
Within 3 months	$ 630,427	$ 25,982	$ 100,786	$ 592	$ 3,342	$ 4,958	$ 766,087	24 %
3 to 6 months	447,815	169	33,032	26,690	3,497	43	511,246	16
6 to 12 months	350,374	13,248	31,917	28,357	12,074	2,753	438,723	14
12 to 24 months	425,260	4,124	30,807	27,652	178,824	16,440	683,107	21
24 to 36 months	32,308	152,628	1,288	1,139	129,059	6,011	322,433	10
36 to 60 months	977	26,285	107,428	22,431	333,925	9,758	500,804	15
Over 60 months	-	-	-	-	-	-	-	-
Total	$ 1,887,161	$ 222,436	$ 305,258	$ 106,861	$ 660,721	$ 39,963	$ 3,222,400	100 %

(a) *Includes certificates of deposit of $100,000 and over totaling $223 million with maturities of 3 months or less, $140 million with maturities of 3 to 6 months, $132 million with maturities of 6 to 12 months and $574 million with a remaining term of over 12 months.*

Navigation Links

Borrowings

At December 31, 2003, borrowings totaled $2.3 billion, up from $1.7 billion at year-end 2002 and $1.6 billion at year-end 2001. The increase during 2003 occurred primarily in advances from the FHLB.

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

December 31,

(Dollars in Thousands)	*2003*	*2002*	*2001*	*2000*	*1999*
Federal Home Loan Bank advances	$ 2,125,150	$ 1,624,084	$ 1,522,705	$ 1,978,348	$ 2,122,407
Real estate notes	4,161	-	7	224	373
Junior subordinated debentures	123,711	123,711	123,711	123,711	123,711
Total borrowings	$ 2,253,022	$ 1,747,795	$ 1,646,423	$ 2,102,283	$ 2,246,491
Weighted average rate on borrowings during the year	4.46 %	4.79 %	5.83 %	6.38 %	5.67 %
Total borrowings as a percentage of total assets	19.35	14.59	14.82	19.29	23.87

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

(Dollars in Thousands)	*2003*	*2002*	*2001*
FHLB advances with original maturities less than one year:			
Balance at end of year	$ 915,000	$ 341,234	$ 671,300
Average balance outstanding during the year	248,905	218,404	581,868
Maximum amount outstanding at any month-end during the year	915,000	497,081	1,260,000
Weighted average interest rate during the year	1.20 %	2.12 %	5.63 %
Weighted average interest rate at end of year	1.11	1.38	2.16
Securities sold under agreement to repurchase:			
Balance at end of year	$ -	$ -	$ -
Average balance outstanding during the year	-	7,494	-
Maximum amount outstanding at any month-end during the year	-	182,358	-
Weighted average interest rate during the year	- %	1.86 %	- %
Total short-term borrowings:			
Average balance outstanding during the year	$ 248,905	$ 225,898	$ 581,868
Weighted average interest rate during the year	1.20 %	2.11 %	5.63 %

At year-end 2003, total intermediate and long-term borrowings totaled $1.3 billion, down from $1.4 billion at December 31, 2002. The weighted average rate on our intermediate and long-term borrowings at year-end 2003 was 5.06%.

The following table sets forth the maturities of our intermediate and long-term borrowings at December 31, 2003.

(In Thousands)	
2004	$ 194,100
2005	415,750

2006	76,300
2007	65,000
2008	430,000
Thereafter [a]	156,872
Total intermediate and long-term borrowings	$ 1,338,022

[a] *Includes Junior subordinated debentures of $124 million that may be redeemed, in whole or in part, beginning in July of 2004 and real estate notes of $4 million.*

Our junior subordinated debentures with a principal amount of $124 million are payable by Downey Financial Corp. to Downey Financial Capital Trust I ("Trust"), a wholly owned special purpose entity. The debentures carry an interest rate of 10.00% and are due September 15, 2029. We may redeem, in whole or in part, the junior subordinated debentures before their maturity at a redemption price of 100% of their principal

amount plus accrued and unpaid interest on or after July 23, 2004. For further information regarding the junior subordinated debentures and the associated capital securities (formerly consolidated), see Note 17 of Notes to the Consolidated Financial Statements on page 93.

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 the recently issued Financial Accounting Standards Board Interpretation 46 (revised December 2003). For further information regarding this interpretation, see Newly Adopted Accounting Principles on page 62. For further information regarding our real estate joint venture partnerships, see Note 6 of Notes to the Consolidated Financial Statements on page 84.

We enter into derivative financial instruments as part of our interest rate risk management process, primarily related to our sale of loans in the secondary market. The associated fair value changes to the notional amount of the derivative instrument are recorded on-balance sheet. For further information regarding our derivative instruments, see Asset/Liability Management and Market Risk on page 45, Contractual Obligations and Other Commitments on page 60 and Note 22 of Notes to the Consolidated Financial Statements on page 100.

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 of credit and letters of credit, and commitments to purchase loans and mortgage-backed securities for our portfolio. The contract or notional amounts of these instruments reflect the extent of involvement we have in particular classes of financial instruments. For further information regarding these commitments, see Asset/Liability Management and Market Risk on page 45, Contractual Obligations and Other Commitments on page 60 and Note 22 of Notes to the Consolidated Financial Statements on page 100.

We use the same credit policies in making commitments to originate or purchase loans, lines of credit and letters of credit as we do for on-balance sheet instruments. For commitments to originate loans held for investment, the contract amounts represent exposure to loss from market fluctuations as well as credit loss. In regard to these commitments, adverse changes from market fluctuations are generally not hedged. We control the credit risk of our commitments to originate loans held for investment through credit approvals, limits and monitoring procedures.

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

Transactions with Related Parties

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

Page 44 **Navigation Links**

Asset/Liability Management and Market Risk

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

In addition to the interest rate risk associated with our lending and deposit taking activities, we also have market risk associated with our secondary marketing activities. Changes in mortgage interest rates, primarily fixed rate mortgages, impact the fair value of loans held for sale as well as our interest rate lock commitment derivatives, where we have committed to an interest rate with a potential borrower for a loan we intend to sell. Our objective is to hedge against fluctuations in interest rates through use of forward sale and purchase contracts with government-sponsored enterprises and whole loan sale contracts with various parties. These contracts are typically obtained at the time the interest rate lock commitments are made. Therefore, as interest rates fluctuate, the changes in the fair value of our interest rate lock commitments and loans held for sale tend to be offset by changes in the fair value of the hedge contracts. 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. Although we continue to hedge as previously done, SFAS 133, as applied to our risk management strategies, may increase or decrease reported net income and stockholders equity, depending on levels of interest rates and other variables affecting the fair values of derivative instruments and hedged items, but will have no effect on the overall economics of the transactions. We generally do not enter into hedging contracts for speculative purposes.

Changes in mortgage interest rates also impact the value of our mortgage servicing rights. Rising interest rates typically result in slower prepayment speeds on the loans being serviced for others which increase the value of mortgage servicing rights. Declining interest rates typically result in faster prepayment speeds which decrease the value of mortgage servicing rights. Generally, we have not hedged our mortgage servicing rights. However, in light of the Federal Reserve s change in bias towards weakness and the potential for further declines in market interest rates, we purchased during the second quarter of 2003 10-year U.S. Treasury securities as a partial economic hedge against the value of our mortgage servicing rights. These securities were classified in a trading account and were carried at fair value, with any changes in fair value reflected in earnings. This partial economic hedge was closed in July of 2003 as interest rates began to rise.

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

Page 45 **Navigation Links**

One measure of our exposure to differential changes in interest rates between assets and liabilities is shown in the following table which sets forth the repricing frequency of our major asset and liability categories as of December 31, 2003, 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 all of our loan portfolio based upon our historical loan prepayment experience and anticipated future prepayments. Repricing mechanisms on a number of our assets are subject to limitations, such as caps on the amount that interest rates and payments on our loans may adjust, and accordingly, these assets do not normally respond to changes in market interest rates as completely or rapidly as our liabilities. The interest rate sensitivity of our assets and liabilities illustrated in the following table would vary substantially if we used different assumptions or if actual experience differed from the assumptions set forth.

	December 31, 2003					
(Dollars in Thousands)	*Within 6 Months*	*7 12 Months*	*1 5 Years*	*6 10 Years*	*Over 10 Years*	*Total Balance*
Interest-earning assets:						
Investment securities and stock [a]	$ 569,421	$ 23,245	$ 222,204	$ 66	$ 3,711	$ 818,647
Loans and mortgage-backed securities: [b]						
Loans secured by real estate:						
Residential:						
Adjustable	8,086,071	343,498	1,451,870	-	-	9,881,439
Fixed	215,629	20,663	54,892	5,869	1,111	298,164
Commercial real estate	26,456	5,661	10,955	4,040	260	47,372
Construction	52,082	-	-	-	-	52,082
Land	12,852	7	51	608	-	13,518
Non-mortgage loans:						
Commercial	2,755	-	-	-	-	2,755
Consumer	98,866	1,527	453	-	-	100,846
Mortgage-backed securities	334	-	-	-	-	334
Total loans and mortgage-backed securities	8,495,045	371,356	1,518,221	10,517	1,371	10,396,510
Total interest-earning assets	$ 9,064,466	$ 394,601	$ 1,740,425	$ 10,583	$ 5,082	$ 11,215,157
Transaction accounts:						
Non-interest-bearing checking	$ 429,743	$ -	$ -	$ -	$ -	$ 429,743

Interest-bearing checking [c]	462,733	-	-	-	-	462,733
Money market [d]	142,418	-	-	-	-	142,418
Regular passbook [d]	4,036,464	-	-	-	-	4,036,464
Total transaction accounts	5,071,358	-	-	-	-	5,071,358
Certificates of deposit [e]	1,277,333	438,723	1,506,344	-	-	3,222,400
Total deposits	6,348,691	438,723	1,506,344	-	-	8,293,758
FHLB advances and real estate notes	975,000	134,100	987,050	33,161	-	2,129,311
Junior subordinated debentures	-	-	-	-	123,711	123,711
Total deposits and borrowings	$ 7,323,691	$ 572,823	$ 2,493,394	$ 33,161	$ 123,711	$ 10,546,780
Excess (shortfall) of interest-earning assets over						
deposits and borrowings	$ 1,740,775	$ (178,222)	$ (752,969)	$ (22,578)	$ (118,629)	$ 668,377
Cumulative gap	1,740,775	1,562,553	809,584	787,006	668,377	
Cumulative gap as a percentage of total assets:						
December 31, 2003	14.95 %	13.42 %	6.95 %	6.76 %	5.74 %	
December 31, 2002	16.80	12.53	9.33	5.79	4.83	
December 31, 2001	12.01	4.76	7.91	4.71	3.86	

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

Our six-month gap at December 31, 2003 was a positive 14.95%. This means that more interest-earning assets mature or reprice within six months than total deposits and borrowings. This compares to a positive six-month gap of 16.80% at December 31, 2002 and 12.01% at December 31, 2001. We originated and purchased for investment approximately $5.0 billion during 2003, $4.7 billion during 2002 and $3.4 billion during 2001 of loans and mortgage-backed securities with adjustable interest rates or maturities of five years or less. These loans represented approximately 99% during 2003, 2002 and 2001 of all loans and mortgage-backed securities originated and purchased for investment during these periods.

At December 31, 2003 and 2002, essentially all of our interest-earning assets mature, reprice or are estimated to prepay within five years, compared to 99% at December 31, 2001. At December 31, 2003, $10.0 billion or 99% of our loans held for investment and mortgage-backed securities portfolios consisted of adjustable rate loans and loans with a due date of five years or less, compared to $10.1 billion or 98% at December 31, 2002 and $9.3 billion or 96% at December 31, 2001. During 2004, we will continue to offer residential fixed rate loan products to our customers to meet customer demand. We primarily originate fixed rate loans for sale in the secondary market and price them accordingly to create loan servicing income and to increase opportunities for originating adjustable rate mortgages. However, we may originate fixed rate loans for investment when funded with long-term funds to mitigate interest rate risk and small volumes to facilitate the sale of real estate acquired through foreclosure or that meet required yield and other approved guidelines. For further information, see Secondary Marketing and Loan Servicing Activities on page 5.

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

In addition to measuring interest rate risk via a gap analysis, we establish limits on, and measure the sensitivity of, our net interest income and net portfolio value to changes in interest rates. Changes in interest rates are defined as instantaneous and sustained movements in interest rates in 100 basis point increments. We utilize an internally maintained asset/liability management simulation model to make the calculations which, for net portfolio value, are calculated on a discounted cash flow basis. First, we estimate our net interest income for the next twelve months and the current net portfolio value assuming no change in interest rates from those at period end. Once the base case has been estimated, we make calculations for each of the defined changes in interest rates, to include any associated differences in the anticipated prepayment speed of loans. We then compare those results against the base case to determine the estimated change to net interest income and net portfolio value due to the changes in interest rates. The following are the estimated impacts to net interest income and net portfolio value from various instantaneous, parallel shifts in interest rates based upon our asset and liability structure as of year-ends 2003 and 2002. Since we base these estimates upon numerous assumptions, like the expected maturities of our interest-bearing assets and liabilities and the shape of the period-end interest rate yield curve, our actual sensitivity to interest rate changes could vary significantly if actual experience differs from those assumptions used in making the calculations.

	2003		*2002*	
	Percentage Change in		*Percentage Change in*	
Change in Interest Rates (In Basis Points)	*Net Interest Income* [a]	*Net Portfolio Value* [b]	*Net Interest Income* [a]	*Net Portfolio Value* [b]
+200	(3.9)%	10.9 %	(4.8)%	21.0 %
+100	(1.9)	6.1	(2.4)	10.7
(100)	0.8	(8.3)	1.6	(13.4)
(200) [c]	N/A	N/A	N/A	N/A

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

Page 47 **Navigation Links**

The following table shows our financial instruments that are sensitive to changes in interest rates, categorized by expected maturity, and the instruments fair values at December 31, 2003. This data differs from that in the gap table as it does not incorporate the repricing characteristics of assets and liabilities. Rather, it only reflects contractual maturities adjusted for anticipated prepayments. Market risk sensitive instruments are generally defined as on and off balance sheet derivatives and other financial instruments. Our assets and liabilities that do not have a stated maturity date, such as certain deposits, are considered to be long term in nature and are reported in the "thereafter" column. We do not consider these financial instruments to be materially sensitive to interest rate fluctuations, and historically, the balances have remained fairly constant over various economic conditions. The weighted average interest rates for the various fixed-rate and variable-rate assets and liabilities presented are based on the actual rates that existed at December 31, 2003. The fair value of our financial instruments is determined as follows:

- Fed funds and FHLB Stock equal their book values due to their short-term repricing characteristics.
- Investment securities and mortgage-backed securities are based on the closing market price quotations from financial market monitoring firms.
- Loans held for sale are based on bid quotations from financial market monitoring firms.
- Loans held for investment takes into consideration discounted cash flows through the estimated maturity or repricing dates using estimated market discount rates.
- Demand deposits, money market and savings accounts are equal to their book values.
- Time deposits and borrowings are based on the discounted value of contractual cash flows, which is estimated using wholesale borrowing rates offered for similar terms.
- Junior subordinated debentures are based upon the closing stock price of the associated capital securities published in financial information services or newspapers and may be called at our option beginning in July of 2004.

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

Page 48 **Navigation Links**

	Expected Maturity Date at December 31, 2003 [a]							
(Dollars in Thousands)	*2004*	*2005*	*2006*	*2007*	*2008*	*Thereafter*	*Total Balance*	*Fair Value*
Investment securities and stock [b]	$ 469,577	$ 63,958	$ 53,764	$ 100,372	$ 4,110	$ 126,866	$ 818,647	$ 818,799
Weighted average interest rate	2.78 %	2.65 %	3.60 %	4.06 %	3.00 %	4.00 %	3.17 %	
Loans held for sale [c]	279,657	-	-	-	-	-	279,657	283,587

Weighted average interest rate	5.51 %	- %	- %	- %	- %	- %	5.51 %