DOWNEY FINANCIAL CORP
Form 10-Q
August 05, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended JUNE 30, 2002

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, CA	92660
(Address of principal executive office)	(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 whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No__

At June 30, 2002, 28,235,022 shares of the Registrant's Common Stock, $0.01 par value were outstanding.

DOWNEY FINANCIAL CORP.

JUNE 30, 2002 QUARTERLY REPORT ON FORM 10-Q

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PART I - FINANCIAL INFORMATION

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands, Except Per Share Data)	(Unaudited) June 30, 2002
ASSETS	
Cash	$ 117,788
Federal funds	16,401
Cash and cash equivalents	134,189
U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value	292,832
Municipal securities held to maturity, at amortized cost (estimated fair value of $6,373 at June 30, 2002 and December 31, 2001 and $6,534 at June 30, 2001)	6,387
Mortgage loans purchased under resale agreements	--

Loans held for sale, at lower of cost or fair value	381,465
Mortgage-backed securities available for sale, at fair value	58,122
Loans receivable held for investment	9,846,446
Investments in real estate and joint ventures	40,283
Real estate acquired in settlement of loans	13,528
Premises and equipment	113,417
Federal Home Loan Bank stock, at cost	114,452
Mortgage servicing rights, net	59,771
Other assets	69,311
	$ 11,130,203
LIABILITIES AND STOCKHOLDERS' EQUITY	
Deposits	$ 8,690,558
Federal Home Loan Bank advances and other borrowings	1,413,607
Accounts payable and accrued liabilities	64,614
Deferred income taxes	54,118
Total liabilities	10,222,897
Company obligated mandatorily redeemable capital securities of subsidiary trust holding solely junior subordinated debentures of the Company ("Capital Securities")	120,000
STOCKHOLDERS' EQUITY	
Preferred stock, par value of $0.01 per share; authorized 5,000,000 shares; outstanding none	--
Common stock, par value of $0.01 per share; authorized 50,000,000 shares; outstanding 28,235,022 shares at June 30, 2002, 28,213,048 shares at December 31, 2001 and 28,211,048 shares at June 30, 2001	282
Additional paid-in capital	93,792
Accumulated other comprehensive income (loss)	236
Retained earnings	692,996
Total stockholders' equity	787,306
	$ 11,130,203

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three Months Ended June 30,	
(Dollars in Thousands, Except Per Share Data)	2002	200
INTEREST INCOME		
Loans receivable	$ 148,448	$ 203,
U.S. Treasury securities and agency obligations	2,163	4,
Mortgage-backed securities	942	
Other investments	1,872	3,
Total interest income	153,425	211,

INTEREST EXPENSE		
Deposits	60,397	114,
Borrowings	14,859	17,
Capital securities	3,041	3,
Total interest expense	78,297	134,
NET INTEREST INCOME	75,128	76,
PROVISION FOR (REDUCTION OF) LOAN LOSSES	(1,106)	
Net interest income after provision for (reduction of) loan losses	76,234	75,
OTHER INCOME, NET		
Loan and deposit related fees	11,396	14,
Real estate and joint ventures held for investment, net	1,016	
Secondary marketing activities:		
Loan servicing loss, net	(15,617)	(2,
Net gains on sales of loans and mortgage-backed securities	6,896	8,
Net gains on sales of mortgage servicing rights	12	
Net gains on sales of investment securities	19	
Other	380	
Total other income, net	4,102	22,
OPERATING EXPENSE		
Salaries and related costs	28,315	24,
Premises and equipment costs	7,754	6,
Advertising expense	1,582	1,
Professional fees	233	1,
SAIF insurance premiums and regulatory assessments	762	
Other general and administrative expense	6,350	5,
Total general and administrative expense	44,996	40,
Net operation of real estate acquired in settlement of loans	27	(
Amortization of excess cost over fair value of branch acquisitions	114	
Total operating expense	45,137	40,
INCOME BEFORE INCOME TAXES	35,199	57,
Income taxes	14,890	24,
NET INCOME	$ 20,309	$ 33,
PER SHARE INFORMATION		
BASIC	$ 0.72	$ 1
DILUTED	$ 0.72	$ 1
CASH DIVIDENDS DECLARED AND PAID	$ 0.09	$ 0
Weighted average diluted shares outstanding	28,284,493	28,271,

See accompanying notes to consolidated financial statements.

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DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

(In Thousands)	Three Months Ende June 30, 2002	2001
NET INCOME	$ 20,309	$ 33,4
OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES (BENEFITS)		
Unrealized gains (losses) on securities available for sale:		
U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value	811	(1
Mortgage-backed securities available for sale, at fair value	1,862	
Less reclassification of realized gains included in net income	(11)	(
Unrealized gains (losses) on cash flow hedges:		
Net derivative instruments	(3,108)	2,0
Less reclassification of realized (gains) losses included in net income	1,970	(6
Total other comprehensive income, net of income taxes	1,524	1,2
COMPREHENSIVE INCOME	$ 21,833	$ 34,6

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(In Thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$
Adjustments to reconcile net income to net cash used for operating activities:	
Depreciation and amortization	
Provision for losses on loans, real estate acquired in settlement of loans, investments in real estate and joint ventures, mortgage servicing rights and other assets	
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, investment securities, real estate and other assets	
Net change in interest capitalized on loans (negative amortization)	
Federal Home Loan Bank stock dividends	
Loans originated for sale	(2,
Proceeds from sales of loans held for sale, including those sold via mortgage-backed securities	2,
Other, net	
Net cash provided by (used for) operating activities	

CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales of:	
U.S. Treasury securities, agency obligations and other investment securities available for sale	
Wholly owned real estate and real estate acquired in settlement of loans	
Proceeds from maturities of U.S. Treasury securities, agency obligations and other investment securities available for sale	
Purchase of:	
U.S. Treasury securities, agency obligations and other investment securities available for sale	(
Mortgage loans under resale agreements	
Loans receivable held for investment	
Premises and equipment	
Originations of loans receivable held for investment (net of refinances of $338,946 at June 30, 2002 and $377,262 at June 30, 2001)	(1,
Principal payments on loans receivable held for investment and mortgage-backed securities available for sale	1,
Net change in undisbursed loan funds	
Investments in real estate held for investment	
Other, net	
Net cash provided by (used for) investing activities	(

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

(UNAUDITED)

(In Thousands)	Six Month June 2002	
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	$ 70,992	$
Proceeds from Federal Home Loan Bank advances and other borrowings	2,213,400	
Repayments of Federal Home Loan Bank advances and other borrowings	(2,322,505)	
Proceeds from exercise of stock options	392	
Cash dividends	(5,080)	
Net cash used for financing activities	(42,801)	
Net increase (decrease) in cash and cash equivalents	(8,891)	
Cash and cash equivalents at beginning of period	143,080	
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 134,189	$
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 160,925	$
Income taxes	18,509	
Supplemental disclosure of non-cash investing:		
Loans transferred to held for investment from held for sale	2,015	
Loans exchanged for mortgage-backed securities	2,169,126	

Real estate acquired in settlement of loans	12,973
Loans to facilitate the sale of real estate acquired in settlement of loans	8,275

See accompanying notes to consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE (1) - BASIS OF FINANCIAL STATEMENT PRESENTATION

In the opinion of Downey Financial Corp. and subsidiaries ("Downey," "we," "us" and "our"), the accompanying consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation of Downey's financial condition as of June 30, 2002, December 31, 2001 and June 30, 2001, the results of operations and comprehensive income for the three months and six months ended June 30, 2002 and 2001, and changes in cash flows for the six months ended June 30, 2002 and 2001. Certain prior period amounts have been reclassified to conform to the current period presentation.

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial statements and are in compliance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial condition, results of operations, comprehensive income and cash flows. The following information under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations is written with the presumption that the interim consolidated financial statements will be read in conjunction with Downey's Annual Report on Form 10-K for the year ended December 31, 2001, which contains among other things, a description of the business, the latest audited consolidated financial statements and notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2001 and for the year then ended. Therefore, only material changes in financial condition and results of operations are discussed in the remainder of Part I.

NOTE (2) - EARNINGS PER SHARE

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

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

	Three Months Ended June			
	2002			
	Net	Weighted Average Shares	Per Share	Net

(Dollars in Thousands, Except Per Share Data)	Income	Outstanding	Amount	Income
Basic earnings per share	$ 20,309	28,232,787	$ 0.72	$ 33,455
Effect of dilutive stock options	--	51,706	--	--
Diluted earnings per share	$ 20,309	28,284,493	$ 0.72	$ 33,455

	Six Months Ended June 3			
	2002			
(Dollars in Thousands, Except Per Share Data)	Net Income	Weighted Average Shares Outstanding	Per Share Amount	Net Income
Basic earnings per share	$ 57,623	28,222,918	$ 2.04	$ 59,319
Effect of dilutive stock options	--	54,915	--	--
Diluted earnings per share	$ 57,623	28,277,833	$ 2.04	$ 59,319

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NOTE (3) - BUSINESS SEGMENT REPORTING

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

(In Thousands)	Banking	Real Estate Investment	Elimination
THREE MONTHS ENDED JUNE 30, 2002			
Net interest income	$ 75,115	$ 13	$ --
Reduction of loan losses	(1,106)	--	--
Other income	2,803	1,299	--
Operating expense	44,893	244	--
Net intercompany income (expense)	86	(86)	--
Income before income taxes	34,217	982	--
Income taxes	14,493	397	--
Net income	$ 19,724	$ 585	$ --
AT JUNE 30, 2002			
Assets:			
Loans and mortgage-backed securities	$ 10,286,033	$ --	$ --
Investments in real estate and joint ventures	--	40,283	--
Other	840,416	1,919	(38,448
Total assets	11,126,449	42,202	(38,448
Equity	$ 787,306	$ 38,448	$ (38,448
THREE MONTHS ENDED JUNE 30, 2001			

Net interest income	$ 76,236	$ 10	$ --
Provision for loan losses	431	--	--
Other income	21,211	1,072	--
Operating expense	38,863	1,278	--
Net intercompany income (expense)	84	(84)	--
Income (loss) before income taxes (benefit)	58,237	(280)	--
Income taxes (benefit)	24,618	(116)	--
Net income (loss)	$ 33,619	$ (164)	$ --
AT JUNE 30, 2001			
Assets:			
Loans and mortgage-backed securities	$ 9,981,213	$ --	$ --
Investments in real estate and joint ventures	--	19,950	--
Other	837,387	1,673	(18,307
Total assets	10,818,600	21,623	(18,307
Equity	$ 680,719	$ 18,307	$ (18,307

(In Thousands)	Banking	Real Estate Investment	Elimination
SIX MONTHS ENDED JUNE 30, 2002			
Net interest income	$ 155,055	$ 18	$ --
Provision for loan losses	341	--	--
Other income	30,865	4,590	--
Operating expense	89,899	466	--
Net intercompany income (expense)	179	(179)	--
Income before income taxes	95,859	3,963	--
Income taxes	40,578	1,621	--
Net income	$ 55,281	$ 2,342	$ --
SIX MONTHS ENDED JUNE 30, 2001			
Net interest income	$ 152,370	$ 38	$ --
Provision for loan losses	483	--	--
Other income	25,956	2,340	--
Operating expense	75,853	1,538	--
Net intercompany income (expense)	181	(181)	--
Income before income taxes	102,171	659	--
Income taxes	43,243	268	--
Net income	$ 58,928	$ 391	$ --

NOTE (4) - MORTGAGE SERVICING RIGHTS

The following table summarizes the activity in our mortgage servicing rights and related allowance for the periods indicated and other related financial data.

Three Month

(Dollars in Thousands)	June 30, 2002	March 31, 2002	December 2001
Gross balance at beginning of period	$ 74,914	$ 65,630	$ 61,651
Additions	10,156	14,997	15,300
Amortization	(3,253)	(2,916)	(2,956
Sales of mortgage servicing rights	--	(35)	(4,916
Impairment write-down	(717)	(2,762)	(3,449
Gross balance at end of period	81,100	74,914	65,630
Allowance balance at beginning of period	6,333	8,735	24,144
Provision for (reduction of) impairment	15,713	360	(11,960
Impairment write-down	(717)	(2,762)	(3,449
Allowance balance at end of period	21,329	6,333	8,735
Total mortgage servicing rights, net	$ 59,771	$ 68,581	$ 56,895
Estimated fair value (1)	$ 59,771	$ 70,532	$ 58,047
Weighted average expected life (in months)	61	87	82
Custodial account earnings rate	3.82%	4.61%	4.36
Weighted average discount rate	9.10	9.13	9.16
AT PERIOD END			
Mortgage loans serviced for others:			
Total	$ 6,962,403	$ 6,408,812	$ 5,805,811
With capitalized mortgage servicing rights (1):			
Amount	6,807,306	6,196,137	5,379,513
Weighted average interest rate	6.80%	6.85%	6.97
Custodial escrow balances	$ 13,044	$ 6,103	$ 10,596

(In Thousands)	Six Months Ended June 30, 2002	2001
Gross balance at beginning of period	$ 65,630	$ 46,214
Additions	25,153	18,797
Amortization	(6,169)	(4,362)
Sales of mortgage servicing rights	(35)	(2,328)
Impairment write-down	(3,479)	(2,473)
Gross balance at end of period	81,100	55,848
Allowance balance at beginning of period	8,735	5,483
Provision for impairment	16,073	10,696
Impairment write-down	(3,479)	(2,473)
Allowance balance at end of period	21,329	13,706
Total mortgage servicing rights, net	$ 59,771	$ 42,142

Key assumptions, which vary due to changes in market interest rates and are used to determine the fair value of our mortgage servicing rights, include: expected prepayment speeds, which impact the average life of the portfolio; the earnings rate on custodial accounts, which impact the value of custodial accounts; and the discount rate used in valuing future cash flows. The table below summarizes the estimated changes in the fair value of our mortgage servicing rights for changes in those assumptions individually and in combination associated with an immediate 100 basis point increase or decrease in market rates. Also summarized is the earnings impact associated with provisions to or reductions in the valuation allowance for mortgage servicing rights. Impairment is measured on a disaggregated basis based upon the predominant risk

characteristics of the underlying mortgage loans such as term and coupon. Certain stratum may have impairment, while other stratum may not. Therefore, changes in overall fair value may not equal provisions to or reductions in the valuation allowance.

The sensitivity analysis in the table below is hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 100 basis point variation in assumptions generally cannot be easily extrapolated because the relationship of the change in the assumptions to the change in fair value may not be linear. Also, in this table, the effect that a change in a particular assumption may have on the fair value is calculated without changing any other assumption. In reality, changes in one factor may result in changes in another, which might magnify or counteract the sensitivities.

(Dollars in Thousands)	Expected Prepayment Speeds	Value of Custodial Accounts	Discount Rate	Co
Increase rates 100 basis points:				
Fair value (1)	$ 20,675	$ 4,532	$ (1,741)	
Reduction of (increase in) valuation allowance ...	17,033	4,519	(1,741)	
Decrease rates 100 basis points:				
Fair value (2)	(17,562)	(4,532)	1,840	
Reduction of (increase in) valuation allowance ...	(17,562)	(4,532)	1,840	

The following table presents a breakdown of the components of our loan servicing income (loss) during the periods indicated.

(In Thousands)	Three Months Ended June 30, 2002	March 31, 2002	December 31, 2001	September 30, 2001
Income from servicing operations	$ 3,349	$ 2,688	$ 2,477	$ 2,576
Amortization of MSRs	(3,253)	(2,916)	(2,956)	(2,495)
(Provision for) reduction of impairment ...	(15,713)	(360)	11,960	(11,852)
Total loan servicing income (loss), net	$(15,617)	$ (588)	$ 11,481	$(11,771)

(In Thousands)	Six Months Ended June 30, 2002	2001
Income from servicing operations	$ 6,037	$ 3,975
Amortization of MSRs	(6,169)	(4,362)
Provision for impairment	(16,073)	(10,696)
Total loan servicing loss, net	$(16,205)	$(11,083)

NOTE (5) - ACCOUNTING FOR DERIVATIVES AND HEDGING ACTIVITIES

DERIVATIVES

We offer short-term interest rate lock commitments to help us attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if our underwriting standards are met, but do not obligate the potential borrower. Accordingly, a certain number of commitments never become loans and merely expire. The residential one-to-four unit rate lock commitments we ultimately expect to result in loans and sell in the secondary market are treated as derivatives. Consequently, as derivatives, the hedging of the expected rate lock commitments do not qualify for hedge accounting. Associated fair value adjustments to the notional amount of the expected rate lock commitments are recorded in current earnings under net gains on sales of loans and mortgage-backed securities with an offset to the balance sheet in either other assets, or accounts payable and accrued liabilities. Fair values for the notional amount of expected rate lock commitments are based on observable market prices acquired from third parties. The carrying amount of loans held for sale includes a basis adjustment to the loan balance at funding resulting from the change in the fair value of the rate lock derivative from the date of commitment to the date of funding. At June 30, 2002 we had a notional amount of expected rate

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lock commitments identified to sell as part of our secondary marketing activities of $503 million, with an estimated fair value gain of $7.5 million, of which $5.1 million was associated with mortgage servicing rights.

HEDGING ACTIVITIES

As part of our secondary marketing activities, we typically utilize short-term forward sale and purchase contracts--derivatives--that mature in less than one year to offset the impact of changes in market interest rates on the value of our residential one-to-four unit expected rate lock commitments and loans held for sale. We do not generally enter into derivative transactions for purely speculative purposes. Contracts designated to loans held for sale are accounted for as cash flow hedges because these contracts have a high correlation to the price movement of the loans being hedged (within a range of 80% - 125%). The measurement approach for determining the ineffective aspects of the hedge is established at the inception of the hedge. Changes in fair value of the notional amount of forward sale contracts not designated to loans held for sale and the ineffectiveness of hedge transactions that are not perfectly correlated are recorded in net gains on sales of loans and mortgage-backed securities. Changes in fair value of the notional amount of forward sale contracts designated as cash flow hedges for loans held for sale are recorded in other comprehensive income, net of tax, provided cash flow hedge requirements are met. The offset to these changes in fair value of the notional amount of forward sale contracts are recorded in the balance sheet as either other assets, or accounts payable and accrued liabilities. The amounts recorded in accumulated other comprehensive income will be recognized in the income statement when the hedged forecasted transactions settle. We estimate that all of the related unrealized gains or losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. Fair values for the notional amount of forward sale contracts are based on observable market prices acquired from third parties. At June 30, 2002, the notional amount of forward sale contracts amounted to $880 million, with an estimated fair value loss of $5.1 million, of which $378 million were designated as cash flow hedges. The notional amount of forward purchase contracts amounted to $3.0 million, with a negligible estimated fair value gain that partially offsets the loss on our forward sale contracts not designated to loans held for sale.

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

The following table shows the impact from non-qualifying hedges and the ineffectiveness of cash flow hedges on net gains (losses) on sales of loans and mortgage-backed securities (i.e., SFAS 133 effect), as well as the impact to other comprehensive income (loss) from qualifying cash flow transactions. Also shown is the notional amount of expected rate lock commitment derivatives for loans originated for sale, loans held for sale and the notional amounts for their associated hedging derivatives (i.e., forward sale contracts).

	Three Mo		
(In Thousands)	June 30, 2002	March 31, 2002	Decem 2
Net gains (losses) on non-qualifying hedge transactions	$ (390)	$ 4,864	$ (
Net gains (losses) on qualifying cash flow hedge transactions:			
Unrealized hedge ineffectiveness	--	--	
Less reclassification of realized hedge ineffectiveness ...	--	--	
Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	(390)	4,864	(
Other comprehensive income (loss)	(1,138)	1,355	
NOTIONAL AMOUNT AT PERIOD END			
Non-qualifying hedge transactions:			
Expected rate lock commitments	$ 503,359	$ 235,099	$ 26
Associated forward sale contracts	501,292	230,660	27
Associated forward purchase contracts	3	--	
Qualifying cash flow hedge transactions:			
Loans held for sale, at lower of cost or fair value	381,465	388,468	49
Associated forward sale contracts	378,238	392,099	50

	Six Months Ended June 30,

(In Thousands)	2002	2001
Net gains (losses) on non-qualifying hedge transactions	$ 4,474	$ (981)
Net losses on qualifying cash flow hedge transactions:		
Unrealized hedge ineffectiveness	--	(440)
Less reclassification of realized hedge ineffectiveness ...	--	440
Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	4,474	(981)
Other comprehensive income	217	1,249

NOTE (6) - INCOME TAXES

Downey and its wholly owned subsidiaries file a consolidated federal income tax return and various state income and franchise tax returns on a calendar year basis. The Internal Revenue Service and state taxing authorities have examined Downey's tax returns for all tax years through 1997. Tax years subsequent to 1997 remain open to review. Downey's management believes it has adequately provided for potential exposure to issues that may be raised in the years open to review.

NOTE (7) - CURRENT ACCOUNTING ISSUES

Statement of Financial Accounting Standards No. 142. Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), applies to all acquired intangible assets whether acquired singularly, as part of a group, or in a business combination. SFAS 142 supersedes APB Opinion No. 17, "Intangible Assets," and carries forward provisions in Opinion 17 related to internally developed intangible assets. SFAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Goodwill should no longer be amortized, but instead tested for impairment at least annually at the reporting unit level. The accounting provisions are effective for fiscal years beginning after December 31, 2001. Our intangible assets and goodwill are related to branch acquisitions and not within the scope of SFAS 142. We recognized an unidentified intangible asset for branch acquisitions because the fair value of the liabilities assumed exceeded the fair value of the assets acquired. However, under a current proposal being considered by the Financial Accounting Standards Board, assets of this nature that meet the definition of a business combination will be accounted for using the impairment-only approach. A final Statement regarding this proposal is expected to be issued in the fourth quarter of 2002. If adopted as proposed, we would stop amortizing the remaining excess of cost over fair value of branch acquisitions and record impairment, if necessary. For the second quarter of 2002, our amortization of excess cost over fair value of branch acquisitions was $0.1 million and as of June 30, 2002, this asset totaled $3 million. For the first six months of 2002, our amortization was $0.2 million.

Statement of Financial Accounting Standards No. 143. Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" ("SFAS 143"), addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. It is anticipated that the financial impact of SFAS 143 will not have a material effect on Downey.

Statement of Financial Accounting Standards No. 144. Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS 144 supersedes SFAS

No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," for the disposal of a business segment. SFAS 144 also eliminates the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of SFAS 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The provisions of SFAS 144 generally are to be applied prospectively. It is anticipated that the financial impact of SFAS 144 will not have a material effect on Downey.

Statement of Financial Accounting Standards No. 145. Statement of Financial Accounting Standards No. 145, "Rescission of SFAS Statements No. 4, 44, and 64, Amendment of SFAS Statement No. 13, and Technical Corrections" ("SFAS 145"), updates, clarifies and simplifies existing accounting pronouncements. SFAS 145 rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt." SFAS 145 amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for

certain lease modifications that have economic effects that are similar to sale-leaseback transactions. The provisions of SFAS 145 related to SFAS No. 4 and SFAS No. 13 are effective for fiscal years beginning and transactions occurring after May 15, 2002, respectively. It is anticipated that the financial impact of SFAS 145 will not have a material effect on Downey.

Statement of Financial Accounting Standards No. 146. Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"), requires Downey to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS 146 replaces Emerging Issues Task Force ("EITF") Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The provisions of SFAS 146 are to be applied prospectively to exit or disposal activities initiated after December 31, 2002.

NOTE (8) - SUBSEQUENT EVENTS

New Director. On July 8, 2002, Downey Financial Corp. announced that James H. Hunter had been elected a director of the boards of both Downey Financial Corp. and Downey Savings and Loan Association, F.A. (the "Bank"), increasing both Boards' membership to nine directors. James H. Hunter is Executive Vice President of Planning and Acquisition for The Corky McMillin Companies. As of June 30, 2002, the Bank had committed loans to The Corky McMillin Companies or affiliates totaling $72.0 million, of which $38.7 million had been disbursed. As of June 30, 2002, DSL Service Company, a wholly owned subsidiary of the Bank, had committed investments in joint ventures associated with The Corky McMillin Companies or affiliates totaling $19.8 million, of which $16.9 million had been disbursed. All such loans and investments are performing in accordance with their terms. The loan terms, including interest rates and collateral, are substantially the same as those prevailing at the time for comparable transactions with other non-related parties. In the opinion of management, those transactions neither involve more than the normal risk of collectibility or of return on investment, nor present any unfavorable features.

Stock Repurchase Program. On July 24, 2002, the Board of Directors of Downey Financial Corp. authorized a share repurchase program of up to $50 million of Downey's common stock. The shares will be repurchased from time-to-time in open market transactions. The timing, volume and price of purchases will be made at the discretion of Downey, and will also be contingent upon Downey's overall financial condition, as well as market conditions in general.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements under this caption may constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995 which involve risks and uncertainties. Our actual results may differ significantly from the results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation.

OVERVIEW

Our net income for the second quarter of 2002 totaled $20.3 million or $0.72 per share on a diluted basis, compared to $33.4 million or $1.18 per share in the second quarter of 2001.

The decline in our net income between second quarters was primarily due to a larger addition to the valuation allowance for mortgage servicing rights. The addition was reflected within the category of loan servicing loss and was necessary due to the decline in long-term interest rates, which resulted in an increase in the projected rate at which loans serviced for others are expected to prepay, thereby shortening their expected average life. In addition, the decline in long-term interest rates also reduced the expected value of associated custodial accounts. The pre-tax addition during the second quarter was $15.7 million, up from $2.4 million in the year-ago second quarter. Excluding the valuation allowances, our net income in the current quarter would have been $29.4 million, down $5.4 million or 15.6% from the adjusted year-ago level. This decline reflected a decrease of $6.2 million in adjusted net income from our banking operations, partially offset by a $0.7 million increase in net income from real estate investment activities. Adjusted net income from banking operations declined due to the following:

- a $6.0 million or 15.5% increase in operating expense due to higher costs associated with the increased number of branch locations and higher loan origination activity;
- a $5.0 million or 21.4% decline in other income primarily due to:
  - a $2.7 million decline in net gains from the sales of loans and mortgage servicing rights, as fewer loans were sold; and
  - a $2.6 million decline in loan and deposit related fees due primarily to lower loan prepayment fees.
- a $1.1 million or 1.5% decrease in net interest income due to a decline in both the effective interest rate spread and average earning assets.

These items were partially offset by a $1.1 million reversal of provision for loan losses during the quarter due to improved credit quality, compared to the year-ago quarter provision of $0.4 million.

For the first six months of 2002, our net income totaled $57.6 million or

$2.04 per share on a diluted basis, compared to $59.3 million or $2.09 per share for the first six months of 2001. The decline between six-month periods reflected lower net income from our banking operations and was primarily due to higher valuation provisions associated with mortgage servicing rights.

For the second quarter of 2002, our return on average assets was 0.75% and our return on average equity was 10.47%. For the first six months of 2002, our return on average assets was 1.06% and our return on average equity was 15.13%.

Our single family loan originations totaled $2.179 billion in the second quarter of 2002, up 2.7% from the $2.122 billion we originated in the second quarter of 2001 but 3.5% below the $2.259 billion we originated in the previous quarter. Of the current quarter total, $1.114 billion represented originations of loans for portfolio, of which $150 million represented subprime credits. In addition to single family loans, we originated $120 million of other loans in the quarter.

At quarter end, our assets totaled $11.1 billion, up 2.8% from a year ago, while our deposits totaled $8.7 billion, down 3.9% from a year ago. During the quarter, four new in-store branches were opened, bringing our total branches at quarter end to 148, of which 78 are in-store. A year ago, branches totaled 129, of which 63 were in-store.

Our non-performing assets declined $10 million during the quarter to $83 million or 0.75% of total assets. The decline was primarily in the residential one-to-four unit category.

At June 30, 2002, our primary subsidiary, Downey Savings and Loan Association, F.A. (the "Bank") exceeded all regulatory capital tests, with capital-to-asset ratios of 7.51% for both tangible and core capital and 15.16% 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.

CRITICAL ACCOUNTING POLICIES

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey's Annual Report on Form 10-K for the year ended December 31, 2001. Certain accounting policies require us to make significant estimates and assumptions which have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and our results of operations for the reporting periods.

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

- Allowance for losses on loans and real estate. For further information, see Financial Condition--Problem Loans and Real Estate--Allowance for Losses on Loans and Real Estate on page 35.

- Allowance for mortgage servicing rights. For further information, see Note 4 on page 8 of Notes to 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, borrowings and capital securities ("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 $75.1 million in the second quarter of 2002, down $1.1 million or 1.5% from the same period last year. The decrease between second quarters reflected both a lower effective interest rate spread and lower interest-earning asset levels. The effective interest rate spread averaged 2.86% in the current quarter, below 2.89% of a year ago. The decrease between second quarters was due to our yield on interest-earning assets declining more rapidly than the decline in our cost of funds. This is indicative of what typically happens when interest rates decline, as there is an administrative lag in the repricing of our loans which are primarily priced to the Federal Home Loan Bank (the "FHLB") Eleventh District Cost of Funds Index ("COFI") and is reflective of the faster decline in COFI earlier in 2002. Our interest-earning assets averaged $10.5 billion during the quarter, slightly below the year-ago level.

For the first six months of 2002, net interest income totaled $155.1 million, up $2.7 million or 1.7% from a year ago. The increase reflected a higher effective interest rate spread as our earning asset levels remained relatively stable.

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

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

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

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

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

	Three Months Ended			
	2002			
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	A B
Interest-earning assets:				
Loans	$10,035,071	$ 148,448	5.92%	$10
Mortgage-backed securities	80,873	942	4.66	
Investment securities	385,738	4,035	4.20	
Total interest-earning assets	10,501,682	153,425	5.84	10
Non-interest-earning assets	391,884			
Total assets	$10,893,566			$10
Transaction accounts:				
Non-interest-bearing checking	$ 295,568	$ --	-- %	$
Interest-bearing checking (1)	425,609	329	0.31	
Money market	113,231	503	1.78	
Regular passbook	2,962,758	18,543	2.51	
Total transaction accounts	3,797,166	19,375	2.05	1
Certificates of deposit	4,763,479	41,022	3.45	7
Total deposits	8,560,645	60,397	2.83	8
Borrowings	1,299,644	14,859	4.59	1
Capital securities	120,000	3,041	10.14	
Total deposits, borrowings and capital securities	9,980,289	78,297	3.15	10
Other liabilities	137,644			
Stockholders' equity	775,633			
Total liabilities and stockholders' equity	$10,893,566			$10
Net interest income/interest rate spread		$ 75,128	2.69%	
Excess of interest-earning assets over deposits, borrowings and capital securities	$ 521,393			$
Effective interest rate spread			2.86	

	Six Months Ended Ju			
	2002			
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	A B
Interest-earning assets:				
Loans	$10,004,439	$ 308,725	6.17%	$10
Mortgage-backed securities	93,624	2,216	4.73	
Investment securities	425,093	8,882	4.21	

Total interest-earning assets	10,523,156	319,823	6.08	10
Non-interest-earning assets	395,186			
Total assets	$10,918,342			$10
Transaction accounts:				
Non-interest-bearing checking	$ 290,362	$ --	-- %	$
Interest-bearing checking (1)	425,386	744	0.35	
Money market	111,973	1,010	1.82	
Regular passbook	2,702,876	33,936	2.53	
Total transaction accounts	3,530,597	35,690	2.04	1
Certificates of deposit	5,011,329	93,066	3.75	6
Total deposits	8,541,926	128,756	3.04	8
Borrowings	1,362,761	29,912	4.43	1
Capital securities	120,000	6,082	10.14	
Total deposits, borrowings and capital securities	10,024,687	164,750	3.31	10
Other liabilities	131,862			
Stockholders' equity	761,793			
Total liabilities and stockholders' equity	$10,918,342			$10
Net interest income/interest rate spread		$ 155,073	2.77%	
Excess of interest-earning assets over deposits, borrowings and capital securities	$ 498,469			$
Effective interest rate spread			2.95	

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

- changes in volume--changes in volume multiplied by comparative period rate;

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

- changes in rate/volume--changes in rate multiplied by changes in volume.

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

	Three Months Ended June 30, 2002 Versus 2001 Changes Due To	Six M 2
	Rate/	

(In Thousands)	Volume	Rate	Volume	Net	Volume	
Interest income:						
Loans	$ (457)	$(55,038)	$ 123	$(55,372)	$ (4,728)	$
Mortgage-backed securities	1,158	(21)	(282)	855	2,786	
Investment securities	(1,687)	(2,086)	480	(3,293)	(1,267)	
Change in interest income	(986)	(57,145)	321	(57,810)	(3,209)	
Interest expense:						
Transaction accounts:						
Interest-bearing checking (1) .	20	(183)	(7)	(170)	64	
Money market	164	(231)	(59)	(126)	313	
Regular passbook	17,914	(2,035)	(4,851)	11,028	31,945	
Total transaction accounts ..	18,098	(2,449)	(4,917)	10,732	32,322	
Certificates of deposit	(34,822)	(44,579)	14,680	(64,721)	(60,210)	
Total interest-bearing deposits	(16,724)	(47,028)	9,763	(53,989)	(27,888)	
Borrowings	813	(3,368)	(148)	(2,703)	(3,440)	
Capital securities	--	--	--	--	--	
Change in interest expense	(15,911)	(50,396)	9,615	(56,692)	(31,328)	
Change in net interest income	$ 14,925	$ (6,749)	$(9,294)	$ (1,118)	$ 28,119	$

PROVISION FOR LOAN LOSSES

During the second quarter, $1.1 million of provision for loan losses was reversed due to an improvement in credit quality, while in the year-ago quarter the provision for loan losses totaled $0.4 million. The allowance for loan losses was $36 million at June 30, 2002, essentially unchanged from year-end 2001. Net charge-offs totaled $0.4 million in the second quarter of 2002, up slightly from $0.2 million a year ago.

For the first six months of 2002, provision for loan losses declined to $0.3 million from $0.5 million a year ago, and net charge-offs were unchanged at $0.6 million. The decline in provision for loan losses was primarily due to the current period improvement in credit quality. For further information regarding our allowance for loan losses, see Financial Condition--Problem Loans and Real Estate--Allowance for Losses on Loans and Real Estate on page 35.

OTHER INCOME

Our total other income was $4.1 million in the second quarter of 2002, down $18.2 million from a year ago reflecting:

- a $12.7 million increase in the loss on our loan servicing activity from the year-ago quarter primarily due to a larger addition to the valuation allowance for mortgage servicing rights, as their fair value dropped in the current quarter due to an approximate 60 basis point decline in long-term interest rates;

- a $2.7 million decrease in net gains on sales of loans and mortgage-backed securities and mortgage servicing rights as fewer loans were sold; and

- a $2.7 million decline in loan and deposit related fees, primarily due to a $3.3 million decline in loan prepayment fees.

Partially offsetting those declines was a $0.3 million increase in income from real estate held for investment.

For the first six months of 2002, total other income was $35.5 million, up $7.2 million from a year ago, primarily reflecting an $11.9 million increase in net gains on sales of loans and mortgage-backed securities, and a $2.3 million increase in income from real estate and joint ventures held for investment. Those favorable items were partially offset by a $5.1 million increase in the loss from loan servicing and a $1.5 million decrease in loan and deposit related fees. Below is a further discussion of the major other income categories.

LOAN AND DEPOSIT RELATED FEES

Loan and deposit related fees totaled $11.4 million in the second quarter of 2002, down $2.7 million from a year ago. Our loan related fees were down $3.5 million between second quarters, of which $3.3 million represented a decline in loan prepayment fees. This was partially offset by a $0.8 million or 18.8% increase in our deposit related fees, primarily due to higher fees from our checking accounts.

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

	Three Months Ended			
(In Thousands)	June 30, 2002	March 31, 2002	December 31, 2001	September 30, 2001
Loan related fees:				
Prepayment fees	$ 4,140	$ 4,686	$ 5,475	$ 6,384
Other fees	1,992	2,167	2,477	2,257
Deposit related fees:				
Automated teller machine fees	1,668	1,543	1,670	1,671
Other fees	3,596	3,122	3,224	2,962
Total loan and deposit related fees	$11,396	$11,518	$12,846	$13,274

For the six months of 2002, loan and deposit related fees totaled $22.9 million, down $1.5 million from the same period of 2001. The decrease reflected a $3.2 million decline in loan prepayment fees, as deposit related fees were up $1.5 million.

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

	Six Months Ended June 30,	
(In Thousands)	2002	2001

Loan related fees:		
Prepayment fees	$ 8,826	$11,980
Other fees	4,159	4,030
Deposit related fees:		
Automated teller machine fees	3,211	3,183
Other fees	6,718	5,173
Total loan and deposit related fees	$22,914	$24,366

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REAL ESTATE AND JOINT VENTURES HELD FOR INVESTMENT

Income from our real estate and joint ventures held for investment totaled $1.0 million in the second quarter of 2002, up $0.3 million from a year ago. The increase reflected increases of $0.9 million in net gains from sales and $0.2 million in interest from joint venture advances. The gains primarily relate to joint venture projects and are reported in the category of equity in net income from joint ventures. Those favorable items were partially offset by an increase of $0.8 million in the provision for losses on real estate and joint ventures due to a decline in the fair value of a shopping center.

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

	Three Months End			
(In Thousands)	June 30, 2002	March 31, 2002	December 31, 2001	S
Rental operations, net of expenses	$ 521	$ 823	$ 1,026	
Equity in net income from joint ventures	1,001	745	212	
Interest from joint venture advances	304	111	83	
Net gains on sales of wholly owned real estate	8	--	127	
(Provision for) reduction of losses on real estate and joint ventures	(818)	1,318	(1)	
Total income from real estate and joint ventures held for investment, net	$ 1,016	$ 2,997	$ 1,447	

For the first six months of 2002, income from real estate and joint ventures held for investment totaled $4.0 million, up $2.3 million from the same period of 2001 due primarily to sales activity.

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

	Six Months Ended June 30,	
(In Thousands)	2002	2001

Rental operations, net of expenses	$ 1,344	$ 960
Equity in net income from joint ventures	1,746	512
Interest from joint venture advances	415	284
Net gains on sales of wholly owned real estate	8	2
(Provision for) reduction of losses on real estate and joint ventures	500	(66)
Total income from real estate and joint ventures held for investment, net	$ 4,013	$ 1,692

SECONDARY MARKETING ACTIVITIES

Sales of loans and mortgage-backed securities decreased in the second quarter of 2002 to $1.093 billion from $1.364 billion a year ago. Net gains associated with these sales totaled $6.9 million in the current quarter, down $2.1 million from a year ago. Net gains in the current quarter included the capitalization of mortgage servicing rights totaling $10.2 million, compared to $13.4 million a year ago.

A loss of $15.6 million was recorded in loan servicing from our portfolio of loans serviced for others during the second quarter of 2002, a deterioration from a loss of $2.9 million in the year-ago period. This increased loss primarily reflected a larger addition to the valuation allowance for mortgage servicing rights, $15.7 million in the current quarter, compared to $2.4 million a year ago. The current quarter valuation addition was associated with the deterioration in fair value of mortgage servicing rights due to the approximate 60 basis point decline in long-term interest rates, which resulted in an increase in the projected rate at which loans serviced for others are expected to prepay, thereby shortening the expected average life. In addition, the decline in long-term interest rates also reduced the expected value of custodial accounts. At June 30, 2002, we serviced $7.0 billion of loans for others, compared to $5.8 billion at December 31, 2001 and $5.1 billion at June 30, 2001.

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The following table presents a breakdown of the components of our loan servicing income (loss) during the periods indicated.

	Three Months Ended			
(In Thousands)	June 30, 2002	March 31, 2002	December 31, 2001	September 3 2001
Income from servicing operations	$ 3,349	$ 2,688	$ 2,477	$ 2,576
Amortization of MSRs	(3,253)	(2,916)	(2,956)	(2,495)
(Provision for) reduction of impairment	(15,713)	(360)	11,960	(11,852)
Total loan servicing income (loss), net	$(15,617)	$ (588)	$ 11,481	$(11,771)

For the first six months of 2002, net gains on sales of loans and mortgage-backed securities totaled $23.1 million, up $11.9 million from the same period of 2001. For the first six months of 2002, a loss of $16.2 million was recorded in loan servicing, compared to a loss of $11.1 million from the same period of 2001 due to the larger addition to the valuation allowance for mortgage servicing rights.

The following table presents a breakdown of the components of our loan servicing income (loss) during the periods indicated.

(In Thousands)	Six Months Ended June 30, 2002	2001
Income from servicing operations .	$ 6,037	$ 3,975
Amortization of MSRs	(6,169)	(4,362)
Provision for impairment	(16,073)	(10,696)
Total loan servicing loss, net	$(16,205)	$(11,083)

For further information regarding mortgage servicing rights, see Notes To Consolidated Financial Statements--Note (4)--Mortgage Servicing Rights on page 8.

OPERATING EXPENSE

Our operating expense totaled $45.1 million in the current quarter, up $5.0 million or 12.4% from the second quarter of 2001 because of higher general and administrative expense. That increase was primarily due to higher costs associated with an increased number of branch locations and higher loan origination activity.

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

(In Thousands)	Three Months Ended June 30, 2002	March 31, 2002	December 31, 2001	September 3 2001
Salaries and related costs	$ 28,315	$ 29,437	$ 27,075	$ 24,943
Premises and equipment costs	7,754	7,133	7,303	6,628
Advertising expense	1,582	1,044	1,168	939
Professional fees	233	564	839	2,432
SAIF insurance premiums and regulatory assessments	762	786	792	786
Other general and administrative expense ...	6,350	6,211	6,339	5,981
Total general and administrative expense	44,996	45,175	43,516	41,709
Net operation of real estate acquired in settlement of loans	27	(58)	237	110
Amortization of excess cost over fair value of branch acquisitions	114	111	113	116
Total operating expense	$ 45,137	$ 45,228	$ 43,866	$ 41,935

For the first six months of 2002, operating expenses totaled $90.4 million, up $13.0 million or 16.8% from the same period of 2001 and also reflected higher costs associated with the increased number of branch locations and higher loan origination activity.

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

(In Thousands)	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001
Salaries and related costs	$ 57,752	$ 47,917
Premises and equipment costs	14,887	12,085
Advertising expense	2,626	2,303
Professional fees	797	2,181
SAIF insurance premiums and regulatory assessments	1,548	1,473
Other general and administrative expense	12,561	11,312
Total general and administrative expense	90,171	77,271
Net operation of real estate acquired in settlement of loans	(31)	(108)
Amortization of excess cost over fair value of branch acquisitions	225	228
Total operating expense	$ 90,365	$ 77,391

PROVISION FOR INCOME TAXES

Income taxes for the second quarter totaled $14.9 million, compared to $24.5 million for the like quarter of a year ago. Our effective tax rate was unchanged at 42.3% for each of the current year and year-ago periods. For further information regarding income taxes, see Notes to Consolidated Financial Statements--Note (6)--Income Taxes on page 11.

BUSINESS SEGMENT REPORTING

The previous discussion and analysis of the Results of Operations pertained to our consolidated results. This section discusses and analyzes the results of operations of our two business segments--banking and real estate investment. For further information regarding business segments, see Notes To Consolidated Financial Statements--Note (3)--Business Segment Reporting on page 7.

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

	Three Months Ended			
(In Thousands)	June 30, 2002	March 31, 2002	December 31, 2001	September 30, 2001
Banking net income	$ 19,724	$ 35,557	$ 38,225	$ 22,301
Real estate investment net income (loss)	585	1,757	871	(535)
Total net income	$ 20,309	$ 37,314	$ 39,096	$ 21,766

	Six Months Ended June 30,	
	2002	2001
Banking net income	$55,281	$58,928
Real estate investment net income	2,342	391
Total net income	$57,623	$59,319

BANKING

Net income from our banking operations for the second quarter of 2002 totaled $19.7 million, down $13.9 million or 41.3% from $33.6 million in the second quarter of 2001. The decrease between second quarters primarily reflected a larger addition to the valuation allowance for mortgage servicing rights. The addition was reflected within the category of loan servicing loss and was necessary due to the approximate 60 basis point decline in long-term interest rates, which resulted in an increase in the projected rate at which loans serviced for others are expected to prepay, thereby shortening their expected

average life. In addition, the decline in long-term interest rates also reduced the expected value of associated custodial accounts. The pre-tax addition during the second quarter was $15.7 million, up from $2.4 million in the year-ago second quarter. Excluding the valuation allowances, our net income from our banking operations in the current quarter would have been $28.8 million, down $6.2 million or 17.6% from the adjusted year-ago level. Adjusted net income from banking operations decreased due to the following:

- a $6.0 million or 15.5% increase in operating expense due to higher costs associated with the increased number of branch locations and higher loan origination activity;
- a $5.0 million or 21.4% decrease in other income primarily due to:
  - a $2.7 million decrease in net gains from the sales of loans and mortgage servicing rights, as fewer loans were sold; and
  - a $2.6 million decrease in loan and deposit related fees due primarily to a $3.3 million decline in loan prepayment fees.
- a $1.1 million or 1.5% decrease in net interest income due to a decline in both the effective interest rate spread and average earning assets.

These items were partially offset by a $1.1 million reversal of provision for loan losses during the quarter due to improved credit quality and compares to the year-ago quarter provision of $0.4 million.

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

Three Months Ended

(In Thousands)	June 30, 2002	March 31, 2002	December 31, 2001	Septem 20
Net interest income	$ 75,115	$ 79,940	$ 79,730	$ 73
Provision for (reduction of) loan losses	(1,106)	1,447	1,290	
Other income	2,803	28,062	31,397	5
Operating expense	44,893	45,006	43,680	40
Net intercompany income	86	93	96	
Income before income taxes	34,217	61,642	66,253	38
Income taxes	14,493	26,085	28,028	16
Net income	$ 19,724	$ 35,557	$ 38,225	$ 22
AT PERIOD END				
Assets:				
Loans and mortgage-backed securities	$ 10,286,033	$ 10,088,113	$ 10,132,413	$ 9,912
Other	840,416	819,407	966,942	797
Total assets	11,126,449	10,907,520	11,099,355	10,710
Equity	$ 787,306	$ 767,622	$ 733,896	$ 698

For the first six months of 2002, our net income from banking totaled $55.3 million, down $3.6 million from the same period a year ago due primarily to the larger addition to the valuation allowance for mortgage servicing rights.

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The following table sets forth our banking operational results for the periods indicated.

(In Thousands)	Six Months Ended June 30, 2002	2001
Net interest income	$155,055	$152,370
Provision for loan losses	341	483
Other income	30,865	25,956
Operating expense	89,899	75,853
Net intercompany income ..	179	181
Income before income taxes	95,859	102,171
Income taxes	40,578	43,243
Net income	$ 55,281	$ 58,928

REAL ESTATE INVESTMENT

Net income from our real estate investment operations totaled $0.6 million in the second quarter of 2002, compared to a net loss of $0.2 million in the year-ago quarter. The increase was primarily attributed to lower operating expenses, as the year-ago quarter included expense pertaining to litigation matters associated with certain joint venture partners.

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

(In Thousands)	Three Months Ended June 30, 2002	March 31, 2002	December 31, 2001	Septembe 2001
Net interest income (expense)	$ 13	$ 5	$ (15)	$ (2
Other income	1,299	3,291	1,773	1,08
Operating expense	244	222	186	1,86
Net intercompany expense	86	93	96	9
Income (loss) before income taxes (benefit) ...	982	2,981	1,476	(89
Income taxes (benefit)	397	1,224	605	(36
Net income (loss)	$ 585	$ 1,757	$ 871	$ (53
AT PERIOD END				
Assets:				
Investment in real estate and joint ventures	$ 40,283	$ 26,384	$ 38,185	$ 38,04
Other	1,919	4,060	2,003	1,62
Total assets	42,202	30,444	40,188	39,67
Equity	$ 38,448	$ 24,963	$ 34,513	$ 33,64

For the first six months of 2002, our net income from real estate investment operations totaled $2.3 million, up from $0.4 million from the same period a year ago due primarily to sales activity and lower operating expenses, for the same reasons previously explained for the quarter.

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

Six Months Ended
June 30,
