DOWNEY FINANCIAL CORP
Form 10-K
February 29, 2008

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United States 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, 2007 or

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

Commission File Number 1-13578

DOWNEY FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

Delaware	33-0633413
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3501 Jamboree Road, Newport Beach, California	92660
(Address of principal executive offices)	(Zip Code)

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 on which registered
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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or section 15(d) of the Act. Yes ¨ No þ

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 (§229.405 of this chapter) 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. þ

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

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act.)
Yes ¨ No þ

The aggregate market value of the registrant s outstanding Common Stock held by non-affiliates on June 30, 2007, based upon the closing sale price on that date of $65.98, as quoted on the New York Stock Exchange, was $1,393,021,630.

At February 29, 2008, 27,853,783 shares of the Registrant's Common Stock, $0.01 par value, were outstanding.

Documents Incorporated by Reference: Portions of the Registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of Stockholders to be held April 23, 2008 are incorporated by reference in Part III hereof.

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PART I

Certain matters discussed in this Annual Report may constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995, which 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. 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, the outcome of ongoing audits by regulatory and taxing authorities and government regulation and factors, identified under Item 1A. Risk Factors on page 22. We do not undertake to update forward-looking statements to reflect the

impact of circumstances or events that arise after the date the forward-looking statements were made, except as required by law.

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 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 Ethical Conduct for Directors and Financial Officers and Summary of the Employee Code of Ethical Conduct are available free of charge from our internet site, www.downeysavings.com, by clicking on "Investor Relations" on our home page and proceeding to "Corporate Governance." Annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are posted on our internet site as soon as reasonably practical after we file them with the SEC and are available free of charge under "Reports - 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, 2007, the Bank conducts its business primarily through 172 retail deposit branches, including 90 full-service, in-store branches.

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

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

General economic conditions, the monetary and fiscal policies of the federal government and the regulatory policies of governmental authorities significantly influence our operations. Additionally, interest rates on competing investments and general market interest rates influence our deposit flows and the costs we incur on deposits and borrowings, which represent 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 ("MBS"), as well as the valuation of our mortgage servicing rights ("MSRs") associated with the 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

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

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

- originating and selling loans to investors in the secondary markets.

Mortgage-backed securities include mortgage pass-through securities issued by other entities and securities issued or guaranteed by government-sponsored enterprises ("GSE") 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 on loans and deposits;
- gains on sales of loans, investment securities and mortgage-backed securities; and
- income we earn on loans that we service for investors.

Our principal expenses and losses in connection with our banking business are:

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

Our primary sources of funds from our banking business are:

- retail deposits;
- principal and interest payments on our loans and investment securities;
- proceeds from sales of 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 sales and prepayment of loans and mortgage-backed securities can vary widely. Below is a more detailed discussion of our banking activities.

Lending Activities

Our lending activities emphasize originating first mortgage loans secured by residential properties. We continue to focus on the origination of adjustable rate single family mortgage loans for our portfolio. To a lesser extent, we originate for portfolio other loans including:

- home equity loans and lines of credit;
- multi-family loans secured by real estate;
- commercial real estate loans, with income producing capabilities;
- construction and land loans to developers for single family and multi-family residential properties and commercial retail neighborhood shopping center projects;
- loans to individuals for the construction and permanent financing of single family homes;
- residential lot loans; 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 6. For additional information on the composition of our loan and mortgage-backed securities portfolio, see Loans and Mortgage-Backed Securities on page 45.

Loan and Mortgage-Backed Securities Portfolio

We carry loans held for investment at cost. Net loans are adjusted for unamortized premiums and unearned discounts, which are amortized into interest income over the life of the underlying loans using the interest method. Investments in mortgage-backed securities represent participating interests in pools of first mortgage loans and are typically 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 over the life of the underlying securities using the interest method.

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 amortized cost or fair value on an aggregate basis. 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 rate lock 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. Downey may sell loans which had been held for investment. In such instances, the loans are transferred to the held for sale portfolio at the lower of amortized cost or fair value. If any part of a decline in value of the loans transferred is due to credit deterioration, that decline is recorded as a charge-off to the allowance for loan losses.

Loans are transferred from held for sale to held for investment at the lower of cost or fair value. If there is an adjustment due to a decline in fair value, the loss is recorded in current earnings within the category of net gains on sales of loans at the time of transfer.

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

Residential Real Estate Lending

Our primary lending activity is originating mortgage loans secured by residential one-to-four unit properties located primarily in California. Residential loans are originated:

- by loan officers located in our branches, loan centers and in a centralized call center, who also solicit loans from realtors and other business sources, including the internet; and
- by wholesale loan representatives who obtain loans submitted by mortgage brokers.

We provide these loans for borrowers to purchase residences or to refinance their existing mortgage loans, and they 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 mortgage loans 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. We may, however, place residential fixed rate loans in our portfolio of loans held for investment if these fixed rate loans meet specific yield, interest rate risk and other approved guidelines, or to facilitate our sale of real estate acquired in settlement of loans. The average term of the fixed rate mortgage loans we originate for our own portfolio historically has been significantly shorter than their contractual maturity as a result of home sales, refinancings and prepayments. For more information, see Secondary Marketing and Loan Servicing Activities on page 6.

Our adjustable rate mortgage loans generally:

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

Most of our adjustable rate mortgage loans are adjustable rate loan products subject to negative amortization with an interest rate that adjusts monthly and a minimum monthly loan payment that adjusts annually. The start rate is lower than the fully-indexed rate and is the effective interest rate for the loan only during the first month. After the first month, interest accrues at the fully-indexed rate. The start rate, however, is used to calculate the minimum monthly loan payment for the first twelve months. The borrower is required to make at least the minimum monthly payment, but retains the option to make a larger payment to reduce loan principal and avoid negative amortization, (the addition to loan principal of accrued interest that exceeds the required minimum monthly loan payment). If the borrower chooses to make the required minimum monthly loan payment, and the interest accrual based on the fully-indexed rate results in monthly interest due exceeding the payment amount, the loan balance will increase by the

difference. These payment options are clearly defined in the loan documents signed by the borrower at funding and explained again on the borrower s monthly statement.

More particularly, these loans currently:

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

The maximum home loan we currently make for our own portfolio, except for limited amounts related to Community Reinvestment Act (CRA) activities, is equal to 85% of a property s appraised value; however, any loan in excess of 80% of appraised value generally requires private mortgage insurance. Typically, this insures the loan down to a 75% loan-to-value ratio, consistent with secondary marketing requirements. If a loan incurs negative amortization, the loan-to-value ratio could rise, which increases credit risk, and the fair value of the underlying collateral could be insufficient to satisfy fully the outstanding loan obligation in the event of a loan default.

Our loan portfolio held for investment does contain loans previously originated with a limit on the maximum loan balance of 125% of the original loan amount. At December 31, 2007, loans with the higher 125% limit on the maximum loan balance represented 2% of our one-to-four unit residential loan portfolio, while those with the 115% limit represented 5% and those with the 110% limit represented 62%. We permit adjustable rate mortgage loans to be assumed by qualified borrowers. For more information, see Loans and Mortgage-Backed Securities on page 45.

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

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

For loans subject to negative amortization, applicants also are qualified based on the full amount of negative amortization permitted by their loans. For interest-only loans, we qualify applicants at the fully amortizing payment amount based on a fully indexed rate.

During 2007, approximately 65% of our one-to-four unit residential real estate loans were originated or purchased through outside mortgage brokers with the remaining amount originated by our residential loan officers. Mortgage brokers do not operate from our offices and are not our employees.

We require that our residential real estate loans be approved at various levels of management, depending upon the amount of the loan and credit risk it presents. On a single family residential loan we originate for our portfolio, the maximum amount we generally will lend is $3 million. Our average loan size, however, is much lower. In 2007, our average loan size was $505,000.

In the 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 staff appraisers or outside appraisers establish the value of the collateral through appraisals or alternative valuation formats that meet regulatory requirements. Based on risk-based criteria, certain appraisal reports prepared by outside appraisers are reviewed by our staff appraisers or by approved fee appraisers. We obtain information about the applicant s income, financial condition, employment and credit history. Depending on the loan product type, borrower credit history, loan-to-value ratio and other underwriting criteria and judgment, we may not deem it necessary to verify

stated borrower income and/or reported assets. We also 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 and, as required, flood insurance.

When underwriting a home equity loan or line of credit, all loans secured by a property are taken into account. The maximum amount Downey will lend is 80% of all combined loans to the property s appraised value. The loan-to-value ratio is calculated using the full credit line and, with respect to first mortgage loans subject to negative amortization, the maximum permissible loan balance. For these reasons, the risk involved with our home equity loans and home equity lines of credit is similar to the risk involved with our residential real estate loans.

Secondary Marketing and Loan Servicing Activities

As part of our secondary marketing activities, we originate residential real estate adjustable rate mortgage loans and fixed rate mortgage loans that we intend to sell. These loans are primarily secured by first liens on one-to-four unit residential properties and generally have maturities of 40 years or less.

We believe that servicing loans for others can be an important asset/liability management tool because it provides an asset whose value tends to move opposite to changes in market interest rates. In contrast to other components of the Bank s balance sheet, a loan servicing portfolio normally increases in value as interest rates rise and loan prepayments decrease and declines in value as interest rates fall and loan prepayments increase. In addition, increased levels of servicing activity 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 based on the difference between the net sales proceeds and the allocated basis of the loans sold. We capitalize MSRs at fair value for residential one-to-four unit mortgage loans we originate and sell with servicing rights retained and for MSRs acquired through purchase at the lower of cost or fair value. We disclose MSRs associated with the origination and sale of loans in our financial statements as a component of the net gains on sales of loans and mortgage-backed securities. We recognize impairment losses on the MSRs through a valuation allowance and record any associated provision as a component of the loan servicing income (loss), net category. For further information, see Note 1 on page 92 and Note 10 on page 109 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 60.

As part of our secondary marketing activity, we enter into forward sales commitments with investors to deliver an MBS collateralized by our loans. This is accomplished through a securitization transaction, which involves the receipt of an MBS from a GSE in exchange for loans that we sell to that GSE. Settlement of the forward sales commitment and the securitization transaction occurs on the same day, whereby we do not retain the MBS. However, based on market conditions in the future, we may retain the MBS for a period of time prior to selling it in the capital markets. In this event, we will not record a gain or loss from the exchange on the date of securitization. However, if we intend to sell the MBS, we will designate the MBS as a trading security in our Consolidated Balance Sheet with changes in fair value included in our Consolidated Statement of Income.

Multi-Family and Commercial Real Estate Lending

We provide 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 with 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:

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

To protect the value of the security for our loan, we require borrowers to maintain casualty insurance for the lesser of the loan amount or replacement cost. In addition, for non-residential loans in excess of $500,000, we require the borrower to obtain

comprehensive general liability insurance. All commercial real estate loans we originate must be approved by at least two of our officers, one of whom must be the originating major loan officer and the other a designated officer with appropriate loan approval authority.

Construction and Land Lending

We provide loan financing for construction of single family and multi-family residential properties and commercial real estate projects and for land development. Our major loan officers principally originate these loans. We generally make construction and land 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 80% or less, 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, we may have to advance additional funds to finance the project s completion before the project can be sold.

Moreover, construction projects are affected by uncertainties inherent in estimating:

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

When providing construction and land loans, we usually 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 floating interest rate loans and lines of credit. We also provide deposit account products and services to meet the needs of business relationships maintained at the Bank.

Consumer Lending

The Bank originates 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. 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 invest in securities is prescribed by 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 and credit 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, 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. For further information on the composition of our investment portfolio, see Investment Securities on page 54.

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 may raise some retail deposits through deposit brokers.

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

For further information, see Deposits on page 57.

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Borrowing Activities

Besides deposits, we utilize 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 additional sources of funds. The FHLB of San Francisco makes advances to us through several different credit programs it offers.

From time to time, we sell securities and mortgage loans under agreements to repurchase to provide additional funding. These 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 repurchase agreements. In addition, we limit the amounts of our borrowings from any single institution.

For further information, see Borrowings on page 58.

Earnings Spread

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

- the interest and dividends we earn on our interest-earning assets like loans and investment securities; and
- the cost we pay on our interest-bearing liabilities like deposits and borrowings.

Our net interest income is also affected 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 and dividends 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 33. For information regarding the return on our assets and other selected financial data, see Selected Financial Data on page 31.

Asset/Liability Management

We are affected by interest rate risk to the degree our interest-bearing liabilities, consisting principally of retail deposits and FHLB advances, reprice or mature on a different basis and frequency than our interest-earning assets, which primarily consist of adjustable rate and fixed rate real estate loans and investment securities. 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 interest income during periods of rising interest rates. Our principal objective is to actively monitor and manage the adverse effects of fluctuations in interest rates on our net interest income.

For further information, see Lending Activities on page 3 and Asset/Liability Management and Market Risk on page 60.

REAL ESTATE INVESTMENT ACTIVITIES

We also engage in real estate investment activities through DSL Service Company, a wholly owned subsidiary of the Bank. DSL Service Company is a diversified real estate development company 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 in California and Arizona. In addition, DSL Service Company invests in joint ventures with other qualified real estate developers. Its primary revenue sources include net rental income and gains from the sale of real estate investments. Its primary expenses are interest expense and general and administrative expense.

Federal law prohibits the Bank from directly investing in real estate development and joint venture operations and requires the Bank 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. These capital deductions and limitations apply only to saving associations and their subsidiaries.

For further information, see Investments in Real Estate and Joint Ventures on page 55.

COMPETITION

We face competition both in attracting deposits and in making loans. Savings institutions and commercial banks located in our principal market areas, including many large financial institutions based in other parts of the country or their subsidiaries, provide the most direct competition. In addition, we face 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, acceptable risk and customer service comparable to that offered by competitors.

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, 2007, we had 1,850 full-time employees and 633 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 laws extensively regulate savings and loan holding companies and savings associations. This regulation is intended primarily to protect our depositors and the DIF and is not for the benefit of our stockholders. Below we describe some of the regulations applicable to us, the Bank and DSL Service Company. 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, would become subject to restrictions applicable to bank holding companies under the Bank Holding Company Act 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. For more information, see Qualified Thrift Lender Test on page 13.

Restrictions on Acquisitions and Changes of Control

Prior to acquiring control of any additional insured depository institution, we must obtain bank regulatory approval from the appropriate agencies. The OTS generally prohibits acquisitions that result in a structure involving a multiple savings and loan holding company controlling savings associations in more than one state. However, the OTS does permit interstate acquisitions and mergers of depository institutions where the transaction is either approved by specific state authorization or is a supervisory acquisition of a failing savings association.

Federal law generally provides that no person or company, 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 prior written notice to the OTS. The OTS then has the opportunity to disapprove the proposed acquisition on financial, reputation or other grounds.

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses accounting oversight and corporate governance matters, including:

- required executive certification of financial presentations;
- increased requirements for board audit committees and their members;
- enhanced disclosure of controls and procedures and internal control over financial reporting;
- enhanced controls on, and reporting of, insider trading; and
- increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

This legislation and its implementing regulations have resulted in increased costs of compliance, including certain outside professional costs.

Regulation of the Bank

General

The OTS extensively regulates the Bank because the Bank is federally chartered, and the FDIC has certain authority to regulate the Bank as a DIF-insured depository institution. 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 with respect to reserve requirements for transaction accounts and non-personal time deposits.

Regulation and supervision by the banking agencies establishes a comprehensive framework of activities in which an institution may engage. The regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies regarding the classification of assets and adequate credit loss reserves for regulatory purposes.

The OTS regularly examines the Bank and prepares reports for the Bank s Board of Directors to consider with respect to any deficiencies the OTS finds in the Bank s operations. The Bank is subject to potential enforcement actions by their federal regulators for unsafe or unsound practices in conducting its businesses or for violations of any law, rule, regulation, or any condition imposed in writing by the agency or any written agreement with the agency. Federal and certain state laws also regulate the relationship between the Bank and its depositors and borrowers, especially in matters regarding the ownership of accounts, the handling of checks and the disclosures provided by the Bank, as well as the financial privacy rights of the Bank s customers.

The Bank must file reports with the OTS concerning its activities and financial condition. In addition, the Bank must file notices or obtain regulatory approvals before entering into some transactions. A savings association that seeks to establish a new subsidiary, acquires control of an existing company, or conducts a new activity through a subsidiary must provide 30 days prior notice to the OTS and conduct any activities of the subsidiary in compliance with regulations and orders of the OTS. The OTS may require a savings association to divest any subsidiary or terminate any activity conducted by a subsidiary that the OTS determines to pose a serious threat to the financial safety, soundness or stability of the savings association or to be otherwise inconsistent with sound banking practices.

Federal Home Loan Bank System

The Bank is a member of the FHLB of San Francisco. 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 of San Francisco member, we are required to own a certain amount of capital stock in the FHLB of San Francisco. At December 31, 2007, we were in compliance with the stock requirements.

Cease and Desist Order

On August 30, 2007, the Bank consented to the issuance of a Cease and Desist Order (the "Order") by the OTS as a result of certain concerns of the OTS relating to the Bank s compliance with specific provisions of the Bank Secrecy Act ("BSA"). No fine or civil money penalty was imposed in connection with the Order. The Order does not restrict the business operations of the Bank. The Order requires the Bank to take certain affirmative actions to ensure its compliance with BSA, including, among other things: strengthening the Bank s written program for compliance with federal anti-money laundering ("AML") and BSA requirements; engaging an independent consultant to review and enhance compliance with AML and BSA requirements; expanding and improving customer identification policies and procedures; adopting policies and procedures to identify higher risk customers and report suspicious activities more effectively; conducting a comprehensive review and independent testing and audit of its AML/BSA program; developing a comprehensive BSA training program for appropriate personnel; and making periodic progress reports to the OTS Regional Director.

We do not expect compliance with the Order to have a material impact on our financial condition or results of operations. We expect some additional expenses to be incurred in connection with making the improvements necessary to strengthen our BSA program.

Regulatory Lending Operations Requirements

Some notable regulatory changes applicable to our lending operations are discussed below.

Subprime Lending Guidelines

Subprime lending involves extending credit to individuals with weakened credit histories. 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 in 2001. The guidelines consider subprime lending a high-risk activity that is unsafe and unsound if the risks are not properly controlled. The guidelines set forth the expectations of regulatory capital at 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
- 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 38.1% of Tier 1 capital as of year-end 2007. We are required by the OTS to risk weight our subprime residential loans at a 75% risk weighting. This change increases the required regulatory capital associated with our subprime loans by one and one-half times that of prime residential loans.

On June 29, 2007, the federal banking agencies issued guidance on subprime mortgage lending to address issues related to adjustable rate mortgage products marketed to subprime borrowers. Although the guidance focuses on subprime borrowers, the principles contained in the guidance are also relevant to adjustable rate mortgages offered to prime borrowers. Consistent with the

Guidance on Nontraditional Mortgage Products (discussed below), this guidance continues to encourage financial institutions to evaluate a borrower s repayment

capacity. In addition, it emphasizes the need to evaluate a borrower s debt-to-income ratio. The guidance recommends that institutions refer to Real Estate Guidelines (12 CFR §§560.101, App.), which provide underwriting standards for all real estate loans. The guidance promotes consumer protection principles relevant to the marketing of mortgage loans and states that financial institutions should provide consumers with information about costs, terms, features and risks of the loan to borrowers.

The federal banking agencies announced their intention to scrutinize more closely underwriting, risk management and consumer compliance processes, policies and procedures of its supervised financial institutions and their intention to take action against institutions that engage in predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices or otherwise engage in unsafe or unsound lending practices.

Guidance on Nontraditional Mortgage Products

In September 2006, the federal banking agencies issued final guidance on alternative residential mortgage loan products that allow borrowers to defer repayment of principal and sometimes interest, including "interest-only" mortgage loans, and "payment option" adjustable rate mortgage loans where a borrower has flexible payment options, including payments that have the potential for negative amortization. While acknowledging that innovations in mortgage lending can benefit some consumers, the final guidance states that management should (1) assess a borrower s ability to repay the loan, including any principal balances added through negative amortization, at the fully indexed rate that would apply after the incentive interest rate period, (2) recognize that certain nontraditional mortgage loans are untested in a stressed environment and warrant strong risk management standards as well as appropriate capital and loan loss reserves, and (3) ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice. Management believes the Bank has implemented appropriate measures to comply with this guidance.

As of December 31, 2007, the Bank held residential one-to-four unit portfolio loans with balances of $9.7 billion under reduced documentation programs.

Commercial Real Estate Lending

In December 2006, the federal banking agencies finalized guidance for banks and thrifts with high and increasing concentrations of commercial real estate (CRE) lending. The OTS issued separate CRE guidance which provides that OTS institutions actively engaged in CRE lending should implement sound risk management procedures commensurate with the size and risks of their CRE portfolios and establish concentration thresholds for internal reporting and monitoring. The Bank has established such risk management procedures and internal concentration thresholds. We believe the Bank has sufficient capital levels appropriate for the risk associated with our CRE concentration.

Guidance on Loss Mitigation Strategies for Servicers of Residential Mortgages

On September 5, 2007, the federal banking agencies issued a statement encouraging regulated institutions and state-supervised entities that service residential mortgages to pursue strategies to mitigate losses while preserving homeownership to the extent possible and appropriate. The guidance recognizes that many mortgage loans, including subprime loans, have been transferred into securitization trusts and servicing for such loans is governed by contracts. The guidance advises servicers to review governing documentation to determine the full extent of their authority to restructure loans that are delinquent or are in default or are in imminent risk of default.

The guidance encourages servicers to take proactive steps to preserve homeownership in situations where there are heightened risks to homeowners losing their homes to foreclosures. Such steps may include loan modification; deferral of payments; extensions of loan maturities , conversion of adjustable rate mortgages into fixed rate or fully indexed, fully amortizing adjustable rate mortgages; capitalization of delinquent amounts; or any combination of these actions.

Pending Subprime Legislation and Regulatory Proposals

As a result of the subprime mortgage crisis, federal and state legislative agencies are considering a broad variety of legislative and regulatory proposals covering mortgage loan products, loan terms and underwriting standards, risk management practices and consumer protection. It is unclear which, if any, of these initiatives will be adopted, what effect they will have on

Downey or the Bank and whether any of these initiatives will change the competitive landscape in the mortgage industry.

Qualified Thrift Lender Test

The OTS requires savings associations to meet a qualified thrift lender or "QTL" 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" " in the Internal Revenue Code. Qualified thrift investments are primarily residential mortgage loans 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 "domestic building and loan association" definition under the Internal Revenue Code requires investments of 60% of assets. The qualified thrift investment asset test requires that compliance be met on a monthly basis in nine out of every twelve months, while the "domestic building and loan association" test under the Internal Revenue Code is measured as of the close of each tax year. 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, 2007, the Bank was in compliance with its qualified thrift lender test requirement and met the definition of a domestic building and loan association.

Insurance of Deposit Accounts

The DIF, as administered by the FDIC, insures the Bank s deposit accounts up to the maximum amount permitted by law. 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 2007, DIF members paid within a range of 0% to 0.27% of insured domestic deposits. The amount of the assessment paid by an institution is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors. The enactment in February 2006, of the Federal Deposit Insurance Reform Act of 2005 ("FDIRA") provided, among other things, changes in the formula and factors to be considered by the FDIC in calculating the FDIC reserve ratio, assessments and dividends, and a one-time aggregate assessment credit for depository institutions in existence on December 31, 1996 (or their successors) which paid assessments to recapitalize the insurance funds after the banking crises of the late 1980s and early 1990s. The FDIC issued final regulations, effective January 1, 2007, implementing the provisions of FDIRA and in February 2007 issued for comment guidelines, including business line concentrations and risk of failure and severity of loss in the event of failure, to be used by the FDIC for possibly raising premiums by up to 0.50 basis points for large banks with $10 billion or more in assets. The Bank received a one-time assessment credit that reduced assessments by the FDIC in 2007.

The Bank, as a former member of the Savings Association Insurance Fund, also pays, in addition to its normal deposit insurance premium, 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 2007, this assessment was equal to .0114% of insured deposits.

The FDIC may terminate insurance of deposits upon a finding that an 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.

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 3.0% of total adjusted assets for institutions such as the Bank; and
- risk-based capital equal to 8.0% of total risk-based assets.

At December 31, 2007, the Bank s regulatory capital exceeded all minimum regulatory capital requirements. See Regulatory Capital Compliance on page 80.

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, OTS regulations provide that the OTS may establish minimum capital levels higher than those specified 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. 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, risks arising from nontraditional activities, other 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 presently not required to meet any such individual minimum regulatory capital requirement.

The current risk-based capital guidelines are based upon the 1988 capital accord of the International Basel Committee on Banking Supervision. A new international accord, referred to as Basel II, which emphasizes internal assessment of credit, market and operational risk, supervisory assessment and market discipline in determining minimum capital requirements, currently becomes mandatory for large international banks outside the U.S. in 2008. In November 2007, the federal banking agencies adopted a final rule to implement Basel II in the United States that requires compliance for U.S. financial institutions with over $250 billion in assets or total on-balance-sheet foreign exposure of $10 billion or more (referred to as "core banks"). The final rule will be effective as of April 1, 2008. It adopts the most complex regime of risk-based capital referred to by the Basel Committee on Banking Supervision as the advanced measurement approach. Other financial institutions can elect to be governed by Basel II. The advanced measurement approach would not apply to Downey or the Bank, and management does not contemplate electing to calculate its risk-based capital based on the Basel II capital framework.

One of the tensions created by the adoption of the advanced measurement approach for core-banks has been the prediction that this approach would lower capital requirements for institutions adopting this approach. This has raised significant concern by other U.S. financial institutions as they may be at a competitive disadvantage under Basel I. To address these concerns and provide more flexibility to U.S. financial institutions that have not adopted the advanced measurement approach, the agencies agreed to proceed promptly to issue a proposed rule that would provide all financial institutions that are not core banks with the option to continue under Basel I standards or to adopt a "standardized approach" under Basel II. The standardized approach would provide non-core banks with an alternative that affords more risk-sensitive capital requirements and simpler approaches for both credit risk and operational risk. The proposal is also expected to provide greater differentiation across corporate exposures based on borrowers underlying credit quality and to recognize a broader spectrum of credit-risk mitigation techniques. The agencies intend that the proposed standardized option would be finalized before the core banks begin the first transition period year under Basel II. Neither Downey nor the Bank have made any decision as to whether they will attempt to adopt the standardized approach.

<u>Consumer Relief Initiative for Borrowers</u>

In October 2007, Treasury Secretary Paulson announced the Homeowner Assistance Initiative to encourage mortgage servicers, mortgage counselors, government officials and non-profit groups to coordinate their efforts to help struggling borrowers restructure their mortgage payments and stay in their homes. The initiative, called HOPE NOW, is aimed at coordinating and improving outreach to borrowers, developing best practices for mortgage counselors across the country and ensuring that groups able to help homeowners work out new loan arrangements with lenders have adequate resources to carry out this mission.

<u>Economic Stimulus Plan for Home Buyers and Home Owners</u>

Congress recently enacted an economic stimulus plan that President Bush signed into law on February 13, 2008. While the main thrust of the plan is to stimulate the economy with a significant infusion of cash to consumers, the plan also addresses the current lack of liquidity in the mortgage market. The plan will temporarily increase the maximum size of mortgage loans (the conforming loan limit) that Fannie Mae and Freddie Mac purchase from the current $417,000 cap to a maximum of $729,750. The plan would also permanently raise the cap on the Federal Housing Administration s conforming loan limit from $362,000 to $729,750. These changes are intended to, among other purposes, provide more liquidity for originators of larger mortgage loans, make lower interest rates available to homebuyers for such loans and enable homeowners to refinance such loans at lower interest rates.

FFIEC Guidance on Pandemic Planning

The Federal Financial Institutions Examination Council ("FFIEC") issued guidance on December 12, 2007, for use by financial institutions in identifying the continuity planning that should be in place to minimize the potential adverse effects of a pandemic. This guidance expanded upon the contents of an Interagency Advisory on Influenza Pandemic Preparedness issued in March 2006. The guidance asserts that pandemic planning presents unique challenges to financial institutions. It further explains that unlike most natural or technical disasters and malicious acts, the impact of a pandemic is much more difficult to determine because of the anticipated difference in scale and duration, and as a result of these differences, no individual or organization is safe from the potential adverse effects of a pandemic event. The guidance cites experts who believe the most significant challenge may be the severe staffing shortages that will likely result from a pandemic outbreak.

The guidance states that the FFIEC agencies believe the potentially significant effects a pandemic could have on an institution justify establishing plans to address how each institution will manage a pandemic event.

Accordingly, the guidance recommends that an institution s business continuity plan should include:

- A preventive program to reduce the likelihood an institution s operations will be significantly affected by a pandemic event;
- A documented strategy that provides for scaling pandemic efforts commensurate with the particular stages of a pandemic outbreak;
- A comprehensive framework of facilities, systems, or procedures to continue critical operations if large numbers of staff members are unavailable for prolonged periods;
- A testing program to ensure the institution s pandemic planning practices and capabilities are effective and will allow critical operations to continue; and
- An oversight program to ensure ongoing review and updates to the pandemic plan.

Downey and the Bank are evaluating how to incorporate pandemic planning into their business continuity plans.

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 any undercapitalized capital category specified in the regulation.

The regulation establishes five categories of capital classification:

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

The OTS regulation uses an institution s risk-based capital, core capital and tangible capital ratios to determine the institution s capital classification. An institution is treated as well capitalized if its total capital to risk-weighted assets ratio is 10.00% or more; its core capital to risk-weighted assets ratio is 6.00% or more; and its core capital to adjusted total assets ratio is 5.00% or more. At December 31, 2007, the Bank s capital ratios exceed these minimum percentage requirements for well capitalized institutions.

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.

 Navigation Links

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 by order of the Director of OTS to make loans to one borrower in an amount not to exceed the lesser of $30 million or 30% of unimpaired capital and surplus to develop residential housing, provided:

- the savings association is in compliance with its capital requirements; and
- the loans comply with applicable loan-to-value requirements.

At December 31, 2007, the Bank s loans-to-one-borrower limit was $229 million based on the 15% of unimpaired capital and surplus measurement, or $381 million for loans secured by readily marketable collateral. The Bank s largest lending relationship consisted of one loan to a non-related party totaling a commitment of $69 million, of which $57 million had been disbursed as of December 31, 2007 with the borrower paying as agreed.

Extensions of Credit to Insiders and Transactions with Affiliates

The Federal Reserve Act and Federal Reserve Board Regulation O, which applies to the Bank, place limitations and conditions on loans or extensions of credit to:

- a bank s or its holding company s executive officers, directors and principal shareholders (i.e., in most cases, those persons who own, control or have power to vote more than 10% of any class of voting securities);
- any company controlled by any such executive officer, director or shareholder; or
- any political or campaign committee controlled by such executive officer, director or principal shareholder or whose funds or services will benefit such person.

Loans and leases extended to any of the above persons must comply with the loan-to-one-borrower limits, require prior full Board of Directors approval when aggregate extensions of credit to the person exceed specified amounts, must be made on substantially the same terms (including interest rates and collateral) as, and follow credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders, and must not involve more than the normal risk of repayment or present other unfavorable features. In addition, Regulation O provides that the aggregate limit on extensions of credit to all insiders of a bank as a group cannot exceed a bank s unimpaired capital and unimpaired surplus. Regulation O also prohibits the Bank from paying an overdraft on an account of an executive officer or director, except pursuant to a written pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or a written pre-authorized transfer of funds from another account of the officer or director at the Bank.

The Bank also is subject to certain restrictions imposed by the Federal Reserve Act and FRB Regulation W as well as the Home Owners Loan Act, 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 the Bank unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments 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 and investment companies whereby the Bank or its affiliate serves as investment advisor. 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 15. Under the Home Owners Loan Act, no loan or other extension of credit may be made to an affiliate unless that affiliate is engaged only in activities permissible for a bank holding company, and no savings association may purchase or invest in securities issued by an affiliate other than with respect to shares of a subsidiary.

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 a savings association to file an application with 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.

As of December 31, 2007, the Bank s capital distributions have been made in accordance with regulatory requirements.

USA PATRIOT Act of 2001

The USA PATRIOT Act of 2001 and its implementing regulations significantly expanded the anti-money laundering and financial transparency laws.

Under the USA PATRIOT Act, financial institutions are required to establish and maintain anti-money laundering programs which include:

- the establishment of a customer identification program;
- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;
- an ongoing employee training program; and
- an independent audit function to test the programs.

The Bank has adopted comprehensive policies and procedures to address the requirements of the USA PATRIOT Act. Material deficiencies in anti-money laundering compliance can result in public enforcement actions by the banking agencies, including the imposition of civil money penalties and supervisory restrictions on growth and expansion. Such actions could have serious reputation consequences for us and the Bank.

Consumer Protection Laws and Regulations

Examination and enforcement by bank regulatory agencies for non-compliance with consumer protection laws and their implementing regulations have become more intense in nature. The Bank is subject to many federal consumer protection statutes and regulations, some of which are discussed below. We and the Bank are also subject to federal and state laws prohibiting unfair or fraudulent business practices, untrue or misleading advertising and unfair competition.

The Home Ownership and Equal Protection Act of 1994, or HOEPA, requires extra disclosures and consumer protections to borrowers for certain lending practices. 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. Predatory lending typically 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.

Regulations and banking agency guidelines aimed at curbing predatory lending significantly widen the pool of high-cost home-secured loans covered by HOEPA. In addition, the regulations bar certain refinances within a year with another loan subject to HOEPA by the same lender or loan servicer. Lenders also will be presumed to have violated the law which says loans should not be made to people unable to repay them unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid. We do not expect these rules and potential state action in this area to have a material impact on our financial condition or results of operations.

Privacy Policies are required by federal banking regulations which 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 non-public 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 protections affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

In addition, state laws may impose more restrictive limitations on the ability of financial institution to disclose such information. California has adopted such a privacy law that, among other things, generally provides that customers must "opt in" before information may be disclosed to certain nonaffiliated third parties.

The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, or the FACT Act, requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and gives consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with the FACT Act, the financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer s election to opt out would be applicable for at least five years. The agencies have also proposed guidelines required by the FACT Act for financial institutions and creditors which require financial institutions to identify patterns, practices and specific forms of activity, known as "Red Flags," that indicate the possible existence of identity theft and require financial institutions to establish reasonable policies and procedures for implementing these guidelines.

On November 7, 2007, the federal banking agencies adopted regulations to implement the affiliate marketing provisions contained in section 214 of the FACT Act. Full compliance is required by October 1, 2008. The regulations generally prohibit a company from using information received from an affiliate to solicit a consumer for marketing purposes, unless the consumer is given notice and an opportunity and simple method to opt out of such solicitations. The regulations provide that (i) notice must be given by an affiliate that has or has previously had a pre-existing business relationship with the consumer and (ii) the election of a consumer to opt out must be effective for a period of at least five years, unless the consumer subsequently revokes the opt-out in writing or, if the consumer agrees, electronically. Bank and Downey do not share information with affiliates for the purpose of allowing an affiliate to market its products or services to consumers. Information shared between affiliates is limited to information permitted to be shared without consumer consent.

 Navigation Links

The Check Clearing for the 21st Century Act, or Check 21, facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a "substitute check," which is the legal equivalent of an original check. Check 21 does not require banks to create substitute checks or accept checks electronically; however, it does require banks to accept a legally equivalent substitute check in place of an original. In addition to its issuance of regulations governing substitute checks, the Federal Reserve has issued final rules governing the treatment of remotely created checks (sometimes referred to as "demand drafts") and electronic check conversion transactions (involving checks that are converted to electronic transactions by merchants and other payees).

The Equal Credit Opportunity Act, or ECOA, generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act, or TILA, is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

The Fair Housing Act, or FH Act, regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The Community Reinvestment Act, or CRA, is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank s record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. In November, 2006, the OTS issued a notice of proposed rulemaking to amend its CRA regulations in certain areas to align its CRA rule with the rule adopted by the other federal banking agencies. The agencies use the CRA assessment to rate the financial institution. The ratings range from a high of "outstanding" to a low of "substantial noncompliance." In its last examination for CRA compliance, as of December 2004, the Bank was rated "satisfactory."

The Home Mortgage Disclosure Act, or HMDA, grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a "fair lending" aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes. In 2004, the FRB amended regulations issued under HMDA to require the reporting of certain pricing data with respect to higher-priced mortgage loans. This expanded reporting is being reviewed by federal banking agencies and others from a fair lending perspective. We do not expect that the HMDA data reported by the Bank will raise material issues regarding the Bank s compliance with the fair lending laws.

The Real Estate Settlement Procedures Act, or RESPA, requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts.

The National Flood Insurance Act, or NFIA, requires homes in flood-prone areas with mortgages from a federally regulated lender to have flood insurance. Hurricane Katrina focused awareness on this requirement. Lenders are required to provide notice to borrowers of special flood hazard areas and require such coverage before making, increasing, extending or renewing such loans. Financial institutions which demonstrate a pattern and practice of lax compliance are subject to the issuance of cease and desist orders and the imposition of per loan civil money penalties, up to a maximum fine which currently is $125,000. Fine payments are remitted to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

Penalties under the above laws may include fines, reimbursements and other penalties. Due to heightened regulatory concern related to compliance with the HOEPA, privacy laws and regulations, the FACT Act, Check 21, ECOA, TILA, FH Act, CRA, HMDA, RESPA and NFIA generally, the Bank may incur additional compliance costs or be required to expend additional funds for CRA investments.

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, its activities, 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 its operations, 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, expense and constraints 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 DSL Service Company s project sites are 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 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.

The Bank and its affiliates file a consolidated federal income tax return on a calendar-year basis.

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 2007 and 2006.

The Bank files a California franchise tax return on a combined reporting basis. Additional income and franchise tax returns are filed in various other states.

The Internal Revenue Service and state taxing authorities have examined the Bank s tax returns for all tax years through 2001. Management believes it has adequately provided for potential exposure to issues that may be raised by tax auditors in years which remain open to review.

ITEM 1A. RISK FACTORS

In addition to the other information contained in this annual report, the following risks may affect us. If any of these risks occur, our business, financial condition, results of operations, cash flows and prospects could be adversely effected.

Changes in economic conditions could adversely affect our business.

Our business is directly affected by factors such as economic, political and market conditions; broad trends in the industry and finance; legislative and regulatory changes; changes in government monetary and fiscal policies; and inflation, all of which are beyond our control. We are principally affected by economic conditions in the state of California where our business is concentrated. Deterioration in economic conditions could result in the following consequences, any of which could have an adverse effect on our business, financial condition, results of operations, cash flows and prospects:

- problem assets and foreclosures may increase;
- demand for our products and services may decline;
- low cost or non-interest bearing deposits may decrease;
- collateral for potential loans, especially real estate, may decline in value, in turn reducing customers borrowing power;
- the value of assets and collateral associated with our existing loans may decline; and
- the borrowers ability to repay their loans may diminish.

In view of the concentration of our operations and the collateral securing our loan portfolio in California, we may be particularly susceptible to the effects from any of these consequences, which could have an adverse effect on our business, financial condition, results of operations, cash flows and prospects.

Our business is subject to interest rate risk and variations in interest rates may negatively affect our financial performance.

A substantial portion of our income is derived from the differential or "spread" between the interest earned on loans, securities and other interest-earning assets, and interest paid on deposits, borrowings and other interest-bearing liabilities. Because of different basis and frequency in the repricing and maturities of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. Changes in interest rates also affect the value of our recorded MSRs on loans we service for others, generally increasing in value as interest rates rise and declining as interest rates fall. Accordingly, fluctuations in interest rates could adversely affect our interest rate spread and other income and, in turn, our profitability. At December 31, 2007, our balance sheet was asset sensitive and, as a result, our net interest margin will tend to expand in a rising interest rate environment and contract in a declining interest rate environment. For additional information, see Asset/Liability Management and Market Risk on page 60. In addition, loan origination volumes and loan repayment rates are affected by market interest rates. Rising interest rates, generally, are associated with a lower volume of loan originations and declining repayment rates, while falling interest rates are usually associated with higher loan originations and increasing repayment rates. In addition, in a rising interest rate environment, we may need to accelerate the pace of rate increases on our deposit accounts as compared with the pace of increases in loan rates. Accordingly, changes in levels of market interest rates could adversely affect our net interest spread, other income, loan origination volume, business, financial condition, results of operations, cash flows and prospects.

We seek to mitigate our interest rate risks through various strategies. However, there can be no assurance that these strategies (including assumptions concerning the correlation thought to exist between different types of instruments) or their implementation will be successful in any particular interest rate environment, as market volatility cannot be predicted.

The types of loans in our portfolio have a higher degree of risk, and a downturn in our real estate markets could adversely affect our business.

A downturn in our real estate markets could adversely affect our business. As of December 31, 2007, virtually all of the value of our loan portfolio consisted of loans collateralized by various types of real estate, of which 67% were subject to negative amortization. A negative amortization loan is one in which accrued interest exceeding the required monthly loan payment is added to loan principal. If a loan incurs significant negative amortization, the loan-to-value ratio could rise, which increases the Bank s credit risk exposure and its susceptibility to a downturn in the real estate markets in which we lend. For further information regarding loans subject to negative amortization and their contractual terms, see Residential Real Estate Lending on page 4.

Real estate values and real estate markets are generally affected by changes in national, regional and local economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other

governmental statutes, regulations and policies, acts of nature and civil unrest. Most of our real estate collateral is located in California. If California real estate prices continue to decline, the value of real estate collateral securing our loans will be reduced and provide less security. Our ability to recover our investment on defaulted loans by foreclosing and selling the real estate collateral would then be diminished, and we would be more likely to suffer losses on defaulted loans. Real estate values could also be affected by, among other things, earthquakes and natural disasters particular to California. Any such downturn could have an adverse effect on our business, financial condition, results of operations, cash flows and prospects.

We are exposed to credit risk with respect to underwriting guidelines related to income and asset verifications that could adversely affect our business.

Our business could be hurt by a downturn in real estate markets from a concentration of loan products offered associated with particular underwriting guidelines related to income and asset verifications. At December 31, 2007, approximately 82% of our residential one-to-four unit loans held for investment were originated based on income as stated by the borrower and asset verification, while an additional 7% were underwritten with no verification of either borrower income or assets. To the extent borrowers overstated their income and/or assets, the ability of borrowers to repay their loans may be impaired, which could adversely affect the quality of our loan portfolio, business, financial condition, results of operations, cash flows and prospects. For further information regarding credit risk in our residential one-to-four unit investment loan portfolio, see Loans and Mortgage-Backed Securities on page 45.

Recent adverse conditions in the secondary mortgage market could negatively affect our business.

As part of our secondary marketing activities, we originate residential real estate adjustable rate mortgage loans and fixed rate mortgage loans that we intend to sell. However the secondary mortgage market is currently experiencing unprecedented disruptions, which could have an adverse effect on our ability to securitize and sell mortgage loans and the gain that we may realize from sales of mortgage loans. In addition, the private secondary mortgage markets are experiencing disruptions resulting from reduced investor demand for "non-conforming" mortgage loans and mortgage-backed securities and increased investor yield requirements for those loans and securities. These conditions may continue or worsen in the future.

In light of current conditions, we may retain a larger portion of mortgage loans and mortgage-backed securities than we would in other environments. While our capital and liquidity positions are currently adequate and we believe we have sufficient capacity to hold additional mortgage loans and mortgage backed securities until investor demand improves and yield requirements moderate, our capacity to retain mortgage loans and mortgage backed securities is not unlimited. As a result, a prolonged period of secondary market illiquidity may reduce our loan production volumes and could adversely affect our secondary marketing activities (including loan servicing income (loss), net and net gains on sales of loans and mortgage-backed securities categories) and financial condition.

Current and further deterioration in the housing market may lead to increased loss severities and further worsening of delinquencies and non-performing assets in our loan portfolios. Consequently, our allowance for credit losses may not be adequate to cover actual losses, and we may be required to materially increase our reserves.

A significant source of risk arises from the possibility that we could sustain losses because borrowers, guarantors, and related parties may fail to perform in accordance with the terms of their loans. The underwriting and credit monitoring policies and procedures that we have adopted to address this risk may not prevent unexpected losses that could have an adverse effect on our business, financial condition, results of operations, cash flows and prospects. Unexpected losses may arise from a wide variety of specific or systemic factors, many of which are beyond our ability to predict, influence or control.

As with most lending institutions, we maintain an allowance for credit losses to provide for defaults and non-performance. Our allowance for credit losses may not be adequate to cover actual credit losses, and future provisions for credit losses could adversely affect our business, financial condition, results of operations, cash flows and prospects. The allowance for credit losses reflects our estimate of the probable losses in our portfolio of loans and loan-related commitments at the relevant balance sheet date. Our allowance for credit losses is based on prior experience as well as an evaluation of the known risks in the current portfolio, composition and growth of the portfolio and economic factors. The determination of an appropriate level of credit loss allowance is an inherently difficult process and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, that may be beyond our control and these losses may exceed current estimates. Federal and state regulatory agencies, as an integral part of their examination process, review our loans, loan-related commitments and allowance for credit losses.

In addition, we sell loans to outside investors that are subject to repurchase risk in the event of breaches of representations or warranties we make in connection with the sales. While we establish secondary marketing reserves in connection with such sales, we cannot be sure that the amount reserved is sufficient to cover all potential losses that may result from such repurchases. Significant loan or servicing sale repurchases could have a material adverse effect on our business, financial condition, results of operations, cash flows and prospects.

Recently, the housing and the residential mortgage markets have experienced a variety of difficulties and changed economic conditions. If market conditions continue to deteriorate, they may lead to additional valuation adjustments on our loan portfolios and real estate owned as we continue to reassess the market value of our loan portfolio, the loss severities of loans in default, and the net realizable value of real estate owned. In addition, the homebuilding industry has experienced a significant and sustained decline in demand for new homes and an oversupply of new and existing homes available for sale in various markets. Our builders/borrowers face a greater difficulty in selling their homes in markets where these trends are more pronounced. We do not anticipate that the housing market will improve in the near-term, and accordingly, additional downgrades, provisions for loan losses and charge-offs relating to this portfolio may occur.

Our ratio of non-performing assets as a percentage of total assets increased from 0.68% at December 31, 2006 to 7.77% at December 31, 2007. During 2007, our provision for credit losses was $310.1 million, compared with $26.6 million in 2006 and $2.3 million in 2005. While we believe our allowance for credit losses is adequate to cover losses currently imbedded in our loan portfolio at year-end 2007, we cannot assure you that we will not increase the allowance for credit losses further or that our regulators will not require us to increase this allowance. Either of these occurrences could have a material adverse effect on our business, financial condition, results of operations, cash flows and prospects.

We are subject to extensive government regulation. These regulations may hamper our ability to increase our assets and earnings.

Our operations and those of the Bank are subject to extensive regulation by federal, state and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of our operations. The laws, rules and regulations applicable to us are subject to regular modification and change. There are currently proposed various laws, rules and regulations that, if adopted, would impact our operations. In particular, we are assessing the final guidance given in September 2006 by federal banking agencies on alternative residential mortgage products, the additional guidance issued in June 2007 on subprime mortgage lending, and the guidance issued in September 2007 on loss mitigation strategies for services of residential mortgages. All of these issuances may hamper our ability to increase our assets and earnings. We cannot assure you that this guidance, together with various proposed laws, rules and regulations or any other laws, rules or regulations will not be adopted in the future, which could make compliance

much more difficult or expensive, restrict our ability to originate, broker or sell loans, further limit or restrict the amount of commissions, interest or other charges earned on loans originated or sold by us or otherwise adversely affect our business, financial condition, results of operations or cash flows and prospects.

We are subject to changes in accounting standards.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time the Financial Accounting Standards Board ("FASB") changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially affect how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, possibly resulting in a restatement of prior period financial statements. In addition, changes in accounting and reporting standards could materially disrupt our business planning efforts, as changes may occur in the profitability of certain lines of business due to accounting changes.

We are exposed to risk of environmental liabilities with respect to properties to which we take title.

In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean-up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination

emanating from the property. Becoming subject to significant environmental liabilities could have an adverse effect on our business, financial condition, results of operations, cash flows and prospects.

If we cannot attract deposits or obtain borrowings, our growth may be inhibited.

Our ability to increase our asset base depends in large part on our ability to attract additional deposits and obtain borrowings at favorable rates. We intend to seek additional deposits by offering deposit products that are competitive with those offered by other financial institutions in our markets and by establishing personal relationships with our customers. We cannot assure you that these efforts will be successful. Although we are not aware of any trends, events or uncertainties, our ability to obtain borrowings could be diminished. Our inability to attract additional deposits or obtain borrowings at competitive rates could have an adverse effect on our business, financial condition, results of operations, cash flows and prospects.

We are dependent on key personnel and the loss of one or more of those key personnel may adversely affect our business.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and expertise in, the banking industry.

The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. The loss of the services of any one of our key personnel could have an adverse effect on our business, financial condition, results of operations, cash flows and prospects.

There is significant competition among employers in the financial services industry and we experience turnover of employees. Should we be subjected to unusual turnover of employees, it may have a negative effect on our business and operating results.

We face strong competition from financial services companies and other companies that offer banking services which could adversely affect our business.

We conduct most of our operations in California. Increased competition in our markets may result in reduced loans and deposits. Ultimately, we may not be able to compete successfully against current and future competitors. Many competitors offer the banking services that we offer in our geographic service areas. These competitors include a variety of financial institutions such as banks, savings and loan associations, mortgage banks, finance companies, brokerage firms, insurance companies, credit unions and other financial intermediaries. In particular, our competitors include major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous locations and mount extensive promotional and advertising campaigns. Areas of competition include interest rates offered on loans and deposits, efforts to obtain loan and deposit customers and a range in quality of products and services provided, including new technology-driven products and services. Technological innovation continues to contribute to greater competition in financial services markets as technological advances enable more companies to provide financial services. We also face competition from out-of-state financial intermediaries that have opened loan production offices or that solicit deposits in our market areas. If we are unable to attract and retain customers, we may be unable to continue our loan growth and level of deposits and our business, financial condition, results of operations, cash flows and prospects may be adversely affected.

Negative public opinion could adversely affect our business.

Negative public opinion, inherent in business, can adversely affect our earnings and capital. Negative public opinion can result from the actual or perceived manner in which we conduct our business activities, including practices in our loan origination, loan servicing and retail banking operations; our management of conflicts of interest and ethical issues; and our protection of confidential customer information. Our ability to keep and attract customers can be affected by negative public opinion and expose us to litigation and regulatory action. If we are unable to attract and retain customers, we may be unable to maintain loan and deposit levels and our business, financial condition, results of operations, cash flows and prospects may be adversely affected.

Our growth and expansion may strain our ability to manage our operations and our financial resources.

Our financial performance and profitability depend on our ability to execute our corporate growth strategy. In addition to seeking deposit and loan growth in our existing markets, we intend to pursue expansion opportunities through strategically placed new branches and by acquiring branch locations that we find attractive. In addition, acquisitions of other financial institutions might be considered. Continued growth, however, may present operating and other problems that could adversely affect our business, financial condition, results of operations, cash flows and prospects. Accordingly, there can be no assurance that we will be able to execute our growth strategy.

Our growth may place a strain on our administrative, operational and financial resources and increase demands on our systems and controls. We plan to pursue opportunities to expand our business primarily through internally generated growth. This business growth may require continued enhancements to and expansion of our operating and financial systems and controls and may strain or significantly challenge them. In addition, our existing operating and financial control systems and infrastructure may not be adequate to maintain and effectively monitor future growth.

Our continued growth may also increase our need for qualified personnel. We cannot assure you that we will be successful in attracting, integrating and retaining such personnel. The following risks, associated with our growth, could have a material adverse effect on our business, financial condition, results of operations, cash flows and prospects:

- our inability to continue to upgrade or maintain effective operating and financial control systems;
- our inability to recruit and hire necessary personnel or to integrate successfully new personnel into our operations; and
- our inability to respond promptly or adequately to the emergence of unexpected expansion difficulties.

Changes in the ability of the Bank to pay dividends to the holding company may adversely affect our ability to pay dividends and service our debt.

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

We are exposed to many types of operational risks.

Operational risk includes fraud by employees or outsiders as well as the risk of operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer or telecommunications systems. Given our high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully corrected. Our dependence on automated systems to record and process transactions may further increase the risk that technical system flaws or employee tampering with, or manipulation of, those systems will result in losses that are difficult to detect. We may be subject to disruptions in our systems, arising from events that are wholly or partially beyond our control (including, for example, computer viruses or electrical or telecommunications outages), which may give rise to losses in service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that our (or our vendors) business continuity and data security systems prove to be inadequate. Some of our vendors may rely on offshore services from vendors in foreign countries for certain functions and this creates the risk of incurring losses arising from unfavorable political, economic and legal developments in those countries. We also face the risk that the design of our controls and procedures may prove to be inadequate or are circumvented, thereby causing delays in detection of errors or inaccuracies in data and information.

Although we maintain a system of controls designed to keep operational risk at appropriate levels, it is possible that any lapse in the effective operations of its controls and procedures could materially affect our earnings or harm our reputation. In an organization as large and complex as Downey, lapses or deficiencies in internal control over financial reporting could be material to Downey.

Economic downturns or disasters in our principal lending markets could adversely impact our earnings

A majority of our loans are geographically concentrated in California. Any adverse economic conditions in this market could have a significant adverse impact on Downey. Also, we could be adversely affected by business disruptions triggered by natural disasters or acts of war or terrorism in these geographic areas.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

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

At December 31, 2007, we had 168 branches throughout California and four in Arizona. We owned the building and land occupied by 63 of our branches. We also owned one branch building on leased land and two branch buildings under construction. We operate branches in 108 locations (including 90 in-store locations) with leases or licenses expiring at various dates through April 2015, with options to extend the terms.

At December 31, 2007, the net book value of our owned branches, including the one on leased land, totaled $82 million, our leased branch offices totaled $1 million and our other properties totaled $7 million. The net book value of our furniture and fixtures was $12 million at December 31, 2007. 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 $14 million at December 31, 2007.

For additional information regarding our offices and equipment, see Note 1 on page 92 and Note 8 on page 108 of Notes to Consolidated Financial Statements.

ITEM 3. LEGAL PROCEEDINGS

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

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

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

No matters were submitted to stockholders during the fourth quarter of 2007.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the New York Stock Exchange ("NYSE") under the trading symbol "DSL." At February 27, 2008, we had approximately 924 stockholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 27,853,783 outstanding shares of common stock.

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

	2007				*2006*			
	4th Quarter	*3rd Quarter*	*2nd Quarter*	*1st Quarter*	*4th Quarter*	*3rd Quarter*	*2nd Quarter*	*1st Quarter*
High	$59.74	$66.95	$74.12	$73.93	$74.93	$71.28	$75.56	$70.19
Low	29.99	45.43	61.85	62.36	66.04	59.84	65.09	60.62
End of period	31.11	57.80	65.98	64.54	72.58	66.54	67.85	67.30

During 2007, we increased our quarterly cash dividends paid to $0.12 per share, or $0.48 per share annually, from our quarterly cash dividends paid in 2006 of $0.10 per share, or $0.40 per share annually. Total cash dividends were $13.4 million in 2007 and $11.1 million in 2006. On February 26, 2008, we paid a $0.12 per share quarterly cash dividend, totaling $3.3 million.

We may pay additional dividends out of funds legally available 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 17.

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PERFOMANCE GRAPH

The table below compares the common stock performance of Downey with that of the S&P 500 composite index and the selected Peer Group. The selected Peer Group is SNL Financial s Western Thrift Index for 19 publicly traded savings institution holding companies. The following table assumes $100 invested on December 31, 2002 in Downey, the S&P 500 and equally in the companies in the Peer Group, and assumes reinvestment of dividends on a daily basis.

Comparison of 5-year Cumulative Total Return
Downey, S&P 500 Index and Peer Group

	2002	2003	2004	2005	2006	2007
Downey	$ 100.00	$ 127.47	$ 148.52	$ 179.28	$ 191.40	$ 82.81
S&P 500	100.00	128.68	142.69	149.70	173.34	182.86
Peer Group	100.00	131.40	150.80	163.89	188.60	66.87

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ITEM 6. SELECTED FINANCIAL DATA

(Dollars in Thousands, Except Per Share Data)	*2007*	*2006*	*2005*	*2004*	*2003*
Income statement data					
Total interest income	$ 980,097	$ 1,133,805	$ 862,849	$ 594,075	$ 542,524
Total interest expense	556,259	615,128	426,476	249,823	233,837
Net interest income	423,838	518,677	436,373	344,252	308,687
Provision for (reduction of) credit losses	310,131	26,604	2,263	2,895	(3,718)
Net interest income after provision for (reduction of) credit losses	113,707	492,073	434,110	341,357	312,405

Other income, net:					
Loan and deposit related fees	36,054	36,151	36,496	34,174	33,002
Real estate and joint ventures held for investment, net	(6,885)	10,953	6,734	13,902	9,835
Secondary marketing activities:					
Loan servicing income (loss), net	(3,179)	(594)	2,059	(19,225)	(27,060)
Net gains on sales of loans and mortgage-backed securities	20,316	43,615	119,961	54,443	61,436
Net gains on sales of mortgage servicing rights	-	-	1,000	616	23
Net losses on trading securities	-	-	-	-	(10,449)
Net gains (losses) on sales of investment securities	-	-	28	(16,103)	8
Litigation award	155	2,233	1,767	-	2,851
Loss on extinguishment of debt	-	-	-	(4,111)	-
Other	15	785	1,887	1,324	1,222
Total other income, net	46,476	93,143	169,932	65,020	70,868
Operating expense:					
General and administrative expense	248,522	242,955	233,647	229,766	207,999
Net operation of real estate acquired in settlement of loans	9,486	250	(96)	(256)	(929)
Total operating expense	258,008	243,205	233,551	229,510	207,070
Net income (loss)	$ (56,599)	$ 199,656	$ 214,477	$ 106,915	$ 101,741
Per share data					
Earnings (loss) per share Basic	$ (2.03)	$ 7.17	$ 7.70	$ 3.83	$ 3.64
Earnings (loss) per share Diluted	(2.03)	7.16	7.69	3.83	3.64
Book value per share at end of period	47.91	50.02	43.24	36.15	32.83
Stock price at end of period	31.11	72.58	68.39	57.00	49.30
Cash dividends declared and paid	0.48	0.40	0.40	0.40	0.36
Selected financial ratios					
	2.96 %	3.09 %	2.69 %	2.54 %	2.79 %

Effective interest rate spread					
Efficiency ratio [a]	52.10	40.58	39.08	57.52	56.70
Return on average assets	(0.38)	1.16	1.29	0.77	0.89
Return on average equity	(3.92)	15.45	19.33	11.29	11.65
Dividend payout ratio	(b)	5.58	5.19	10.45	9.88
Loan activity					
Loans originated	$ 3,765,960	$ 7,803,175	$ 14,982,492	$ 15,399,403	$ 10,548,675
Loans and mortgage-backed securities purchased	15,872	25,857	119,432	305,477	706,949
Loans and mortgage-backed securities sold	1,797,598	3,521,410	8,327,799	6,886,502	6,581,856

[a] The amount of general and administrative expense expressed as a percentage of net interest income plus other income, excluding income associated with real estate held for investment, loss on extinguishment of debt and litigation award.
[b] In years where we experience a net loss, this ratio is not relevant.

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ITEM 6. SELECTED FINANCIAL DATA (CONTINUED)

(Dollars in Thousands, Except Per Share Data)	*2007*	*2006*	*2005*	*2004*	*2003*
Balance sheet summary (end of period)					
Total assets	$ 13,409,057	$ 16,207,382	$ 17,095,663	$ 15,650,179	$ 11,646,999
Loans and mortgage-backed securities	11,136,655	14,170,750	15,821,923	14,544,149	10,397,529
Investments, cash and cash equivalents	1,639,619	1,558,042	816,709	616,511	803,514
Deposits	10,496,041	11,784,869	11,876,848	9,657,978	8,293,758
Borrowings	1,395,545	2,809,016	3,755,602	4,757,546	2,253,022
Stockholders equity	1,334,417	1,393,235	1,204,515	1,006,904	917,018
Loans serviced for others	5,525,357	5,908,233	5,292,253	6,672,984	9,313,948
Average balance sheet data					
Assets	$ 14,802,586	$ 17,239,397	$ 16,641,119	$ 13,971,819	$ 11,458,956
Loans	12,495,977	15,688,297	15,461,684	12,791,590	10,445,684
Deposits	11,137,388	11,962,834	10,995,933	9,097,861	8,787,851
Stockholders equity	1,442,165	1,292,592	1,109,709	946,856	873,051
Capital ratios					
Average stockholders equity to average assets	9.74 %	7.50 %	6.67 %	6.78 %	7.62 %
Bank only end of period [a]					
Tangible and core capital	10.18	8.76	7.62	7.09	7.98
Risk-based capital	19.01	17.78	14.89	13.70	15.63

Selected asset quality data (end of period)										
Total non-performing assets [b]	$	1,041,769	$	110,362	$	35,221	$	34,189	$	48,631
Non-performing assets as a percentage of total assets:										
Performing troubled debt restructurings [b]		2.99 %		- %		- %		- %		- %
All other non-performing assets		4.78		0.68		0.21		0.22		0.42
Total non-performing assets		7.77		0.68		0.21		0.22		0.42
Allowance for loan losses:										
Amount	$	348,167	$	60,943	$	34,601	$	33,343	$	29,311
As a percentage of non-accrual loans		37.59 %		59.84 %		100.84 %		105.40 %		68.44 %
Total net loan charge-offs (recoveries):										
Amount	$	22,264	$	521	$	1,062	$	(1,489)	$	951
As a percentage of average loans		0.18 %		- %		0.01 %		(0.01)%		0.01 %

[a] For more information regarding these ratios, see Regulatory Capital Compliance on page 80.
[b] Includes $401 million at December 31, 2007 of loans modified pursuant to Downey s borrower retention program. These loans are considered troubled debt restructurings and have been placed on non-accrual status even through the interest rate following modification was no less than that offered new borrowers at the time of modification. To the extent borrowers whose loans were modified pursuant to our borrower retention program are current with their loan payments, it is relevant to distinguish them from total non-performing assets because, unlike other loans classified as non-performing assets, these loans are paying interest at rates no less than those offered new borrowers. At December 31, 2007, approximately 95% of loans modified pursuant to our borrower retention program had made all payments due. For further information, see Troubled Debt Restructurings on page 69.

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

Certain matters discussed in this Annual Report may constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995, which 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. 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, the outcome of ongoing audits by regulatory and taxing authorities and government regulation and factors, identified under Item 1A. Risk Factors on page 22. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made, except as required by law.

OVERVIEW

In 2007, we incurred a net loss of $56.6 million or $2.03 per share on a diluted basis, compared to net income of $199.7 million or $7.16 per share in 2006.

The $439.8 million unfavorable change in pre-tax income/(loss) between years was due primarily to:

- A $283.5 million increase in provision for credit losses;
- A $94.8 million or 18.3% decline in net interest income due to a lower level of interest-earning assets and a lower effective interest rate spread;
- A $23.3 million or 53.4% decline in net gains on the sale of loans and mortgage-backed securities due to both a lower level of loans sold and gain per dollar of loan sold;
- A $17.8 million unfavorable change in income from real estate and joint ventures held for investment, as the current year included writedowns to reflect declines in the value of single family home lots in which the company is a joint venture partner and net gains from sales were below a year ago; and
- A $14.8 million increase in operating expense, of which $9.2 million related to higher costs related to the operation of real estate acquired in settlement of loans.

For 2007, our return on average assets was a negative 0.38% and our return on average equity was a negative 3.92%. These compare to our 2006 returns of 1.16% on average assets and 15.45% on average equity.

At December 31, 2007, assets totaled $13.409 billion, down $2.798 billion or 17.3% from a year ago. The decline was primarily in loans held for investment as payoffs outpaced originations, partially offset by an increase in securities available for sale. Included within loans held for investment at year end were $7.531 billion of residential one-to-four unit adjustable rate mortgages subject to negative amortization. These loans comprised 69% of the single family residential loan portfolio held for investment at year end, compared to 85% a year ago. The amount of negative amortization included in loan balances increased $58 million during 2007 to $379 million or 5.03% of loans subject to negative amortization. At origination, these loans had a weighted average loan-to-value ratio of 73%. During the year, approximately 28% of loan interest income represented negative amortization, compared to 27% in the previous year and 16% in 2005.

Loan originations (including purchases) totaled $3.782 billion in 2007, down $4.047 billion or 51.7% from $7.829 billion originated in 2006. Loans originated for sale declined $1.903 billion or 54.8% to $1.572 billion, while single family loans originated for portfolio declined $2.040 billion or 48.9% to $2.129 billion. In addition to single family loans, $81 million of other loans were originated during 2007, down from $185 million a year ago.

Not included in the above originations are loans in which we modify the terms of the note for borrowers. During 2007, we modified $420 million of loans associated with our borrower retention program, wherein borrowers were current with their loan payments and the new interest rates were no less than those offered new borrowers, and $12 million of loans at below market interest rates in loan workout situations. Most of the modifications related to adjustable rate loans subject to negative amortization that were modified into adjustable rate loans where the interest rate is fixed for the first three to five years or adjustable rate loans with interest rates that adjust annually. Both of these products do not permit negative amortization.

Deposits totaled $10.496 billion at year end, down $1.289 billion or 10.9% from a year ago. Although deposits declined during the year, the number of checking accounts increased 5.7%. At year end, the number of branches totaled 172 (168 in California and four in Arizona). At year end, the average deposit size of our 82 traditional branches was $102 million, while the average deposit size of our 90 in-store branches was $24 million. During the year, borrowings declined by $1.413 billion and at year end represented 10.4% of total assets.

Non-performing assets increased during the year by $931 million to $1.042 billion and represented 7.77% of total assets, compared with 0.68% at year-end 2006. Of the increase, $401 million or about 43% represented loans modified as part of our borrower retention program that are current on their loan payments at December 31, 2007. This program was initiated at the beginning of the third quarter of 2007 to provide borrowers who are current with their loan payments a cost effective means to change from an adjustable rate loan subject to negative amortization to a less costly financing alternative. These loans are considered troubled debt restructurings because the modified interest rates were lower than the interest rates on the original loans and the loans were not re-underwritten to prove the new interest rates were, in fact, market interest rates for borrowers with similar credit quality. Even though the interest rates following modification were no less than those offered new borrowers, these loans have been placed on non-accrual status. Interest income will be recorded as these borrowers make their loan payments on a cash basis. If these borrowers perform pursuant to the modified terms for six consecutive months, the loans will be placed back on accrual status and, while still reported as troubled debt restructurings, they will no longer be classified as non-performing assets because the borrowers will have demonstrated an ability to perform in accordance with the loan modification and the interest rates are no less than those offered new borrowers at the time of modification.

To the extent borrowers whose loans were modified pursuant to our borrower retention program are current with their loan payments, it is relevant to distinguish them from total non-performing assets because, unlike other loans classified as non-performing assets, these loans are paying interest at interest rates no less than those offered new borrowers. At year-end

2007, approximately 95% of such borrowers had made all loan payments due. Accordingly, when these performing modified loans are excluded from the ratio of non-performing assets to total assets, the adjusted ratio drops to 4.78%, compared to the actual ratio of 7.77%.

At December 31, 2007, the Bank exceeded all regulatory capital requirements, with capital-to-asset ratios of 10.18% for both tangible and core capital and 19.01% 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 13, Investments in Real Estate and Joint Ventures on page 55 and Regulatory Capital Compliance on page 80.

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 92. Certain accounting policies require us to make significant estimates and assumptions which could have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the future carrying value of assets and liabilities and our results of operations for the reporting periods. Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors.

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

- The allowance for credit and real estate losses. The allowance for credit losses, which includes an allowance for loan losses reported as a reduction of outstanding loans and an allowance for loan-related commitments included in accounts payable and accrued liabilities, and the allowance for real estate losses reported as a reduction to real estate held for investment are maintained at amounts management deems adequate to cover inherent losses in the portfolios at the balance sheet date. We use an internal asset review system and credit loss allowance methodology designed to provide for the detection of problem assets and an adequate allowance to cover credit and real estate losses. Unless an individual loan or borrower relationship warrants separate analysis, we generally determine the allowance for credit losses related to loans under $5 million through a statistical analysis of the expected performance of each loan based on historic trends for similar types of borrowers, loans, collateral and economic circumstances. Those amounts may be adjusted based upon an analysis of macro-economic and other trends that are likely to affect a borrower s ability to repay their loan according to their loan terms. In determining the allowance for credit losses related to borrower relationships of $5 million or more, we evaluate the loans on an individual basis, including an analysis of the borrower s creditworthiness, cash flows and financial status, and the condition and the estimated value of the collateral. For troubled debt restructures of residential one-to-four unit loans, a specific valuation allowance is calculated as the difference between the recorded investment of the original loan and the present value of the expected cash flows of the modified loan (discounted at the effective interest rate of the original loan based on an expected life). This difference is recorded as a provision for credit losses in current earnings and subsequently amortized over the expected life of the loans as an adjustment to loan yield or as a reduction of the provision if the loan is prepaid. The allowance for credit and real estate losses totaled $350 million at December 31, 2007, compared with $62 million at December 31, 2006. For further information, see Allowance for Credit and Real Estate Losses on page 72 and Note 5 on page 102 and Note 6 on page 105 of Notes to the Consolidated Financial Statements.
- The valuation of interest rate lock commitments. We enter into commitments to make loans that we intend to sell to investors whereby the interest rate on the loan is set prior to funding. These interest rate lock commitments are considered to be derivatives and are recorded at fair value. This value is calculated using market sources, reduced by an anticipated fallout factor for interest rate lock commitments that are not expected to fund. At December 31, 2007, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $53 million, with a fair value gain of $0.2 million, compared with a notional amount of interest rate lock commitments of $197 million with a fair value loss of $0.7 million at December 31, 2006. For further information, see Note 1 on page 92 and Note 20 on page 120 of Notes to the Consolidated Financial Statements.

- The valuation of mortgage servicing rights ("MSRs"). The fair value of MSRs is measured using a discounted cash flow analysis based on available market quotes, anticipated prepayment speeds, a custodial account rate and market-adjusted discount rates. Market sources are used to determine prepayment speeds, the net cost of servicing per loan, inflation rate, and default and interest rates for mortgage loans. MSRs are reviewed for impairment based on their fair value. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, which include loans by loan term and coupon rate stratified at 50 basis point increments. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income (loss), net. An impairment is considered permanent when the underlying loans have repaid faster than the amortization of the associated MSRs, thereby requiring a reduction in the carrying value of the MSR. The MSR valuation allowance totaled $2 million at December 31, 2007 and less than $1 million at December 31, 2006. For further information, see Note 1 on page 92 and Note 10 on page 109 of Notes to the Consolidated Financial Statements.
- The prepayment reserves related to sales of loans and of MSRs. The gains on sales of loans and of MSRs are recorded net of reserves for anticipated prepayments. These loans and MSR sales contracts typically contain provisions to refund sale price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale s settlement date. Loan and MSR sales reserves are estimated using the prepayment experience of similar products. The estimates are updated during the 120 day period for actual payoffs. The reserve was less than $1 million at both December 31, 2007 and 2006. For further information, see Secondary Marketing Activities on page 41, Note 1 on page 92 and Note 10 on page 109 of Notes to the Consolidated Financial Statements.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the difference between the interest and dividends earned on loans, mortgage-backed securities and investment securities ("interest-earning assets") and the interest paid on deposits and borrowings ("interest-bearing liabilities"). The spread between the yield on interest-earning assets and the cost of interest-bearing liabilities and the relative dollar amounts of these assets and liabilities principally affects net interest income.

Our net interest income totaled $423.8 million in 2007, down $94.8 million or 18.3% from 2006 and $12.5 million or 2.9% from 2005. The decline during 2007 reflected a lower level of interest-earning assets, which declined by $2.5 billion or 14.8% to $14.3 billion, and a lower effective interest rate spread, which averaged 2.96% in 2007, down 0.13% from 2006 but up 0.27% from 2005. Compared to a year ago, the effective interest rate spread was unfavorably impacted by a lower proportion of loan prepayment fees to the amount of deferred loan origination costs written-off as a result of those payoffs, which declined to 69% in the current year from 99% a year ago. This decline was primarily the result of a higher proportion of loans being repaid that were no longer subject to prepayment fees primarily due to the increasing age of the loan portfolio. In addition, the current year effective interest rate spread was unfavorably impacted by a higher proportion of non-performing assets and a higher proportion of interest-earning assets comprised of investment securities and adjustable rate mortgage loans where the interest rate is fixed for the first three to five years, both of which have lower yields than those of adjustable rate loans subject to negative amortization that comprised a larger proportion of interest-earning assets a year ago.

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

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

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

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

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

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	2007			2006			2005		
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Average Yield/ Rate
Interest-earning assets:									
Loans:									
Loan prepayment fees		$ 52,054	0.42 %		$ 101,219	0.64 %		$ 70,849	0.46 %
Write-off of deferred costs and premiums from loan payoffs		(74,995)	(0.60)		(102,204)	(0.65)		(80,243)	(0.52)
All other		908,397	7.27		1,081,776	6.90		842,934	5.45
Total loans	$ 12,495,977	885,456	7.09	$ 15,688,297	1,080,791	6.89	$ 15,461,684	833,540	5.39
Mortgage-backed securities	123	12	5.83	264	13	5.17	291	12	4.12
Investment securities [a]	1,812,913	94,629	5.22	1,113,878	53,001	4.76	762,131	29,297	3.84
Total interest-earning assets	14,309,013	$ 980,097	6.85 %	16,802,439	$ 1,133,805	6.75 %	16,224,106	$ 862,849	5.32 %
Non-interest-earning assets	493,573			436,958			417,013		
Total assets	$ 14,802,586			$ 17,239,397			$ 16,641,119		
Transaction accounts:									
Non-interest-bearing checking [b]	$ 740,747	$ -	- %	$ 746,401	$ -	- %	$ 748,273	$ -	- %
Interest-bearing checking [b]	478,223	1,459	0.31	499,978	1,718	0.34	530,112	1,886	0.36
Money market	142,805	1,482	1.04	156,629	1,632	1.04	160,550	1,679	1.05
Regular passbook	1,152,565	10,946	0.95	1,503,867	15,082	1.00	2,221,129	23,732	1.07
Total transaction accounts	2,514,340	13,887	0.55	2,906,875	18,432	0.63	3,660,064	27,297	0.75
Certificates of deposit	8,623,048	425,174	4.93	9,055,959	399,158	4.41	7,335,869	242,765	3.31
Total deposits	11,137,388	439,061	3.94	11,962,834	417,590	3.49	10,995,933	270,062	2.46
FHLB advances and other borrowings [c]	1,789,993	103,991	5.81	3,457,357	184,343	5.33	4,087,217	143,230	3.50
Senior notes	198,358	13,207	6.66	198,178	13,195	6.66	198,009	13,184	6.66
Total deposits and borrowings	13,125,739	$ 556,259	4.24 %	15,618,369	$ 615,128	3.94 %	15,281,159	$ 426,476	2.79 %
Other liabilities	234,682			328,436			250,251		
Stockholders equity	1,442,165			1,292,592			1,109,709		

Total liabilities and stockholders equity	$ 14,802,586			$ 17,239,397			$ 16,641,119		
Net interest income/interest rate spread		$ 423,838	2.61 %		$ 518,677	2.81 %		$ 436,373	2.53 %
Excess of interest-earning assets over deposits and borrowings	$ 1,183,274			$ 1,184,070			$ 942,947		
Effective interest rate spread			2.96			3.09			2.69

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

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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.

	2007 Versus 2006 Changes Due To				*2006 Versus 2005 Changes Due To*			
(In Thousands)	*Volume*	*Rate*	*Rate/ Volume*	*Net*	*Volume*	*Rate*	*Rate/ Volume*	*Net*
Interest income:								
Loans	$ (219,924)	$ 30,871	$ (6,282)	$ (195,335)	$ 12,217	$ 231,639	$ 3,395	$ 247,251
Mortgage-backed securities	(2)	2	(1)	(1)	-	1	-	1
Investment securities	33,262	5,140	3,226	41,628	13,522	6,967	3,215	23,704
Change in interest income	(186,664)	36,013	(3,057)	(153,708)	25,739	238,607	6,610	270,956
Interest expense:								
Transaction accounts:								
Interest-bearing checking	(75)	(192)	8	(259)	(108)	(64)	4	(168)
Money market	(144)	-	(6)	(150)	(41)	(6)	-	(47)

Regular passbook	(3,523)	(800)	187	(4,136)	(7,663)	(1,457)	470	(8,650)
Total transaction accounts	(3,742)	(992)	189	(4,545)	(7,812)	(1,527)	474	(8,865)
Certificates of deposit	(19,081)	47,361	(2,264)	26,016	56,923	80,577	18,893	156,393
Total interest-bearing deposits	(22,823)	46,369	(2,075)	21,471	49,111	79,050	19,367	147,528
FHLB advances and other borrowings	(88,902)	16,515	(7,965)	(80,352)	(22,071)	74,695	(11,511)	41,113
Senior notes	12	-	-	12	11	-	-	11
Change in interest expense	(111,713)	62,884	(10,040)	(58,869)	27,051	153,745	7,856	188,652
Change in net interest income	$ (74,951)	$ (26,871)	$ 6,983	$ (94,839)	$ (1,312)	$ 84,862	$ (1,246)	$ 82,304

Provision for Credit Losses

During 2007, provision for credit losses totaled $310.1 million, compared with $26.6 million in 2006 and $2.3 million in 2005. The increase to the allowance this year primarily reflected further increases in delinquent loans and declines in the value of underlying home collateral due to the continued weakening and uncertainty relative to the housing market. This has been particularly true in certain geographic areas such as the greater Sacramento, Stockton, Modesto and Monterey areas of Northern California, the Inland Empire and San Diego County. As a result, an increase in the allowance for credit losses was deemed appropriate. Also, of the current year provision for credit losses, $39.5 million is related to the creation of a specific allowance associated with certain troubled debt restructurings resulting from our borrower retention program which is discussed more fully in the section entitled Non-Performing Assets and Troubled Debt Restructurings on page 67. The increase in the prior year provision for credit losses reflected an increase in unsold housing inventory, a decline in home prices, and increases in both negative amortization balances and loan defaults. These trends are typically leading indicators of increased losses.

For further information, see Allowance for Credit Real Estate Losses on page 72.

Other Income

Our total other income was $46.5 million in 2007, down $46.7 million or 50.1% from $93.1 million in 2006 and down $123.5 million from 2005. The decline from 2006 primarily reflected:

- a $23.3 million decrease in net gains on sales of loans and mortgage-backed securities due to declines in both the volume of loans sold and gain per dollar of loan sold; and
- a $17.8 million unfavorable change in income from real estate and joint ventures held for investment, as the current year included writedowns to reflect declines in the value of single family home lots in which the company is a joint venture partner and net gains from sales were below a year ago.

Total other income declined $76.8 million during 2006 due primarily to a $76.3 million decrease in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans sold and, to a lesser extent, a lower gain per dollar of loan sold; and a $2.7 million unfavorable change in loan servicing activities due primarily to increases in payoff curtailment interest losses and a unfavorable change in MSR valuations. Those favorable items were partially offset by a $4.2 million increase in income from real estate and joint ventures held for investment due primarily to higher gains from sales.

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

Loan and Deposit Related Fees

Loan and deposit related fees totaled $36.1 million in 2007, down $0.1 million from 2006 and $0.4 million from 2005. During 2007, our loan related fees declined $1.2 million or 30.7% due to lower loan originations, while our deposit related fees increased $1.1 million or 3.4%, due primarily to higher fees from our checking accounts.

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

(In Thousands)	*2007*	*2006*	*2005*
Loan related fees	$ 2,700	$ 3,894	$ 5,525
Deposit related fees:			
Automated teller machine fees	9,317	9,324	10,588
Other fees	24,037	22,933	20,383
Total loan and deposit related fees	$ 36,054	$ 36,151	$ 36,496

Real Estate and Joint Ventures Held for Investment

We recorded a loss in our real estate and joint ventures held for investment of $6.9 million in 2007, compared to income of $11.0 million in 2006 and $6.7 million in 2005. The current year unfavorable change was primarily attributed to writedowns of $8.8 million to reflect declines in the value of single family home lots in which the company is a joint venture partner and lower net gains from sales of $8.9 million (declines of $3.0 million in gains from sales of wholly owned real estate and $5.9 million in gains related to joint venture projects). The writedowns and lower gains related to joint ventures is reported within equity (deficit) in net income (loss) from joint ventures.

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

(In Thousands)	*2007*	*2006*	*2005*
Net rental operations and income from community development funds	$ 1,121	$ 871	$ 1,342
Net gains on sales of wholly owned real estate	22	3,051	477
Equity (deficit) in net income (loss) from joint ventures	(7,709)	7,031	3,582
(Provision for) reduction of losses on real estate and joint ventures	(319)	-	1,333
Total income (loss) from real estate and joint ventures held for investment, net	$ (6,885)	$ 10,953	$ 6,734

For additional information, see Investments in Real Estate and Joint Ventures on page 55, Allowance for Credit and Real Estate Losses on page 72 and Note 6 of Notes to Consolidated Financial Statements on page 105.

Secondary Marketing Activities

A loss of $3.2 million was recorded from our loan servicing activities in 2007, compared with a loss of $0.6 million in 2006 and income of $2.1 million in 2005. The primary reason for the $2.6 million unfavorable change from 2006 was a $2.4 million provision for impairment of MSRs, compared to $0.1 million in 2006. Also, the current year payoff and curtailment interest cost category increased $1.3 million from 2006. These unfavorable changes were partially offset by higher cash servicing fees of $0.7 million. At December 31, 2007, loans we serviced with capitalized MSRs totaled $2.4 billion, virtually unchanged from both December 31, 2006 and December 31, 2005. In addition to the loans we serviced for others with capitalized MSRs, we serviced $3.1 billion of loans at December 31, 2007 on a sub-servicing basis for which we have no risk associated with changing MSR values. On loans we sub-service, we receive a fixed fee per loan each month from the owner of the MSRs.

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

(In Thousands)	*2007*	*2006*	*2005*
Net cash servicing fees	$ 7,028	$ 6,370	$ 7,091
Payoff and curtailment interest cost [a]	(3,785)	(2,533)	(1,047)
Amortization of mortgage servicing rights	(4,026)	(4,370)	(5,156)
(Provision for) reduction of impairment of mortgage servicing rights	(2,396)	(61)	1,171
Total loan servicing income (loss), net	$ (3,179)	$ (594)	$ 2,059

[a] *Represents the difference between the contractual obligation to pay interest to the investor for an entire month and the actual interest received when a loan prepays prior to the end of the month. However, loan servicing activities do not include the benefit of the use of total loan repayments to increase net interest income.*

Sales of loans and mortgage-backed securities we originated declined in 2007 to $1.8 billion, from $3.5 billion in 2006 and $8.3 billion in 2005. Of those sold in 2007, $769 million were nontraditional residential one-to-four unit loans. Net gains associated with sales in 2007 totaled $20.3 million, down from $43.6 million in 2006 and $120.0 million in 2005. Included in these gains was the SFAS 133 impact of valuing derivatives associated with the sale of loans, for which we recorded a gain of $0.1 million in 2007, compared with a loss of $1.1 million in 2006 and a gain of $3.6 million in 2005. Excluding the SFAS 133 impact, a gain of $20.2 million or 1.12% of loans sold was realized in 2007, down from both 1.27% in 2006 and 1.40% in 2005. Net gains included capitalized MSRs of $5.6 million in 2007, compared with $5.3 million in 2006 and $6.4 million in 2005.

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

(In Thousands)	*2007*	*2006*	*2005*
Mortgage servicing rights	$ 5,606	$ 5,266	$ 6,424
All other components excluding SFAS 133	14,606	39,457	109,925
SFAS 133	104	(1,108)	3,612
Total net gains on sales of loans and mortgage-backed securities	$ 20,316	$ 43,615	$ 119,961
Secondary marketing gain excluding SFAS 133 as a percentage of associated sales	1.12 %	1.27 %	1.40 %

For additional information concerning MSRs, see Note 10 of Notes to Consolidated Financial Statements on page 109.

Securities Available for Sale

We had no sales of investment securities in 2007 or 2006, compared with gains from sales of less than $1 million in 2005. These securities were classified as available for sale. No securities were held as a partial economic hedge during or at year-end 2007.

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Operating Expense

Our operating expense totaled $258.0 million in 2007, an increase of 6.1% from $243.2 million in 2006 and an increase of 10.5% from $233.6 million in 2005. The current year increase was due primarily to higher costs from our operations of real estate acquired in settlement of loans, which increased $9.2 million to $9.5 million. Our increase in costs of operations of real estate acquired in settlement of loans was due to a higher number of foreclosed properties, as the inventory of single family homes available for sale totaled 326 at year end, up from 33 a year ago, and we had one property comprising 113 single family lots. Our general and administrative expense increased $5.6 million or 2.3%. The increase was primarily in deposit insurance premiums, up $3.7 million, premises and equipment cost, up $3.0 million, and professional fees, up $0.9 million. Those increases were partially offset by lower salaries and related costs of $2.2 million. In 2007, the FDIC changed the deposit insurance premium rates and issued a one-time assessment credit of $5.8 million to recognize our past contributions to the deposit insurance fund. Excluding that credit, our deposit insurance premiums and regulatory assessments would have increased by $9.6 million from a year ago.

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

(In Thousands)	*2007*	*2006*	*2005*
Salaries and related costs	$ 158,813	$ 161,060	$ 153,749
Premises and equipment costs	37,924	34,959	32,271
Advertising expense	5,912	6,227	6,068
Deposit insurance premiums and regulatory assessments	10,175	6,439	3,795
Professional fees	2,695	1,793	1,208
Other general and administrative expense	33,003	32,477	36,556
Total general and administrative expense	248,522	242,955	233,647
Net operation of real estate acquired in settlement of loans	9,486	250	(96)
Total operating expense	$ 258,008	$ 243,205	$ 233,551

Provision for Income Taxes

Our effective tax rate was 42.1% for 2007, compared with 41.6% for 2006 and 42.1% for 2005. The effective tax rate in each year is affected by various items, including interest expense related to payments of prior year taxes, reductions to federal tax expense due to the settlement of prior year tax return issues and adjustments to income tax reserves related to management s favorable assessment of our income tax exposure. The net impact of these items was $0.2 million of expense in 2007 and expense reductions of $1.5 million in 2006 and $0.2 million in 2005. See Note 1 on page 92 and Note 16 on page 114 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 relevant accounting policies, see Item 1. Business on page 1 and Note 1 on page

92 and Note 22 on page 127 of Notes to Consolidated Financial Statements.

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

(In Thousands)	*2007*	*2006*	*2005*
Banking net income (loss)	$ (53,096)	$ 191,349	$ 210,926
Real estate investment net income (loss)	(3,503)	8,307	3,551
Total net income (loss)	$ (56,599)	$ 199,656	$ 214,477

Banking

Our banking operations had a net loss of $53.1 million in 2007, compared to net income of $191.3 million in 2006 and $210.9 million in 2005. The $419.7 million unfavorable change in 2007 of pre-tax income/(loss) primarily reflected the following:

- A $283.5 million increase in provision for credit losses;
- A $94.8 million or 18.3% decline in net interest income due to a lower level of interest-earning assets and a lower effective interest rate spread;
- A $23.3 million or 53.4% decline in net gains on the sale of loans and mortgage-backed securities due to both a lower level of loans sold and gain per dollar of loan sold; and
- A $13.5 million increase in operating expense, of which $9.2 million related to higher costs associated with the operation of real estate acquired in settlement of loans.

During 2006, net income from our banking operations decreased $19.6 million. Contributing to the decline was a $76.3 million decrease in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans sold and, to a lesser extent, a lower gain per dollar of loan sold; a $24.3 million increase in provision for credit losses; and a $12.3 million or 5.3% increase in operating expense. Those unfavorable items were partially offset by a $81.6 million or 18.7% increase in net interest income, primarily due to a higher effective interest rate spread.

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

(In Thousands)	*2007*	*2006*	*2005*
Net interest income	$ 422,564	$ 517,321	$ 435,771
Provision for credit losses	310,131	26,604	2,263
Other income, net	52,480	80,498	161,984
Operating expense	256,738	243,245	230,946
Net intercompany income (expense)	68	(34)	(93)
Income (loss) before income taxes (tax benefits)	(91,757)	327,936	364,453
Income taxes (tax benefits)	(38,661)	136,587	153,527
Net income (loss)	$ (53,096)	$ 191,349	$ 210,926

At period end			
Assets:			
Loans and mortgage-backed securities, net	$ 11,136,655	$ 14,170,750	$ 15,821,923
Other	2,258,746	2,025,790	1,265,220
Total assets	13,395,401	16,196,540	17,087,143
Equity	$ 1,334,417	$ 1,393,235	$ 1,204,515

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Real Estate Investment

Our real estate investment operations had a loss of $3.5 million in 2007, compared to income of $8.3 million in 2006 and $3.6 million in 2005. The unfavorable pretax change of $20.1 million during 2007 was due primarily to impairment writedowns of $8.8 million to reflect declines in the value of single family home lots in which the company is a joint venture partner and declines in net gains from sales of $8.9 million.

The increase during 2006 was primarily due to a $7.6 million increase from gains on sales and a $1.2 million reversal of a litigation reserve established in prior periods due to the successful outcome of a legal matter.

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

(In Thousands)	*2007*	*2006*	*2005*
Net interest income	$ 1,274	$ 1,356	$ 602
Other income	(6,004)	12,645	7,948
Operating expense	1,270	(40)	2,605
Net intercompany income (expense)	(68)	34	93
Income (loss) before income taxes (tax benefits)	(6,068)	14,075	6,038
Income taxes (tax benefits)	(2,565)	5,768	2,487
Net income (loss)	$ (3,503)	$ 8,307	$ 3,551
At period end			
Assets:			
Investments in real estate and joint ventures	$ 68,679	$ 59,843	$ 49,344
Other	19,023	28,548	28,418
Total assets	87,702	88,391	77,762
Equity	$ 74,046	$ 77,549	$ 69,242

For a further discussion regarding income from real estate investment, see Real Estate and Joint Ventures Held for Investment on page 40, and for information regarding related assets, see Investments in Real Estate and Joint Ventures on page 55.

FINANCIAL CONDITION

Loans and Mortgage-Backed Securities

Total loans and mortgage-backed securities, including those we hold for sale, declined $3.0 billion or 21.4% from year-end 2006 to a total of $11.1 billion or 83.1% of total assets at December 31, 2007. The decline occurred primarily in loans held for investment, which were down $2.8 billion as repayments exceeded portfolio originations.

Our loan originations, including loans purchased, totaled $3.8 billion in 2007, down from $7.8 billion in 2006 and $15.1 billion in 2005. During 2007, originations of one-to-four unit residential loans declined by $3.9 billion to $3.7 billion. Of the total one-to-four unit residential loans originated, $2.1 billion or 58% were for portfolio, with the balance for sale in the secondary market. Our prepayment speed, which measures the annualized percentage of loans repaid, for one-to-four unit residential loans held for investment was 37% during 2007, compared with 39% in 2006 and 38% in 2005. Refinancing activities related to residential one-to-four unit loans, including new loans to refinance existing loans which we or other lenders originated, constituted 85% of originations during 2007, down from 87% during 2006 but up from 80% during 2005. Loan originations other than one-to-four unit residential declined $104 million to $81 million in 2007, primarily due to a lower level of originations of residential five or more units and land development loans.

Not included in the above originations are loans in which we modified the terms of the note for borrowers. During 2007, we modified $420 million of loans associated with our borrower retention program. This program provided borrowers who were current with their loan payments to change from an adjustable rate loan subject to negative amortization to less costly financing alternatives, albeit at new interest rates that were no less than those offered new borrowers. Most of these modifications involved adjustable rate loans subject to negative amortization that were modified into either adjustable rate loans whereby the interest rate is fixed for the first three to five years or adjustable rate loans whereby the interest rate adjusts annually. Neither of these products permit negative amortization. An additional $12 million of loans were modified at below market interest rates in loan workout situations.

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

Originations of adjustable rate residential one-to-four unit loans for portfolio, including loans purchased, totaled $2.1 billion in 2007, down from $4.2 billion in 2006 and $7.1 billion in 2005. Of the 2007 total:

- 62% were adjustable fixed for 3-5 years, compared with 27% in 2006;
- 22% were adjustable rate loans tied to either the LIBOR index, which typically adjust every six months, or the Constant Maturity Treasury ("CMT") index; and
- 16% were adjustable rate loans tied to either the FHLB Eleventh District Cost of Funds Index ("COFI") or the 12-month moving average of yields on actively traded U.S. Treasury securities adjusted to a constant maturity of one year ("MTA") index and generally have rates that adjust monthly and provide for negative amortization, compared with 65% in 2006. Of these two indexes, loans tied to the COFI index represented 96% of originations, compared with 90% in 2006.

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

(In Thousands)	*2007*	*2006*	*2005*	*2004*	*2003*
Loans originated and purchased					
Loan investment portfolio:					
Residential one-to-four units:					
Adjustable by index:					
COFI	$ 334,364	$ 2,431,406	$ 5,578,906	$ 5,995,317	$ 1,077,726
MTA	12,574	268,360	1,481,639	1,505,413	1,795,628
LIBOR	385,171	229,374	14,188	667,227	405,080
CMT	74,115	125,783	-	-	-
Adjustable fixed for 3-5 years	1,321,510	1,113,255	5,827	124,008	1,353,320
Fixed	873	224	525	482	22,647
Total residential one-to-four units	2,128,607	4,168,402	7,081,085	8,292,447	4,654,401
Other	80,801	185,078	305,639	628,715	377,355
Total for investment portfolio	2,209,408	4,353,480	7,386,724	8,921,162	5,031,756
Sale portfolio [(a)]	1,572,424	3,475,552	7,715,200	6,783,718	6,223,868
Total for investment and sale portfolios	$ 3,781,832	$ 7,829,032	$ 15,101,924	$ 15,704,880	$ 11,255,624

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

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

	December 31,									
	2007		*2006*		*2005*		*2004*		*2003*	
(Dollars in Thousands)	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*
Loan Investment Portfolio										
Residential one-to-four units:										
Adjustable by index:										

COFI	$ 6,383,837	75 %	$ 9,231,837	77 %	$ 10,733,770	76 %	$ 8,461,835	72 %	$ 4,819,852	61 %
MTA	1,256,672	15	2,094,828	18	2,846,273	20	2,224,130	19	2,503,336	32
LIBOR	444,483	5	364,537	3	410,010	3	908,596	8	403,450	5
Other, primarily CMT	394,829	5	209,191	2	155,498	1	119,475	1	185,437	2
Total adjustable loans [(a)]	$ 8,479,821	100 %	$ 11,900,393	100 %	$ 14,145,551	100 %	$ 11,714,036	100 %	$ 7,912,075	100 %

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

At December 31, 2007, $7.5 billion or 69% of our total residential one-to-four unit loans held for investment were subject to negative amortization, of which $379 million or 5.03% represented the amount of negative amortization included in the loan balance. The amount of negative amortization included in the loan balance increased $58 million during 2007, as borrowers took advantage of the flexibility of this product. During 2007, approximately 28% of our loan interest income represented negative amortization, compared to 27% in 2006 and 16% in 2005. At origination, these loans had a weighted average loan-to-value ratio of 73%. In addition, $2.7 billion or 25% of our residential one-to-four unit loans held for investment represented loans requiring interest only payments over the initial terms of the loans, generally the first three to five years.

The following table sets forth our investment portfolio of residential one-to-four unit adjustable rate loans subject to negative amortization and with interest only payments, along with negative amortization included in the loan balance, loan to value ratio information and weighted average age of the loans, at the dates indicated.

	December 31,					
(Dollars in Thousands)	*Loan Balance*	*% of Total*	*Negative Amortization Included in the Loan Balance*	*Loan to Value Ratio at Origination*	*Current Loan to Value Ratio* [(a)]	*Weighted Average Age (Months)*
Loan Investment Portfolio						
Residential one-to-four units subject to negative amortization:						
2007:						
With negative amortization:						
Balance less than or equal to original loan amount	$ 189,508	3 %	$ 1,253	70 %	69 %	37
Balance greater than original loan amount	6,501,649	86	377,411	74	78	29
Total with negative amortization	6,691,157	89	378,664	74	78	30
Not utilizing negative amortization	839,433	11	-	69	65	55
Total loans subject to negative amortization	$ 7,530,590	100 %	$ 378,664	73 %	77 %	32
As a percentage of total residential one-to-four unit loans	69 %					

Total loans with interest only payments	$ 2,745,117			70 %	70 %	16
As a percentage of total residential one-to-four unit loans	25 %					
2006:						
With negative amortization:						
Balance less than or equal to original loan amount	$ 477,873	4 %	$ 1,933	70 %	69 %	31
Balance greater than original loan amount	9,320,945	83	318,533	73	76	20
Total with negative amortization	9,798,818	87	320,466	73	75	21
Not utilizing negative amortization	1,401,052	13	-	69	65	41
Total loans subject to negative amortization	$ 11,199,870	100 %	$ 320,466	73 %	74 %	23
As a percentage of total residential one-to-four unit loans	85 %					
Total loans with interest only payments	$ 1,578,202			69 %	68 %	12
As a percentage of total residential one-to-four unit loans	12 %					

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

Our adjustable rate loans subject to negative amortization require a payment recast every five years and additionally when the loan balance reaches the maximum permissible level of negative amortization, while interest only loans require a payment recast when the initial fixed rate or interest only period expires. At payment recast, the fully-indexed interest rate is used to calculate a new monthly loan payment that provides for full amortization of the loan balance over the remaining term of the loan. Generally, the new loan payment is significantly higher and therefore default risk typically increases. We have other adjustable rate loans that also are subject to payment recasts but the new loan payments are not likely to be as severe as those associated with loans subject to negative amortization or interest only payments because the original loan payments already include principal amortization.

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The following table sets forth projected first-time loan payment recasts for our residential one-to-four unit adjustable rate loans subject to negative amortization and interest only payments for the four quarters of 2008 and the annual periods of 2008, 2009 and 2010, but excludes payment recasts projected beyond 2010. To determine projected first-time loan payment recasts, we assumed that borrowers will continue to utilize negative amortization at the same rate as they did in the preceding 12 months and no loans prepay. Therefore, the projected recast amounts may be overstated as some portion of these loans is likely to prepay or be modified as part of our borrower retention or loan workout programs. For example, at the end of 2006, we forecasted that $1.4 billion of loans subject to negative amortization would recast for the first-time in 2007, of which $527 million did recast while:

- $552 million paid off;
- $162 million were modified during 2007 as part of our borrower retention program prior to recast;
- $106 million did not recast during 2007 as borrowers reduced their utilization of negative amortization;
- $17 million were foreclosed upon; and
- $6 million were modified as part of our loan workout program.

Projected First-Time Loan Recasts at December 31, 2007 for						
1st Quarter 2008	*2nd Quarter 2008*	*3rd Quarter 2008*	*4th Quarter 2008*	*Year Ended 2008*	*Year Ended 2009*	*Year Ended 2010*

(Dollars in Thousands)							
Loan Investment Portfolio							
Residential one-to-four units:							
Loans subject to negative amortization	$ 705,018	$ 967,339	$ 865,604	$ 593,525	$ 3,131,486	$ 1,776,267	$ 901,161
Loans with interest only payments	-	96,532	12,567	2,218	111,317	181,898	30,366
Total	$ 705,018	$ 1,063,871	$ 878,171	$ 595,743	$ 3,242,803	$ 1,958,165	931,527
As a percentage of total residential							
one-to-four unit loans	6 %	10 %	8 %	5 %	30 %	18 %	9 %

At year-end 2007, 17% of our residential one-to-four unit loans were originated in 2007, with an additional 27% in 2006 and 32% in 2005, which are relatively new and unseasoned. The following table sets forth our investment portfolio of residential one-to-four unit loans by year of origination segregated by those subject to negative amortization, those with interest only payments and all others at the dates indicated. From year to year, loans may change categories due to modification.

	Loans by Year of Origination					
ollars in Thousands)	*2003 and Prior*	*2004*	*2005*	*2006*	*2007*	*Balance*
an Investment Portfolio						
sidential one-to-four units:						
December 31, 2007:						
oans subject to negative mortization	$ 624,937	$ 1,440,183	$ 3,144,364	$ 1,888,298	$ 432,808	$ 7,530,590
oans with interest only payments	125,118	108,723	183,345	1,024,462	1,303,469	2,745,117
l other loans	214,360	47,660	99,946	78,344	161,211	601,521
otal residential one-to-four units	$ 964,415	$ 1,596,566	$ 3,427,655	$ 2,991,104	$ 1,897,488	$ 10,877,228
a percentage of total residential						
e-to-four unit loans	9 %	15 %	32 %	27 %	17 %	100 %

	2002 and Prior	*2003*	*2004*	*2005*	*2006*	*Balance*
December 31, 2006:						
oans subject to negative mortization	$ 676,964	$ 463,638	$ 2,862,683	$ 4,713,128	$ 2,483,457	$ 11,199,870
oans with interest only payments	-	178,416	97,103	12,446	1,290,237	1,578,202
l other loans	225,312	78,341	28,146	7,329	109,804	448,932
otal residential one-to-four units	$ 902,276	$ 720,395	$ 2,987,932	$ 4,732,903	$ 3,883,498	$ 13,227,004
a percentage of total residential						
e-to-four unit loans	7 %	5 %	23 %	36 %	29 %	100 %

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At year-end 2007, 89% of our real estate loans were concentrated and secured by properties located in California. The following table sets forth the major geographic distribution of our investment portfolio of residential one-to-four unit loans at the dates indicated.

	December 31,			
	2007		2006	
(Dollars in Thousands)	*Amount*	% of *Total*	*Amount*	% of *Total*
Loan Investment Portfolio				
Residential one-to-four units:				
California county:				
Los Angeles	$ 2,000,364	18 %	$ 2,503,267	19 %
San Diego	1,255,132	12	1,524,947	11
Orange	877,618	8	1,066,863	8
Santa Clara	849,659	8	936,406	7
Alameda	538,137	5	618,164	5
Riverside	537,485	5	677,960	5
Contra Costa	476,209	4	563,727	4
San Bernardino	338,590	3	431,193	3
Sacramento	325,473	3	395,679	3
San Mateo	273,983	3	340,691	3
All other counties	2,182,131	20	2,642,564	20
Total California	9,654,781	89	11,701,461	88
Arizona	466,600	4	523,532	4
All other states	755,847	7	1,002,011	8

Total residential one-to-four units	$ 10,877,228	100 %	13,227,004	100 %

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

	December 31,			
	2007		*2006*	
(Dollars in Thousands)	*Amount*	*% of Total*	*Amount*	*% of Total*
Loan Investment Portfolio				
Residential one-to-four units:				
FICO score at Origination:				
620 or below	$ 407,764	4 %	$ 645,004	5 %
621 to 659	2,573,185	24	3,344,594	25
660 to 719	4,122,326	38	5,095,599	39
720 and above	3,630,721	33	3,964,348	30
Not available	143,232	1	177,459	1
Total residential one-to-four units	$ 10,877,228	100 %	$ 13,227,004	100 %
Weighted average FICO score for loan investment portfolio of residential one-to-four units	697		692	

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

	December 31,					
	2007			*2006*		
(Dollars in Thousands)	*Amount*	*% of Total*	*% of Total*	*Amount*	*% of Total*	*% of Total*
Loan Investment Portfolio						

Residential one-to-four units:						
80% or below:						
60% or less	$ 1,539,989	15 %	14 %	$ 1,940,772	15 %	15 %
61% to 70%	1,931,397	19	18	2,349,016	19	18
71% to 80%	6,866,261	66	63	8,271,605	66	62
Total 80% or below	10,337,647	100	95	12,561,393	100	95
81% to 85%:						
With private mortgage insurance:						
MGIC	7,805	9		5,935	6	
RMIC	42,231	51		45,584	47	
UGI	31,131	38		42,779	44	
All others	1,452	2		2,385	3	
Total with private mortgage insurance	82,619	100	1	96,683	100	1
Without private mortgage insurance	1,728		-	1,789		-
Total 81% to 85%	84,347		1	98,472		1
86% to 90%:						
With private mortgage insurance:						
MGIC	19,563	10		20,411	9	
RMIC	107,673	58		129,320	56	
UGI	53,423	29		73,780	32	
All others	4,959	3		7,960	3	
Total with private mortgage insurance	185,618	100	2	231,471	100	2
Without private mortgage insurance	4,624		-	5,960		-
Total 86% to 90%	190,242		2	237,431		2
90% and above:						
With private mortgage insurance:						
MGIC	19,981	9		24,574	8	
RMIC	132,823	57		164,307	55	
UGI	73,066	31		100,030	33	
All others	7,398	3		11,635	4	
Total with private mortgage insurance	233,268	100 %	2	300,546	100 %	2
Without private mortgage insurance [a]	28,778		-	25,569		-
Total 90% and above	262,046		2	326,115		2
Not available	2,946		-	3,593		-
Total residential one-to-four units	$ 10,877,228		100 %	$ 13,227,004		100 %
Weighted average loan-to-value ratio for loan investment						

portfolio of residential one-to-four units	72 %	72 %

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

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In addition to the other credit risks already identified, 82% of our residential one-to-four unit loans held for investment at year-end 2007 were underwritten based on borrower stated income and asset verification and an additional 7% were underwritten with no verification of either borrower income or assets.

Credit risks are mitigated primarily by various minimum borrower credit requirements and maximum loan-to-value ratio limitations. For example, at December 31, 2007, the average loan-to-value ratio at origination of our residential one-to-four unit loan portfolio was 72%. However, even with these requirements and limitations, our risk mitigation strategy is limited by potential defects in the underwriting process as well as potential changes in the loan-to-value ratio due to negative amortization and declines in home values after the loans were originated. For example, while residential property values increased in the past thereby further reducing our exposure to credit risk, home value declines emerged in 2006 and are continuing in most markets in which we lend. The uncertainty of future home value changes may materially impact the risk associated with our loan portfolio since 44% of these loans were originated in the last two years. For further information, see Residential Real Estate Lending on page 4, and Risk Factors on page 22.

We originated $11 million of home equity loans and lines of credit in 2007, down from $27 million in 2006 and $159 million in 2005. We originated $1 million of loans secured by multi-family properties in 2007, compared with $70 million in 2006 and none in 2005. During 2007, we originated $55 million of construction loans, compared to $34 million in 2006 and $97 million in 2005. Our origination of land development loans totaled $6 million in 2007, down from $49 million in 2006 and $46 million in 2005. Origination of commercial non-mortgage loans totaled $1 million in 2007, with none in 2006. Origination of consumer loans totaled $5 million in 2007, unchanged from 2006 and up from $3 million in 2005.

At December 31, 2007, our unfunded loan application pipeline totaled $741 million. Within that pipeline, we had commitments to borrowers for short-term interest rate locks, before the reduction of expected fallout, of $278 million, of which $82 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 $248 million and loans in process of $59 million. We believe our current sources of funds will be adequate relative to these obligations.

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

(In Thousands)	*2007*	*2006*	*2005*	*2004*	*2003*
Investment Portfolio					
Loans originated:					
Loans secured by real estate:					
Residential one-to-four units:					
Adjustable	$ 806,224	$ 3,033,321	$ 7,012,206	$ 7,930,764	$ 3,260,914
Adjustable fixed for 3-5 years	1,321,510	1,113,255	5,827	124,008	704,318
Fixed	873	155	525	284	21,915
Total residential one-to-four units	2,128,607	4,146,731	7,018,558	8,055,056	3,987,147
Home equity loans and lines of credit	11,493	26,512	158,697	528,453	176,820
	1,185	69,668	-	20,801	46,774

Residential five or more units adjustable					
Total residential	2,141,285	4,242,911	7,177,255	8,604,310	4,210,741
Commercial real estate	1,350	630	-	10,039	3,847
Construction	55,159	33,567	97,437	36,817	80,201
Land	5,899	49,389	46,218	28,053	19,589
Non-mortgage:					
Commercial	800	-	200	1,375	2,585
Consumer	4,915	5,312	3,087	2,124	8,906
Total loans originated	2,209,408	4,331,809	7,324,197	8,682,718	4,325,869
Real estate loans purchased:					
One-to-four units	-	21,671	62,527	237,391	667,254
Other [a]	-	-	-	1,053	38,633
Total real estate loans purchased	-	21,671	62,527	238,444	705,887
Total loans originated and purchased	2,209,408	4,353,480	7,386,724	8,921,162	5,031,756
Loan repayments	(4,777,673)	(6,215,012)	(5,716,880)	(4,570,630)	(5,212,106)
Other net changes [b, c]	(205,859)	311,658	279,754	(1,059,114)	(24,171)
Increase (decrease) in loans held for investment, net	(2,774,124)	(1,549,874)	1,949,598	3,291,418	(204,521)
Sale Portfolio					
Originated whole loans:					
Residential one-to-four units	1,556,552	3,471,366	7,658,295	6,715,955	6,219,652
Non-mortgage loans	-	-	-	730	3,154
Residential one-to-four unit loans purchased	15,872	4,186	56,905	67,033	1,062
Loans transferred from (to) the investment portfolio [c]	(24,140)	(44,163)	(31,582)	977,625	(7,274)
Originated whole loans sold	(758,492)	(2,588,250)	(7,298,576)	(5,090,301)	(939,373)
Loans exchanged for mortgage-backed securities [d]	(1,039,106)	(933,160)	(1,029,223)	(1,796,201)	(5,642,483)
Capitalized basis adjustment [e]	(125)	733	3,625	(4,331)	(1,816)
Other net changes [f]	(10,392)	(11,985)	(31,241)	(15,278)	(7,135)
Increase (decrease) in loans held for sale, net	(259,831)	(101,273)	(671,797)	855,232	(374,213)
Mortgage-backed securities, net:					
Received in exchange for loans [d]	1,039,106	933,160	1,029,223	1,796,201	5,642,483
Sold [c]	(1,039,106)	(933,160)	(1,029,223)	(1,796,201)	(5,642,483)
Repayments	(141)	(26)	(24)	(24)	(1,882)
Other net changes	1	-	(3)	(6)	(37)
Decrease in mortgage-backed securities available for sale	(140)	(26)	(27)	(30)	(1,919)

Increase (decrease) in loans held for sale and					
mortgage-backed securities available for sale	(259,971)	(101,299)	(671,824)	855,202	(376,132)
Total increase (decrease) in loans and					
mortgage-backed securities, net	$ (3,034,095)	$ (1,651,173)	$ 1,277,774	$ 4,146,620	$ (580,653)

[a] *Primarily five or more unit residential loans.*
[b] *Primarily included changes in undisbursed funds for lines of credit and construction loans, in loss allowances, in net deferred costs and premiums, in interest capitalized on loans (negative amortization), and from loans transferred to real estate acquired in settlement of loans or from (to) the held for sale portfolio.*
[c] *During the fourth quarter of 2004, we transferred to our sale portfolio and sold approximately $1 billion of our loans held for investment.*
[d] *These transactions typically involve creation of an MBS by a government sponsored entity (GSE) from loans sold by, and delivered by, us to the GSE. While the GSE is obligated to provide us with the MBS in exchange for the sold loans, the GSE typically fulfills this commitment through delivery of the MBS directly to the third-party purchaser based on a forward sales commitment made by us to that third party. The sales of both the loans and MBS are settled typically on a same-day basis such that we do not retain the MBS. If the MBS were to be retained with an intent to sell, we would classify the security as held for trading and record changes in fair value in our consolidated statement of income.*
[e] *Reflected the change in fair value of the interest rate lock derivative from the date of rate lock to the date of funding.*
[f] *Primarily included repayments and the change in net deferred costs and premiums.*

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

	December 31,				
(In Thousands)	*2007*	*2006*	*2005*	*2004*	*2003*
Investment Portfolio					
Loans secured by real estate:					
Residential one-to-four units:					
Adjustable	$ 8,302,538	$ 11,786,038	$ 14,014,908	$ 11,657,649	$ 7,885,761
Adjustable fixed for 3-5 years	2,528,287	1,397,516	608,355	1,037,373	1,730,275
Fixed	46,403	43,450	51,427	68,497	109,474
Total residential one-to-four units	10,877,228	13,227,004	14,674,690	12,763,519	9,725,510
Home equity loans and lines of credit	138,305	187,939	274,014	276,666	84,215
Residential five or more units:					
Adjustable	100,098	112,580	68,390	95,163	91,024
Fixed	865	908	1,141	1,424	1,904
Commercial real estate:					
Adjustable	23,837	23,943	25,547	28,384	36,142
Fixed	2,590	2,757	3,244	4,294	13,144
Construction	81,098	52,922	82,379	67,519	105,706
Land	49,521	58,910	23,630	25,569	16,855

Non-mortgage:					
Commercial	5,000	2,400	3,981	4,997	4,975
Consumer	5,989	6,778	6,693	7,990	14,927
Total loans held for investment	11,284,531	13,676,141	15,163,709	13,275,525	10,094,402
Increase (decrease) for:					
Undisbursed loan funds	(60,057)	(40,208)	(51,838)	(49,089)	(56,543)
Net deferred costs and premiums	156,853	232,294	279,888	214,467	107,594
Allowance for loan losses	(348,167)	(60,943)	(34,601)	(33,343)	(29,311)
Total loans held for investment, net	11,033,160	13,807,284	15,357,158	13,407,560	10,116,142
Sale Portfolio					
Loans held for sale:					
Residential one-to-four units	103,320	358,128	459,081	1,122,534	276,295
Non-mortgage	-	-	-	-	3,090
Net deferred costs and premiums	(109)	4,789	5,841	17,810	1,396
Capitalized basis adjustment [a]	173	298	(434)	(4,059)	272
Total loans held for sale, net	103,384	363,215	464,488	1,136,285	281,053
Mortgage-backed securities available for sale:					
Adjustable	111	251	277	304	334
Fixed	-	-	-	-	-
Total mortgage-backed securities available for sale	111	251	277	304	334
Total loans held for sale and mortgage-backed securities available for sale	103,495	363,466	464,765	1,136,589	281,387
Total loans and mortgage-backed securities, net	$ 11,136,655	$ 14,170,750	$ 15,821,923	$ 14,544,149	$ 10,397,529

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

We carry loans for sale at the lower of cost or fair value. At December 31, 2007, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

We carry mortgage-backed securities available for sale at fair value which, at December 31, 2007, was essentially equal to our cost basis.

The table below sets forth the scheduled contractual maturities, including principal amortization, of our loan and mortgage-backed securities portfolio, including loans held for sale, at December 31, 2007.

(In Thousands)	Within 1 Year	After 1 Year Through 2 Years	After 2 Years Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	After 10 Years Through 15 Years	Beyond 15 Years	Total
Loans secured by real estate:								
Residential:								
One-to-four units:								
Adjustable by index:								
COFI	$ 49,929	$ 54,001	$ 58,407	$ 131,503	$ 434,948	$ 643,804	$ 5,022,080	$ 6,394,672
MTA [a]	10,458	11,307	12,222	27,496	90,794	134,079	1,078,363	1,364,719
LIBOR [b]	31,735	33,806	36,016	79,237	248,046	340,316	1,803,829	2,572,985
Other, primarily CMT [c]	8,422	8,910	9,423	20,507	62,573	82,833	306,938	499,606
Fixed	2,182	2,327	2,719	5,450	17,104	23,529	95,255	148,566
Home equity loans and								
lines of credit [d]	393	635	854	5,476	130,947	-	-	138,305
Five or more units:								
Adjustable	16,785	18,019	19,343	22,947	2,604	20,400	-	100,098
Fixed	27	27	28	204	202	294	83	865
Commercial real estate:								
Adjustable	486	524	562	1,253	20,909	103	-	23,837
Fixed	140	157	2,061	232	-	-	-	2,590
Construction	53,416	27,682	-	-	-	-	-	81,098
Land	47,522	30	33	74	248	374	1,240	49,521
Non-mortgage:								
Commercial	5,000	-	-	-	-	-	-	5,000
Consumer	1,353	1,517	1,705	1,414	-	-	-	5,989
Total loans	227,848	158,942	143,373	295,793	1,008,375	1,245,732	8,307,788	11,387,851
Mortgage-backed securities	3	4	4	8	25	34	33	111
Total loans and mortgage-backed securities	$ 227,851	$ 158,946	$ 143,377	$ 295,801	$ 1,008,400	$ 1,245,766	$ 8,307,821	$ 11,387,962

[a] Included $19 million of residential one-to-four unit adjustable fixed for 3-5 year loans still in their initial fixed rate period.
[b] Included $213 million of residential one-to-four unit adjustable fixed for 3-5 year loans still in their initial fixed rate period.
[c] Included $2.2 billion of residential one-to-four adjustable fixed for 3-5 year loans still in their initial fixed rate period.
[d] Home equity loans 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, 2007, the maximum amount the Bank could have loaned to any one borrower, and related entities, per regulatory limits was $229 million or $381 million for loans secured by readily marketable collateral, compared with $234 million or $390 million for loans secured by readily marketable collateral at year-end 2006. We do not expect these regulatory limitations will adversely impact our proposed lending activities during 2008.

Investment Securities

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

	December 31,				
(In Thousands)	*2007*	*2006*	*2005*	*2004*	*2003*
Federal funds	$ 5,900	$ 1	$ -	$ -	$ 1,500
Investment securities available for sale:					
U.S. Treasury	-	-	-	-	-
Government sponsored entities	1,549,818	1,433,113	626,249	496,944	690,281
Other	61	63	64	65	66
Total investment securities	$ 1,555,779	$ 1,433,177	$ 626,313	$ 497,009	$ 691,847

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The fair value of temporarily impaired investment securities, the amount of unrealized losses and the length of time these unrealized losses existed as of December 31, 2007 are presented in the following table. The unrealized losses on investment securities that have been in a loss position for less than 12 months and 12 months or longer are due to changes in market interest rates and are not considered to be other than temporary. We have the intent and ability to hold these securities until the temporary impairment is eliminated.

	Less than 12 months		*12 months or longer*		*Total*	
(In Thousands)	*Fair Value*	*Unrealized Losses*	*Fair Value*	*Unrealized Losses*	*Fair Value*	*Unrealized Losses*
Investment securities available for sale:						
U.S. Treasury	$ -	$ -	$ -	$ -	$ -	$ -
Government sponsored entities	99,980	20	4,997	3	104,977	23
Other	-	-	-	-	-	-
Total temporarily impaired securities	$ 99,980	$ 20	$ 4,997	$ 3	$ 104,977	$ 23

The following table sets forth the contractual maturities of our investment securities and their weighted average yields at December 31, 2007.

	Amount Due as of December 31, 2007				
(Dollars in Thousands)	*In 1 Year or Less*	*After 1 Year Through 5 Years*	*After 5 Years Through 10 Years*	*After 10 Years*	*Total*

Federal funds	$ 5,900	$ -	$ -	$ -	$ 5,900
Weighted average yield	1.00 %	- %	- %	- %	1.00 %
Investment securities available for sale:					
U.S. Treasury	-	-	-	-	-
Weighted average yield	- %	- %	- %	- %	- %
Government sponsored entities [(a)]	-	941,453	508,385	99,980	1,549,818
Weighted average yield	- %	5.16 %	5.02 %	5.00 %	5.11 %
Other	-	-	-	61	61
Weighted average yield	- %	- %	- %	6.25 %	6.25 %
Total investment securities	$ 5,900	$ 941,453	$ 508,385	$ 100,041	$ 1,555,779
Weighted average yield	1.00 %	5.16 %	5.02 %	5.00 %	5.09 %

[(a)] At December 31, 2007, 14% of our investment securities had step-up provisions that stipulate increases in the coupon rate ranging from 0.25% to 1.00% at various specified dates ranging from November 2008 to November 2021. In addition, at December 31, 2007, all of these investment securities contained call provisions from January 2008 to August 2022. Yields for investment securities available for sale are calculated using historical cost balances and are not adjusted for changes in fair value that are reflected as a separate component of stockholders equity.

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 residential developments and retail neighborhood shopping centers, most of which are located in California. At December 31, 2007, the Bank had no loan commitments to the joint ventures. For additional information regarding these real estate investments, see Note 6 of Notes to the Consolidated Financial Statements on page 105.

DSL Service Company is entitled to a priority return on its equity invested in its joint venture projects after third-party debt, and it 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, 2007, DSL Service Company was involved with one joint venture partner. This partner was the operator of three residential housing development projects. DSL Service Company also had three wholly owned retail neighborhood shopping centers located in California and Arizona.

Our investment in real estate and joint ventures amounted to $69 million at December 31, 2007, compared with $60 million at December 31, 2006 and $49 million at December 31, 2005. The increase during 2007 was primarily attributed to additional investments of $10 million primarily in existing wholly owned projects, $3 million in investments of community development funds and $3 million for the purchase of land. These increases were partially offset by our share of net losses on joint ventures of $7 million. The increase during 2006 was primarily attributed to the purchase of an investment with a carrying value of $11 million, additional increases of $4 million in investments of community development funds and $2 million primarily in existing wholly owned projects. This was offset by the partial sale of a project with a carrying value of $6 million.

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

December 31,

(Dollars in Thousands)	*2007*	*2006*
Assets		
Cash	$ 5,157	$ 8,683
Projects under development	48,763	74,659
Other assets	264	4,079
	$ 54,184	$ 87,421
Liabilities and Equity		
Liabilities:		
Notes payable	$ 41,110	$ 56,088
Other	4,448	4,743
Equity (deficit):		
DSL Service Company [a]	17,365	24,791
Allowance for losses provided by DSL Service Company [b]	319	-
Other partners [b]	(9,058)	1,799
Net equity	8,626	26,590
	$ 54,184	$ 87,421
Number of joint venture projects	3	4

[a] *Included priority return payments from joint ventures to DSL Service Company.*
[b] *Represents the other partner s equity (deficit) 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 funding costs and asset impairment writedowns. 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 joint venture real estate assets, net of secured notes payable to others, to the partners equity (deficit) investment. To the extent the net fair value of real estate assets is less than the partners equity (deficit) investment, we make a provision to create a valuation allowance for DSL Service Company s share of the loss. No valuation allowance was required at December 31, 2006.*

The following table sets forth by property type our investments in real estate and related allowances for losses at December 31, 2007 and 2006. For further information regarding the establishment of loss allowances, see Allowance for Credit and Real Estate Losses on page 72.

(Dollars in Thousands)	*Residential*	*Retail Neighborhood Shopping Centers*	*Land*	*Total*

2007:				
Investment in wholly owned projects [a]	$ -	$ 890	$ 39,698	$ 40,588
Investment in community development funds	10,829	-	-	10,829
Allowance for losses	-	-	(103)	(103)
Net investment in real estate projects	$ 10,829	$ 890	$ 39,595	$ 51,314
Number of projects	9	3	8	20
2006:				
Investment in wholly owned projects [a]	$ -	$ 911	$ 26,613	$ 27,524
Investment in community development funds	7,631	-	-	7,631
Allowance for losses	-	-	(103)	(103)
Net investment in real estate projects	$ 7,631	$ 911	$ 26,510	$ 35,052
Number of projects	9	3	6	18

[a] Included five free-standing stores that are part of neighborhood shopping centers totaling less than $1 million, which we counted as one project at both December 31, 2007 and 2006.

Real estate investments entail risks similar to those associated with our construction and commercial lending activities. In addition, California courts have imposed warranty-like responsibility on 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 $1.3 billion or 10.9% in 2007 and totaled $10.5 billion at year end. Compared with the year-ago period, our certificates of deposit declined $890 million or 9.8%, while our lower-rate transaction accounts (i.e., checking, money market and regular passbook) declined $399 million or 14.9%, due primarily to a decline of $233 million in regular passbook accounts. Although deposits declined during the year, the number of checking accounts increased 5.7%.

During 2007, one in-store branch was closed due to the closure or sale of the grocery stores in which it was located and one traditional branch was opened. At December 31, 2007, our total number of branches was 172, of which 168 were in California and four were in Arizona. The average deposit size of our 82 traditional branches was $102 million, while the average deposit size of our 90 in-store branches was $24 million.

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

December 31,		
2007	*2006*	*2005*

(Dollars in Thousands)	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*
Transaction accounts:						
Non-interest-bearing checking [(a)]	- %	$ 645,730	- %	$ 769,086	- %	$ 705,077
Interest-bearing checking [(a)]	0.27	464,980	0.28	493,620	0.30	529,133
Money market	1.04	134,640	1.04	148,448	1.05	164,192
Regular passbook	0.95	1,035,964	0.97	1,269,420	1.04	1,816,635
Total transaction accounts	0.55	2,281,314	0.57	2,680,574	0.69	3,215,037
Certificates of deposit:						
Less than 2.00%	1.25	21,915	1.29	22,566	1.68	86,992
2.00-2.49	2.31	148	2.29	686	2.41	147,632
2.50-2.99	2.83	6,889	2.80	25,375	2.78	215,297
3.00-3.49	3.28	72,288	3.30	128,294	3.27	1,001,901
3.50-3.99	3.86	43,481	3.89	237,155	3.78	4,114,751
4.00-4.49	4.29	306,302	4.31	692,386	4.17	2,622,618
4.50-4.99	4.85	6,026,108	4.82	2,722,829	4.81	455,192
5.00-5.49	5.10	1,736,673	5.19	5,008,378	5.07	14,516
5.50 and greater	6.00	923	5.54	266,626	5.61	2,912
Total certificates of deposit	4.85	8,214,727	4.94	9,104,295	3.83	8,661,811
Total deposits	3.92 %	$ 10,496,041	3.95 %	$ 11,784,869	2.98 %	$ 11,876,848

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

The following table shows at December 31, 2007 our certificates of deposit maturities by interest rate category.

(Dollars in Thousands)	*Less Than 3.49%*	*3.50% - 3.99%*	*4.00% - 4.49%*	*4.50% - 4.99%*	*5.00% - 5.49%*	*5.50% and Greater*	*Total [(a)]*	*Percent of Total*
Within 3 months	$ 47,776	$ 12,563	$ 26,578	$ 2,515,872	$ 990,838	$ 233	$ 3,593,860	44 %
4 to 6 months	9,355	509	32,749	2,117,216	487,099	683	2,647,611	32
7 to 12 months	26,345	2,058	155,070	1,223,459	255,802	7	1,662,741	20
	17,753	18,993	33,439	83,841	1,970	-	155,996	2

13 to 24 months								
25 to 36 months	10	9,271	46,927	16,107	526	-	72,841	1
37 to 60 months	1	87	11,539	69,613	438	-	81,678	1
Over 60 months	-	-	-	-	-	-	-	-
Total	$ 101,240	$ 43,481	$ 306,302	$ 6,026,108	$ 1,736,673	$ 923	$ 8,214,727	100 %

[a] Includes certificates of deposit of $100,000 and over totaling $1.7 billion with maturities within 3 months, $1.2 billion with maturities of 4 to 6 months, $0.7 billion with maturities of 7 to 12 months and $0.1 billion with a remaining term of more than 12 months.

Borrowings

At December 31, 2007, borrowings totaled $1.4 billion, down from $2.8 billion at year-end 2006 and $3.8 billion at year-end 2005. The decrease during 2007 was due primarily to a decline of $944 million in FHLB advances and $470 million in securities sold under agreements to repurchase. During 2004, the holding company issued $200 million of 6.5% 10-year unsecured senior notes. The net proceeds, after deducting underwriting discounts and our offering expenses, were approximately $198 million. Those proceeds were used to redeem our $124 million of 10% junior subordinated debentures prior to their maturity and, in turn, to redeem the related capital securities and make a capital investment in the Bank to support its asset growth. We redeemed our junior subordinated debentures because of the lower interest rate at which we were able to issue the senior debt, which has resulted in lower interest expense.

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

	December 31,				
(Dollars in Thousands)	*2007*	*2006*	*2005*	*2004*	*2003*
Securities sold under agreements to repurchase	$ -	$ 469,971	$ -	$ -	$ -
Federal Home Loan Bank advances [a]	1,197,100	2,140,785	3,557,515	4,559,622	2,125,150
Real estate notes	-	-	-	-	4,161
Senior notes	198,445	198,260	198,087	197,924	-
Junior subordinated debentures [b]	-	-	-	-	123,711
Total borrowings	$ 1,395,545	$ 2,809,016	$ 3,755,602	$ 4,757,546	$ 2,253,022
Weighted average rate on borrowings during the year [a]	5.89 %	5.40 %	3.65 %	2.62 %	4.46 %
	10.41	17.33	21.97	30.40	19.35

Total borrowings as a percentage of total assets

[(a)] *Starting in the first quarter of 2004, the impact of interest rate swap contracts was included, with notional amounts totaling $430 million of receive-fixed, pay-3-month LIBOR variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.*
[(b)] *On July 23, 2004, we redeemed our junior subordinated debentures before maturity.*

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

(Dollars in Thousands)	*2007*	*2006*	*2005*
FHLB advances with original maturities less than one year:			
Balance at end of year	$ 745,490	$ 1,660,000	$ 2,975,000
Average balance outstanding during the year	839,336	2,666,010	3,337,865
Maximum amount outstanding at any month-end during the year	1,399,600	3,290,000	4,360,000
Weighted average interest rate during the year	5.23 %	5.04 %	3.19 %
Weighted average interest rate at end of year	4.55	5.38	4.39
Securities sold under agreements to repurchase:			
Balance at end of year	$ -	$ 469,971	$ -
Average balance outstanding during the year	507,099	234,596	-
Maximum amount outstanding at any month-end during the year	666,575	469,971	-
Weighted average interest rate during the year	5.25 %	5.32 %	- %
Weighted average interest rate at the end of year	- %	5.30 %	- %
Total short-term borrowings:			
Average balance outstanding during the year	$ 1,346,435	$ 2,900,422	$ 3,337,865
Weighted average interest rate during the year	5.24 %	5.06 %	3.19 %

At year-end 2007, intermediate and long-term borrowings totaled $650 million, down from $679 million at December 31, 2006. The weighted average rate on our intermediate and long-term borrowings at year-end 2007 was 7.13%.

The following table sets forth the maturities of our intermediate and long-term borrowings at December 31, 2007.

(In Thousands)	
2008	$ 426,610
2009	-
2010	-
2011	-
2012	25,000
Thereafter	198,445
Total intermediate and long-term borrowings	$ 650,055

Off-Balance Sheet Arrangements

We consolidate majority-owned subsidiaries that we control. We account for other affiliates, including joint ventures, in which we do not exhibit significant control or have majority ownership, by the equity method of accounting. For those relationships in which we own less than 20%, we generally carry them at cost. In the course of our business, we participate in real estate joint ventures through our wholly-owned subsidiary, DSL Service Company. Our real estate joint ventures do not require consolidation as a result of applying the provisions of Financial Accounting Standards Board Interpretation 46 (revised December 2003). For further information regarding our real estate joint venture partnerships, see Note 6 of Notes to the Consolidated Financial Statements on page 105.

We also utilize financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to originate fixed and variable rate mortgage loans held for investment, undisbursed loan funds, lines and letters of credit, and commitments to purchase loans, mortgage-backed securities for our portfolio, and commitments to invest in community development funds. The contract or notional amounts of these instruments reflect the extent of involvement we have in particular classes of financial instruments. For further information regarding these commitments, see Asset/Liability Management and Market Risk on page 60, Contractual Obligations and Other Commitments on page 79 and Note 20 of Notes to the Consolidated Financial Statements on page 120.

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 are made in the ordinary course of business and are made on substantially the same terms as comparable transactions.

Asset/Liability Management and Market Risk

Market risk is the risk of loss or reduced earnings from adverse changes in market prices and interest rates. Our market risk arises primarily from interest rate risk in our lending and deposit taking activities. Interest rate risk primarily occurs to the degree that our interest-bearing liabilities reprice or mature on a different basis and frequency than our interest-earning assets. Since our earnings depend primarily on our net interest income, which is the difference between the interest and dividends earned on interest-earning assets and the interest paid on interest-bearing liabilities, our principal objectives are to actively monitor and manage the effects of adverse changes in interest rates on net interest income. Our primary strategy in managing interest rate risk is to emphasize the origination for investment of adjustable rate mortgage loans or loans with relatively short maturities. Interest rates on adjustable rate mortgage loans are primarily tied to COFI, MTA, LIBOR and CMT. We also may execute swap contracts to change interest rate characteristics of our interest-earning assets or interest-bearing liabilities to better manage interest rate risk.

In addition to the interest rate risk associated with our lending for investment and deposit-taking activities, we also have market risk associated with our secondary marketing activities. Changes in mortgage interest rates, primarily fixed rate mortgage loans, impact the fair value of loans held for sale as well as our interest rate lock commitment derivatives, where we have committed to an interest rate with a potential borrower for a loan we intend to sell. Our objective is to hedge against fluctuations in interest rates through the use of loan forward sale and purchase contracts with government-sponsored enterprises and whole loan sale contracts with various parties. These contracts are typically obtained at the time the interest rate lock commitments are made. Therefore, as interest rates fluctuate, the changes in the fair value of our interest rate lock commitments and loans held for sale tend to be offset by changes in the fair value of the hedge contracts. We continue to hedge as previously done before the issuance of SFAS 133. As applied to our risk management strategies, SFAS 133 may increase or decrease reported net income and stockholders equity, depending on interest rates and other variables affecting the fair values of derivative instruments and hedged items, but will have no effect on the overall economics of the transactions. The method used for assessing the effectiveness of a

hedging derivative, as well as the measurement approach for determining the ineffective aspects of the hedge, is established at the inception of the hedge. We generally do not enter into derivative contracts for speculative purposes.

Changes in mortgage interest rates also impact the value of our MSRs. Rising interest rates typically result in slower prepayment speeds on the loans being serviced for others which increase the value of MSRs. Declining interest rates typically result in faster prepayment speeds which decrease the value of MSRs. Over time, we may use derivatives or securities to provide an economic hedge against value changes in our MSRs. However, no such hedges have been employed since 2004 when we sold approximately 80% of our MSRs.

Our Asset/Liability Management Committee is responsible for implementing the Bank s 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 Office of Thrift Supervision ("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 reviews various simulations and other analyses to determine the potential impact of various business strategies in controlling the Bank s interest rate risk and the potential impact of those strategies upon future earnings under various interest rate scenarios. Based on these reviews, our Asset/Liability Management Committee formulates a strategy that is intended to implement the objectives set forth in our business plan without exceeding the net interest income and net portfolio value limits set forth in our interest rate risk policy.

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One measure of our exposure to differential changes in interest rates between assets and liabilities is shown in the following table which sets forth the repricing frequency of our major asset and liability categories as of December 31, 2007, as well as other information regarding the repricing and maturity differences between our interest-earning assets and the total of deposits and borrowings in future periods. We refer to these differences as "gap." We have determined the repricing frequencies by reference to projected maturities, based upon contractual maturities as adjusted for scheduled repayments and "repricing mechanisms" (i.e., 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 to anticipate future prepayments. Since the 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, these assets may not respond to changes in market interest rates as completely or as 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, 2007					
(Dollars in Thousands)	*Within 6 Months*	*After 6 Months Through 12 Months*	*After 1 Year Through 5 Years*	*After 5 Years Through 10 Years*	*Beyond 10 Years*	*Total Balance*
Interest-earning assets:						
Investment securities and stock [a]	$ 1,093,958	$ 532,724	$ 61	$ -	$ -	$ 1,626,743
Loans and mortgage-backed securities, net: [b]						
Loans secured by real estate:						
Residential one-to-four						

units:						
Adjustable	8,690,792	232,279	1,729,791	-	-	10,652,862
Fixed	104,835	3,799	20,783	11,398	6,215	147,030
Home equity loans and lines of credit	137,233	8	41	4	-	137,286
Residential five or more units:						
Adjustable	72,289	9,267	5,689	-	-	87,245
Fixed	98	104	431	187	39	859
Commercial real estate	20,107	3,043	2,399	-	-	25,549
Construction	39,051	-	-	-	-	39,051
Land	37,407	-	-	-	-	37,407
Non-mortgage loans:						
Commercial	3,595	-	-	-	-	3,595
Consumer	5,660	-	-	-	-	5,660
Mortgage-backed securities	111					111
Total loans and mortgage-backed securities, net	9,111,178	248,500	1,759,134	11,589	6,254	11,136,655
Total interest-earning assets	$ 10,205,136	$ 781,224	$ 1,759,195	$ 11,589	$ 6,254	$ 12,763,398
Transaction accounts:						
Non-interest-bearing checking [(c)]	$ 645,730	$ -	$ -	$ -	$ -	$ 645,730
Interest-bearing checking [(d)]	464,980	-	-	-	-	464,980
Money market [(e)]	134,640	-	-	-	-	134,640
Regular passbook [(e)]	1,035,964	-	-	-	-	1,035,964
Total transaction accounts	2,281,314	-	-	-	-	2,281,314
Certificates of deposit [(f)]	6,241,471	1,662,741	310,515	-	-	8,214,727
	8,522,785	1,662,741	310,515	-	-	10,496,041

Total deposits						
FHLB advances and other borrowings	770,490	426,610	-	-	-	1,197,100
Senior notes	-	-	-	198,445	-	198,445
Impact of swap contracts hedging borrowings	430,000	(430,000)	-	-	-	-
Total deposits and borrowings	$ 9,723,275	$ 1,659,351	$ 310,515	$ 198,445	$ -	$ 11,891,586
Excess (shortfall) of interest-earning assets over						
deposits and borrowings	$ 481,861	$ (878,127)	$ 1,448,680	$ (186,856)	$ 6,254	$ 871,812
Cumulative gap	481,861	(396,266)	1,052,414	865,558	871,812	
Cumulative gap as a percentage of total assets:						
December 31, 2007	3.59 %	(2.96)%%	7.85 %	6.46 %	6.50 %	
December 31, 2006	10.86	0.92	8.29	7.14	7.18	
December 31, 2005	23.22	11.19	7.08	5.80	5.82	

[a] Includes FHLB stock and is based on contractual maturity and repricing/call date.
[b] Based on contractual maturity, repricing date and projected repayment and prepayments of principal.
[c] Even though no interest is paid on these accounts, they are classified as repricing within 6 months, which increases negative gap.
[d] Included amounts swept into money market deposit accounts and is subject to immediate repricing.
[e] Subject to immediate repricing.
[f] Based on contractual maturity.

Our cumulative gap at December 31, 2007 was a positive 6.50%. This means more interest-earning assets mature or reprice compared with deposits and borrowings. This is down from a positive cumulative gap of 7.18% at December 31, 2006 and up from a positive cumulative gap of 5.82% at December 31, 2005.

We continue to emphasize the origination of adjustable rate mortgages for our investment portfolio. We originated and purchased for investment loans and mortgage-backed securities with adjustable interest rates or maturities of five years or less of approximately $2.2 billion during 2007, $4.4 billion during 2006 and $7.4 billion during 2005. These loans represented essentially

all loans and mortgage-backed securities originated and purchased for investment during 2007, 2006 and 2005.

At December 31, 2007, 2006 and 2005, essentially all of our interest-earning assets mature, reprice or are estimated to prepay within five years. Essentially all of our loans held for investment and mortgage-backed securities portfolios consisted of adjustable rate loans and loans with a due date of five years or less. At December 31, 2007, these loans amounted to $11.2 billion, compared with $13.6 billion at December 31, 2006, and $15.1 billion at December 31, 2005. During 2007, we will continue to offer residential fixed rate loan products to our customers primarily for sale in the secondary market and price them accordingly to create loan servicing income and to increase opportunities for originating adjustable rate mortgage loans. However, we may originate fixed rate loans for investment if these loans meet specific yield, interest rate risk and other approved guidelines, or to facilitate the sale of real estate acquired through foreclosure. For further information, see Secondary Marketing and Loan Servicing Activities on page 6.

In general, we are better protected against rising interest rates with a positive cumulative 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, primarily parallel, 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 this "base-case" has been estimated, we make calculations for each of the defined changes in interest rates, to include any anticipated differences in the prepayment speeds 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 2007 and 2006. Since we base these estimates on numerous assumptions, like the expected maturities of our interest-bearing assets and liabilities and the shape of the period-ending 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.

	2007		*2006*	
	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	(17.2)%	(11.1)%	(7.7)%	(11.9)%
+100	(8.7)	(3.1)	(3.1)	(3.5)
(100)	6.1	(1.1)	3.8	0.1
(200)	12.3	(7.1)	5.9	(1.8)

[(a)] The percentage change in this column represents net interest income for 12 months in the base-case 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 the base-case interest rate environment versus the net portfolio value in the various rate scenarios.

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, 2007. This data differs from that in the gap table as it is not based on the repricing characteristics of assets and liabilities. Rather, it reflects expected maturities for certificates of deposits and assets, other than loans originated for sale, based on contractual maturities, call provisions (if any) for investment securities, and prepayments of principal for loans based primarily on our recent experience. The average projected constant prepayment rate ("CPR") is 18% on our residential mortgage loan portfolios, excluding the impact of loans modified pursuant to our borrower retention program. The expected maturities for loans originated for sale are based on their underlying sales contracts and prior sales experience, resulting in maturities of less than one year. For transaction accounts, we have applied "decay factors" to estimate deposit account runoff based on our historical experience adjusted for current market conditions. These decay factors average 26% per year for all transaction accounts on an aggregate basis. The actual maturities of the above noted instruments could vary substantially if future prepayments or deposit runoff differ from our assumptions.

Market risk sensitive instruments are generally defined as on-and off-balance sheet derivatives and other financial instruments. 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, 2007. 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 bid prices, or bid quotations received from securities dealers or readily available market quote systems.
- The fair value of single family residential loans is derived from bid prices or price indications from securities dealers or readily available market quote systems for loans with similar characteristics. The fair value of all other loans is derived by discounting future contractual cash flows by estimated market interest rates for loans with similar characteristics, adjusted for anticipated losses.
- MSRs related to loans serviced for others are determined by computing the present value of the expected net servicing income from the portfolio by strata determined by key characteristics of the underlying loans, primarily coupon interest rate and whether the loans are fixed or variable rate.
- Interest rate lock commitments and loan forward sale and purchase contracts are based on dealer quoted market prices acquired from third parties.
- Demand deposits, money market and savings accounts are based on the carrying amounts reported in the balance sheet.
- Time deposits and borrowings are based on the discounted value of contractual cash flows using discount rates equal to current FHLB of San Francisco borrowing rates for similar remaining terms.
- Senior notes are based on bid prices, or bid quotations received from securities dealers or readily available market quote systems.

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

	Expected Maturity at December 31, 2007							
n Thousands)	*2008*	*2009*	*2010*	*2011*	*2012*	*Thereafter*	*Total Balance*	*Fair Value*
nt securities and FHLB								
	$ 1,555,718	$ -	$ -	$ -	$ -	$ 71,025	$ 1,626,743	$ 1,626,743
d average interest rate [a]	5.09 %	- %	- %	- %	- %	5.49 %	5.11 %	
-backed securities								
e for sale	47	27	16	9	5	7	111	111
d average interest rate [a]	5.80 %	5.80 %	5.80 %	5.80 %	5.80 %	5.80 %	5.80 %	
cured by real estate, net:								
tial:								

ble (g)	1,927,587	1,593,298	1,291,378	1,048,896	852,542	4,026,406	10,740,107	10,470,083
ted average interest rate	7.45 %	7.46 %	7.46 %	7.46 %	7.45 %	7.35 %	7.42 %	
	24,917	20,717	17,455	14,456	12,089	58,255	147,889	148,481
ted average interest rate	6.46 %	6.42 %	6.40 %	6.41 %	6.40 %	6.39 %	6.41 %	
quity loans and lines of	16	13	11	136,463	8	775	137,286	137,286
ted average interest rate	7.41 %	7.41 %	7.41 %	7.84 %	7.41 %	8.32 %	7.84 %	
	41,689	4,136	3,960	2,389	1,864	47,969	102,007	103,574
ed average interest rate	8.13 %	7.20 %	7.33 %	7.15 %	7.14 %	8.68 %	8.28 %	
gage: (b)								
cial	3,595	-	-	-	-			