DOWNEY FINANCIAL CORP
Form 10-Q
November 01, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **September 30, 2006**

OR

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

For the transition period from __________ to __________

Commission File Number **1-13578**

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

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

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

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

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

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

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

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DOWNEY FINANCIAL CORP.

September 30, 2006 QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Data)	*September 30, 2006*	*December 31, 2005*	*September 30, 2005*
Assets			
Cash	$ 179,780	$ 190,396	$ 171,225
Federal funds	1	-	2
Cash and cash equivalents	179,781	190,396	171,227
U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value	1,162,614	626,313	550,621
Loans held for sale, at lower of cost or fair value	323,428	464,488	501,611
Mortgage-backed securities available for sale, at fair value	257	277	284
Loans held for investment	14,872,642	15,391,759	14,877,306
Allowance for loan losses	(60,784)	(34,601)	(34,565)
Loans held for investment, net	14,811,858	15,357,158	14,842,741
Investments in real estate and joint ventures	55,663	49,344	49,351
Real estate acquired in settlement of loans	5,761	908	2,323
Premises and equipment	115,442	109,574	105,996
Federal Home Loan Bank stock, at cost	187,186	179,844	222,228
Mortgage servicing rights, net	20,310	20,302	19,117
Other assets	120,493	97,059	101,795
	$ 16,982,793	$ 17,095,663	$ 16,567,294
Liabilities and Stockholders Equity			
Deposits	$ 11,945,758	$ 11,876,848	$ 11,752,236
Securities sold under agreements to repurchase	463,678	-	-
Federal Home Loan Bank advances	2,680,546	3,557,515	3,162,808
Senior notes	198,216	198,087	198,045
Accounts payable and accrued liabilities	220,497	114,527	151,794
Deferred income taxes	121,869	140,467	130,883
Total liabilities	15,630,564	15,887,444	15,395,766
Stockholders equity			
Preferred stock, par value of $0.01 per share; authorized 5,000,000 shares;			

outstanding none	-	-	-
Common stock, par value of $0.01 per share; authorized 50,000,000 shares;			
issued 28,235,022 shares at September 30, 2006, December 31, 2005 and			
September 30, 2005; outstanding 27,853,783 shares at September 30, 2006,			
December 31, 2005 and September 30, 2005	282	282	282
Additional paid-in capital	93,792	93,792	93,792
Accumulated other comprehensive loss	(4,516)	(5,408)	(2,995)
Retained earnings	1,279,463	1,136,345	1,097,241
Treasury stock, at cost, 381,239 shares at September 30, 2006,			
December 31, 2005 and September 30, 2005	(16,792)	(16,792)	(16,792)
Total stockholders equity	1,352,229	1,208,219	1,171,528
	$ 16,982,793	$ 17,095,663	$ 16,567,294

See accompanying notes to consolidated financial statements.

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DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Data)	*Three Months Ended September 30,* 2006	2005	*Nine Months Ended September 30,* 2006	2005
Interest income				
Loans	$ 277,974	$ 214,068	$ 808,552	$ 604,022
U.S. Treasury and government sponsored entities securities	11,404	5,331	27,670	15,198
Mortgage-backed securities	3	3	9	9
Other investment securities	2,419	2,374	6,941	8,032
Total interest income	291,800	221,776	843,172	627,261
Interest expense				
Deposits	110,033	74,900	301,666	184,885
Federal Home Loan Bank advances and other borrowings	48,229	33,554	143,109	107,106
Senior notes	3,299	3,296	9,895	9,887
Total interest expense	161,561	111,750	454,670	301,878
Net interest income	130,239	110,026	388,502	325,383
Provision for (recovery of) credit losses	9,640	(751)	26,359	1,870
Net interest income after provision for (recovery of) credit losses	120,599	110,777	362,143	323,513
Other income, net				
Loan and deposit related fees	9,279	9,573	27,008	27,419
Real estate and joint ventures held for investment, net	5,331	3,307	10,173	7,615
Secondary marketing activities:				
Loan servicing income (loss), net	(377)	2,166	264	1,121
Net gains on sales of loans and mortgage-backed securities	14,847	29,499	35,120	108,962
Net gains on sales of mortgage servicing rights	-	19	-	1,000
Net gains on sales of investment securities	-	-	-	28
Litigation award	1,625	-	1,625	1,767
Other	(36)	971	719	1,830
Total other income, net	30,669	45,535	74,909	149,742
Operating expense				
Salaries and related costs	38,943	38,155	120,596	116,352

Premises and equipment costs	8,804	8,079	25,752	23,970
Advertising expense	1,211	1,557	4,332	4,458
Deposit insurance premiums and regulatory assessments	2,224	957	4,246	2,811
Professional fees	254	(69)	1,496	612
Other general and administrative expense	7,087	9,938	24,557	26,935
Total general and administrative expense	58,523	58,617	180,979	175,138
Net operation of real estate acquired in settlement of loans	166	91	185	76
Total operating expense	58,689	58,708	181,164	175,214
Income before income taxes	92,579	97,604	255,888	298,041
Income taxes	35,403	37,868	104,415	122,496
Net income	$ 57,176	$ 59,736	$ 151,473	$ 175,545
Per share information				
Basic	$ 2.05	$ 2.14	$ 5.43	$ 6.30
Diluted	$ 2.05	$ 2.14	$ 5.43	$ 6.30
Cash dividends declared and paid	$ 0.10	$ 0.10	$ 0.30	$ 0.30
Weighted average shares outstanding				
Basic	27,853,783	27,853,783	27,853,783	27,853,783
Diluted	27,883,198	27,884,352	27,883,567	27,883,489

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*	*2006*	*2005*
Net income	$ 57,176	$ 59,736	$ 151,473	$ 175,545
Other comprehensive income (loss), net of income taxes (benefits)				
Unrealized gains (losses) on securities available for sale:				
U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value	7,874	(1,962)	899	(3,677)
Mortgage-backed securities available for sale, at fair value	-	(1)	-	-
Reclassification of realized amounts included in net income	-	-	-	(17)
Unrealized gains (losses) on cash flow hedges:				
Net derivative instruments	(516)	344	923	289
Reclassification of realized amounts included in net income	315	51	(930)	92
Total other comprehensive income (loss), net of income tax (benefits)	7,673	(1,568)	892	(3,313)
Comprehensive income	$ 64,849	$ 58,168	$ 152,365	$ 172,232

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In Thousands)	*Nine Months Ended September 30,* 2006	2005
Cash flows from operating activities		
Net income	$ 151,473	$ 175,545
Adjustments to reconcile net income to net cash used for operating activities:		
Depreciation	9,809	9,486
Amortization	86,356	68,132
Provision for losses on loans, loan-related commitments, investments, real estate and joint ventures, mortgage servicing rights, real estate acquired in settlement of loans, and other assets	26,282	107
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, investment securities, real estate and other assets	(44,535)	(114,223)
Interest capitalized on loans (negative amortization)	(212,744)	(85,789)
Federal Home Loan Bank stock dividends	(6,903)	(7,618)
Loans originated and purchased for sale	(2,696,550)	(6,647,339)
Proceeds from sales of loans held for sale, including those sold as mortgage-backed securities	2,839,563	7,336,595
Other, net	(88,666)	(70,583)
Net cash provided by operating activities	64,085	664,313
Cash flows from investing activities		
Federal Home Loan Bank stock	-	46,364
Proceeds from maturities or calls of U.S. Treasury, government sponsored entities and other investment securities available for sale	51,450	26,555
Purchase of:		
U.S. Treasury, government sponsored entities and other investment securities available for sale	(486,220)	(86,601)
Loans held for investment	(21,671)	(39,196)
Premises and equipment	(25,413)	(12,700)
Federal Home Loan Bank stock	(439)	(17,361)
Originations of loans held for investment (net of refinances of $608,708 for the nine months ended September 30, 2006 and $517,559 for the nine months ended September 30, 2005)	(3,161,923)	(4,821,754)
Principal payments on loans held for investment and mortgage-backed securities available for sale	3,944,788	3,602,834
Net change in undisbursed loan funds	(39,625)	(17,505)
Investments in real estate and joint ventures held for investment:		

Proceeds from sales of wholly owned real estate and real estate acquired in settlement		
of loans	11,080	12,934
Other	(3,810)	413
Other, net	9,690	4,219
Net cash provided by (used for) investing activities	277,907	(1,301,798)

See accompanying notes to consolidated financial statements.

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DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

(In Thousands)	*Nine Months Ended September 30,* 2006	2005
Cash flows from financing activities		
Net increase in deposits	$ 68,910	$ 2,094,258
Proceeds from Federal Home Loan Bank advances and other borrowings	24,174,521	25,989,675
Repayments of Federal Home Loan Bank advances and other borrowings	(24,590,143)	(27,378,425)
Cash dividends	(8,355)	(8,355)
Other, net	2,460	(7,943)
Net cash provided by (used for) financing activities	(352,607)	689,210
Net increase (decrease) in cash and cash equivalents	(10,615)	51,725
Cash and cash equivalents at beginning of period	190,396	119,502
Cash and cash equivalents at end of period	$ 179,781	$ 171,227
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 459,210	$ 298,270
Income taxes	125,671	127,321
Supplemental disclosure of non-cash investing:		
Loans transferred to held for investment from held for sale	22,297	26,801
Loans transferred from held for investment to held for sale	953	106
U.S. Treasury, government sponsored entities and other investment securities		
available for sale, purchased and not settled	100,000	-
Loans exchanged for mortgage-backed securities	693,764	759,800
Real estate acquired in settlement of loans	5,937	1,959
Loans to facilitate the sale of real estate acquired in settlement of loans	-	126

See accompanying notes to consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) Basis of Financial Statement Presentation

In the opinion of Downey Financial Corp. and subsidiaries (Downey, we, us and our), the accompanying consolidated financial statements contain all adjustments (consisting of normal recurring accruals unless otherwise disclosed in this Form 10-Q) necessary for a fair presentation of Downey s financial condition as of September 30, 2006, December 31, 2005 and September 30, 2005, the results of operations and comprehensive income for the three months and nine months ended September 30, 2006 and 2005, and changes in cash flows for the nine months ended September 30, 2006 and 2005. Certain prior period amounts have been reclassified to conform to the current period presentation.

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements and are in compliance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial condition, results of operations, comprehensive income and cash flows. The information under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations presumes that the interim consolidated financial statements will be read in conjunction with Downey s Annual Report on Form 10-K for the year ended December 31, 2005, which contains among other things, a description of the business, the latest audited consolidated financial statements and notes thereto, together with Management s Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2005 and for the year then ended. Therefore, only material changes in financial condition and results of operations are discussed in the remainder of Part I.

NOTE (2) Reclassification of Prior Period Amounts

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

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

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NOTE (3) Mortgage Servicing Rights (MSRs)

The following table summarizes the activity in MSRs and its related allowance for the periods indicated and other related financial data.

	Three Months Ended				
(Dollars in Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Gross balance at beginning of period	$ 20,665	$ 20,420	$ 21,157	$ 20,917	$ 20,626
Additions [(a)]	896	1,285	1,022	1,740	1,858
Amortization	(1,056)	(1,029)	(1,198)	(1,252)	(1,346)
Sales	-	-	-	-	(87)
Impairment write-down	(22)	(11)	(561)	(248)	(134)
Gross balance at end of period	20,483	20,665	20,420	21,157	20,917
Allowance balance at beginning of period	104	255	855	1,800	3,793
Provision for (reduction of) impairment	91	(140)	(39)	(697)	(1,859)
Impairment write-down	(22)	(11)	(561)	(248)	(134)
Allowance balance at end of period	173	104	255	855	1,800
Total mortgage servicing rights, net	$ 20,310	$ 20,561	$ 20,165	$ 20,302	$ 19,117
As a percentage of associated mortgage loans	0.87 %	0.87 %	0.85 %	0.86 %	0.83 %
Estimated fair value [(b)]	$ 22,383	$ 23,644	$ 21,894	$ 20,351	$ 19,139
Weighted average expected life (in months)	51	56	51	47	47
Custodial account earnings rate	5.28 %	5.39 %	4.90 %	4.46 %	3.99 %
Weighted average discount rate	9.41	9.39	9.45	9.32	9.20
At period end					
Mortgage loans serviced for others:					
Total	$ 6,595,462	$ 6,377,737	$ 5,794,067	$ 5,292,253	$ 11,444,758
With capitalized mortgage servicing rights:[(b)]					
Amount	2,345,880	2,369,543	2,372,534	2,362,539	2,310,726
Weighted average interest rate	5.70 %	5.66 %	5.63 %	5.60 %	5.57 %
Total loans sub-serviced without mortgage					
servicing rights: [(c)]					
Term less than six months	$ 981,883	$ 228,455	$ 153,655	$ 123,552	$ 292,480
Term indefinite	3,249,905	3,760,642	3,248,012	2,785,090	8,818,890

Custodial account balances	$ 171,481	$ 147,831	$ 124,324	$ 117,451	$ 326,906

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

	Nine Months Ended September 30,	
(Dollars in Thousands)	*2006*	*2005*
Gross balance at beginning of period	$ 21,157	$ 20,502
Additions [(a)]	3,203	4,684
Amortization	(3,283)	(3,904)
Sales	-	(101)
Impairment write-down	(594)	(264)
Gross balance at end of period	20,483	20,917
Allowance balance at beginning of period	855	2,538
Reduction of impairment	(88)	(474)
Impairment write-down	(594)	(264)
Allowance balance at end of period	173	1,800
Total mortgage servicing rights, net	$ 20,310	$ 19,117

[(a)] *Includes minor amounts repurchased.*

Key assumptions, which vary due to changes in market interest rates and are used to determine the fair value of MSRs, include: expected prepayment speeds, which impact the average life of the portfolio; the earnings rate on custodial accounts, which impacts the value of custodial accounts; and the discount rate used in valuing future cash flows. The following table summarizes the estimated changes in the fair value of mortgage servicing rights for changes in those assumptions individually and in combination associated with an immediate 100 basis point increase or decrease in market rates. The table also summarizes the earnings impact associated with provisions for or reductions of the valuation allowance for mortgage servicing rights. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, which include loans by loan term and coupon rate stratified in 50 basis point increments. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income. Certain stratum may have impairment, while other stratum may not. Therefore, changes in overall fair value may not equal provisions for or reductions of the valuation allowance.

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

(Dollars in Thousands)	*Expected Prepayment Speeds*	*Custodial Accounts Rate*	*Discount Rate*	*Combination*
Increase rates 100 basis points: [(a)]				
Increase (decrease) in fair value	$ 1,865	$ 1,156	$ (785)	$ 2,223
Reduction of (increase in) valuation allowance	113	77	(92)	123
Decrease rates 100 basis points: [(b)]				
Increase (decrease) in fair value	(5,049)	(1,188)	800	(6,034)
Reduction of (increase in) valuation allowance	(4,245)	(190)	63	(4,872)

[(a)] *The weighted-average expected life of the MSRs portfolio becomes 60 months.*
[(b)] *The weighted-average expected life of the MSRs portfolio becomes 33 months.*

The following table presents a breakdown of the components of loan servicing income (loss), net included in Downey s results of operations for the periods indicated.

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Net cash servicing fees	$ 1,583	$ 1,574	$ 1,566	$ 1,743	$ 1,968
Payoff and curtailment interest cost [(a)]	(813)	(233)	(218)	(250)	(315)
Amortization of mortgage servicing rights	(1,056)	(1,029)	(1,198)	(1,252)	(1,346)
(Provision for) reduction of impairment of mortgage servicing rights	(91)	140	39	697	1,859
Total loan servicing income (loss), net	$ (377)	$ 452	$ 189	$ 938	$ 2,166

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Net cash servicing fees	$ 4,723	$ 5,348
Payoff and curtailment interest cost [a]	(1,264)	(797)
Amortization of mortgage servicing rights	(3,283)	(3,904)
Reduction of impairment of mortgage servicing rights	88	474
Total loan servicing income, net	$ 264	$ 1,121

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

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NOTE (4) Derivatives, Hedging Activities, Financial Instruments with Off-Balance Sheet Risk and Other Contractual Obligations (Risk Management)

Derivatives

Downey offers short-term interest rate lock commitments to help attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if underwriting standards are met, but do not obligate the potential borrower. Accordingly, some commitments never become loans and merely expire. The residential one-to-four unit interest rate lock commitments Downey ultimately expects to result in loans to be sold in the secondary market are treated as derivatives. Consequently, as derivatives, the hedging of the interest rate lock commitments does not qualify for hedge accounting. Associated fair value adjustments to the interest rate lock commitments are recorded in current earnings under net gains (losses) on sales of loans and mortgage-backed securities with an offset to the balance sheet in either other assets, or accounts payable and accrued liabilities. Fair values for the interest rate lock commitments are based on dealer quoted market prices acquired from third parties. The carrying amount of loans held for sale includes a basis adjustment to the loan balance at funding resulting from the change in fair value of the interest rate lock derivative from the date of commitment to the date of funding. At September 30, 2006, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $236 million, with a change in fair value resulting in a recorded gain of $0.1 million.

Downey does not generally enter into derivative transactions for purely speculative purposes.

Hedging Activities

As part of its secondary marketing activities, Downey typically utilizes short-term loan forward sale and purchase contracts derivatives that mature in less than one year to offset the impact of changes in market interest rates on the value of residential one-to-four unit interest rate lock commitments and loans held for sale. In general, interest rate lock commitments associated with fixed rate loans require a higher percentage of loan forward sale contracts to mitigate interest rate risk than those associated with adjustable rate loans. Contracts designated as hedges for the forecasted sale of loans from the held for sale portfolio are accounted for as cash flow hedges because these contracts have a high correlation to the price movement of the loans being hedged (within a range of 80% - 125%). The measurement approach for determining the ineffective aspects of the hedge is established at the inception of the hedge. Changes in fair value of the loan forward sale contracts not designated as cash flow hedges and the ineffectiveness of hedge transactions that are not perfectly correlated are recorded in net gains (losses) on sales of loans and mortgage-backed securities. Changes in expected future cash flows related to the fair value of the loan forward sale contracts designated as cash flow hedges for the forecasted sale of loans held for sale are recorded in other comprehensive income (loss), net of tax, provided cash flow hedge requirements are met. The offset to these changes are recorded in the balance sheet as either other assets, or accounts payable and accrued liabilities. The amounts recorded in accumulated other comprehensive income (loss) are recognized in the income statement when the hedged forecasted transactions settle. Downey estimates that all of the related unrealized gains or losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. Fair values for the loan forward sale contracts are based on dealer quoted market prices acquired from third parties. At September 30, 2006, the notional amount of loan forward sale contracts amounted to $522 million, with a change in fair value resulting in a loss of $1.2 million, of which $308 million were designated as cash flow hedges. There were no loan forward purchase contracts at September 30, 2006.

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

In connection with its interest rate risk management, Downey from time-to-time enters into interest rate exchange agreements (swap contracts) with certain national investment banking firms or the Federal Home Loan Bank (FHLB) under terms that provide mutual payment of interest on the outstanding notional amount of swap contracts. These swap contracts help Downey manage the effects of adverse changes in interest rates on net interest income. Downey has interest rate swap contracts on which Downey pays variable interest based on the 3-month London Inter-Bank Offered Rate (LIBOR) while receiving fixed interest. The swaps were designated as a hedge of changes in the fair value of certain FHLB fixed rate advances due to changes in market interest rates. The payment and maturity dates of the swap contracts match those of the advances. This hedge effectively converts fixed interest rate advances into debt that adjusts quarterly to movements in 3-month LIBOR. Because the terms of the swap contracts match those of the advances, the hedge has no ineffectiveness and results are reported in interest expense. The fair value of interest rate swap contracts is based on dealer quoted market prices acquired from third parties and represents the estimated amount Downey would receive or pay upon terminating the contracts, taking into consideration current interest rates and the remaining contract terms. The fair value of the swap contracts is recorded on the balance sheet in either other assets or accounts payable and accrued liabilities. With no ineffectiveness, the recorded swap contract values will essentially act as fair value adjustments to the advances being hedged.

At September 30, 2006, swap contracts with a notional amount totaling $430 million were outstanding and had a fair value loss of $15 million recorded on the balance sheet in accounts payable and accrued liabilities and as a decrease to the advances being hedged.

The following table summarizes Downey s interest rate swap contracts at September 30, 2006.

(Dollars in Thousands)	*Notional Amount*	*Weighted Average Interest Rate*	*Term*	
Pay Variable (3-month LIBOR)	$ (100,000)	5.40 %	March 2004	October 2008
Receive Fixed	100,000	3.20		
Pay Variable (3-month LIBOR)	(130,000)	5.40	March 2004	October 2008
Receive Fixed	130,000	3.21		
Pay Variable (3-month LIBOR)	(100,000)	5.40	March 2004	November 2008
Receive Fixed	100,000	3.26		
Pay Variable (3-month LIBOR)	(100,000)	5.40	March 2004	November 2008
Receive Fixed	100,000	3.27		

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Net gains (losses) on non-qualifying hedge transactions	$ (304)	$ (733)	$ 238	$ 841	$ (1,400)
Net gains on qualifying cash flow hedge transactions:					
Unrealized hedge ineffectiveness	-	-	-	-	-
Less reclassification of realized hedge ineffectiveness	-	-	-	-	-
Total net gains (losses) recognized in sales of loans and					
mortgage-backed securities (SFAS 133 effect)	(304)	(733)	238	841	(1,400)
Other comprehensive income (loss)	(201)	(385)	579	(406)	395
Notional amount or balance at period end					
Non-qualifying hedge transactions:					
Interest rate lock commitments [(a)]	$ 236,435	$ 237,867	$ 307,635	$ 285,002	$ 513,459

Associated loan forward sale contracts	213,783	209,815	261,359	268,321	402,363
Qualifying cash flow hedge transactions:					
Loans held for sale, at lower of cost or fair value	323,428	417,691	561,511	464,488	501,611
Associated loan forward sale contracts	307,982	398,741	544,141	449,923	489,137
Qualifying fair value hedge transactions:					
Designated FHLB advances pay-fixed	430,000	430,000	430,000	430,000	430,000
Associated interest rate swap contracts					
pay-variable, receive-fixed	430,000	430,000	430,000	430,000	430,000

[a] *Amounts are reduced by an anticipated fallout factor for those commitments not expected to fund.*

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Net gains (losses) on non-qualifying hedge transactions	$ (799)	$ 2,771
Net gains on qualifying cash flow hedge transactions:		
Unrealized hedge ineffectiveness	-	-
Less reclassification of realized hedge ineffectiveness	-	-
Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	(799)	2,771
Other comprehensive income (loss)	(7)	381

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

Financial Instruments with Off-Balance Sheet Risk

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

Commitments to originate fixed and variable rate mortgage loans are agreements to lend to a customer as long as there is no violation of any condition established in the commitment. Commitments generally have fixed expiration dates or other termination clauses and some require payment of a fee. Since some commitments expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Undisbursed loan funds on construction projects and unused lines of credit on home equity and commercial loans include committed funds not disbursed. Letters of credit are conditional commitments issued by Downey to guarantee the performance of a customer to a third party. Downey also enters into commitments to purchase loans and mortgage-backed securities, investment securities and to invest in community development funds.

The following is a summary of commitments with off-balance sheet risk at the dates indicated.

(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Commitments to originate adjustable rate loans held for investment	$ 201,662	$ 338,222	$ 508,426	$ 390,238	$ 639,249
Undisbursed loan funds and unused lines of credit	370,159	391,395	406,675	409,555	440,257

Downey uses the same credit policies in making commitments to originate loans held for investment and lines and letters of credit as it does for on-balance sheet instruments. For commitments to originate loans held for investment, the committed amounts represent exposure to loss from market fluctuations as well as credit loss. In regard to these commitments, adverse changes from market fluctuations are generally not hedged. Downey controls the credit risk of its commitments to originate loans held for investment through credit approvals, limits and monitoring procedures. The credit risk involved in issuing lines and letters of credit requires the same creditworthiness evaluation as that involved in extending loan facilities to customers. Downey evaluates each customer s creditworthiness.

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

Downey maintains an allowance for losses to provide for inherent losses for loan-related commitments associated with undisbursed loan funds and unused lines of credit. The allowance for losses on loan-related commitments was $1 million at September 30, 2006, December 31, 2005 and September 30, 2005.

Other Contractual Obligations

Downey sells all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty made to the investor in connection with the sale. If such a defect is identified, Downey may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, Downey has no commitment to repurchase the loan. During the first nine months of 2006, Downey recorded a $0.9 million repurchase loss related to defects in the origination process and repurchased $3 million of loans. These loan and servicing sale contracts typically contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Downey reserved less than $1 million at September 30, 2006, December 31, 2005 and September 30, 2005 to cover the estimated loss exposure related to early payoffs. However, if all the loans related to those sales prepaid within the refund period, as of September 30, 2006, Downey s maximum sales price premium refund would be $10.1 million.

Through the normal course of business, Downey has entered into certain contractual obligations. Downey s obligations generally relate to the funding of operations through deposits and borrowings, loan servicing, as well as leases for premises and equipment. Downey s long-term operating leases are principally for building space and land. Lease terms generally cover a five-year period, with options to extend, and are non-cancelable. Downey also has vendor contractual relationships, but the contracts are not considered to be material.

At September 30, 2006, scheduled maturities of certificates of deposit, FHLB advances and other borrowings, senior notes and future operating minimum lease commitments were as follows:

(In Thousands)	*Within 1 Year*	*1 3 Years*	*4 5 Years*	*Over 5 Years*	*Total Balance*
Certificates of deposit	$ 8,728,363	$ 325,881	$ 125,185	$ -	$ 9,179,429
FHLB advances and other borrowings	2,729,678	414,546	-	-	3,144,224
Senior notes	-	-	-	198,216	198,216
Operating leases	5,005	7,181	3,180	987	16,353
Total other contractual obligations	$ 11,463,046	$ 747,608	$ 128,365	$ 199,203	$ 12,538,222

Litigation

On June 21, 2005, a former loan underwriting employee brought an action in Contra Costa Superior Court, Case No. C05-01293, entitled Teresa Sims, et al. v. Downey Savings and Loan Association. The complaint seeks unspecified damages for alleged unpaid overtime wages and bonuses, inadequate meal and rest breaks, and related claims. The plaintiff is seeking class action status to represent all other current and former Downey Savings employees that held the position of loan underwriter, including, but not limited to, the job title of Senior Loan Underwriter within the State of California (a) at any time during the four years prior to June 21, 2005 and/or (b) who was employed by Downey Savings on or about September 30, 2002, when Downey Savings terminated an annual bonus program. Based on a review of the current facts and circumstances with retained outside counsel, (i) Downey Savings plans to oppose the claim and assert all appropriate defenses and (ii) management has provided for what is believed to be a reasonable estimate of exposure for this matter in the event of loss. While acknowledging the uncertainties of litigation, management believes that the ultimate outcome of this matter will not have a material adverse effect on its operations, cash flows or financial position.

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

NOTE (5) Income Taxes

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

During the third quarter of 2006, Downey resolved prior year tax issues that resulted in a reduction to tax expense of $3.6 million.

NOTE (6) Employee Stock Option Plans

During 1994, the Bank adopted and the stockholders approved the Downey Savings and Loan Association 1994 Long Term Incentive Plan (LTIP). The LTIP provided for the granting of stock appreciation rights, restricted stock, performance awards and other awards. Effective January 23, 1995, Downey Financial Corp. and the Bank executed an amendment to the LTIP by which Downey Financial Corp. adopted and ratified the LTIP such that shares of Downey Financial Corp. shall be issued upon exercise of options or payment of other awards, for which payment is to be made in stock, in lieu of the Bank s common stock. The LTIP terminated in 2004; however, options granted and outstanding at termination remain exercisable until the specific termination date of the option. At September 30, 2006, options for 52,914 shares were outstanding at a weighted average remaining contractual life of 3 years, all of which were exercisable at a weighted average option price per share of $25.44, which represented at least the fair market value of such shares on the date the options were granted. At September 30, 2006, 381,239 shares of treasury stock existed that may be used to satisfy the exercise of the options. No other stock based plan exists.

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

NOTE (7) Earnings Per Share

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

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

	Three Months Ended September 30,					
	2006			*2005*		
(Dollars in Thousands, Except Per Share Data)	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*
Basic earnings per share	$ 57,176	27,853,783	$ 2.05	$ 59,736	27,853,783	$ 2.14
Effect of dilutive stock options	-	29,415	-	-	30,569	-
Diluted earnings per share	$ 57,176	27,883,198	$ 2.05	$ 59,736	27,884,352	$ 2.14

Nine Months Ended September 30,

2006 *2005*

(Dollars in Thousands, Except Per Share Data)	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*
Basic earnings per share	$ 151,473	27,853,783	$ 5.43	$ 175,545	27,853,783	$ 6.30
Effect of dilutive stock options	-	29,784	-	-	29,706	-
Diluted earnings per share	$ 151,473	27,883,567	$ 5.43	$ 175,545	27,883,489	$ 6.30

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

NOTE (8) Business Segment Reporting

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

(In Thousands)	*Banking*	*Real Estate Investment*	*Elimination*	*Totals*
Three months ended September 30, 2006				
Net interest income	$ 129,870	$ 369	$ -	$ 130,239
Provision for credit losses	9,640	-	-	9,640
Other income	25,090	5,579	-	30,669
Operating expense	59,801	(1,112)	-	58,689
Net intercompany income (expense)	(38)	38	-	-
Income before income taxes	85,481	7,098	-	92,579
Income taxes	32,493	2,910	-	35,403
Net income	$ 52,988	$ 4,188	$ -	$ 57,176
At September 30, 2006				
Assets:				
Loans and mortgage-backed securities, net	$ 15,135,543	$ -	$ -	$ 15,135,543
Investments in real estate and joint ventures	-	55,663	-	55,663
Other	1,838,950	28,978	(76,341)	1,791,587
Total assets	16,974,493	84,641	(76,341)	16,982,793
Equity	$ 1,352,229	$ 76,341	$ (76,341)	$ 1,352,229
Three months ended September 30, 2005				
Net interest income	$ 109,878	$ 148	$ -	$ 110,026
Recovery of credit losses	(751)	-	-	(751)
Other income	41,881	3,654	-	45,535
Operating expense	58,426	282	-	58,708
Net intercompany income (expense)	29	(29)	-	-
Income before income taxes	94,113	3,491	-	97,604
Income taxes	36,426	1,442	-	37,868
Net income	$ 57,687	$ 2,049	$ -	$ 59,736
At September 30, 2005				
Assets:				
	$ 15,344,636	$ -	$ -	$ 15,344,636

Loans and mortgage-backed securities, net				
Investments in real estate and joint ventures	-	49,351	-	49,351
Other	1,214,285	29,429	(70,407)	1,173,307
Total assets	16,558,921	78,780	(70,407)	16,567,294
Equity	$ 1,171,528	$ 70,407	$ (70,407)	$ 1,171,528

(In Thousands)	*Banking*	*Real Estate Investment*	*Elimination*	*Totals*
Nine months ended September 30, 2006				
Net interest income	$ 387,523	$ 979	$ -	$ 388,502
Provision for loan losses	26,359	-	-	26,359
Other income	63,949	10,960	-	74,909
Operating expense	181,250	(86)	-	181,164
Net intercompany income (expense)	(5)	5	-	-
Income before income taxes	243,858	12,030	-	255,888
Income taxes	99,484	4,931	-	104,415
Net income	$ 144,374	$ 7,099	$ -	$ 151,473
Nine months ended September 30, 2005				
Net interest income	$ 325,022	$ 361	$ -	$ 325,383
Provision for loan losses	1,870	-	-	1,870
Other income	141,241	8,501	-	149,742
Operating expense	174,314	900	-	175,214
Net intercompany income (expense)	(48)	48	-	-
Income before income taxes	290,031	8,010	-	298,041
Income taxes	119,202	3,294	-	122,496
Net income	$ 170,829	$ 4,716	$ -	$ 175,545

NOTE (9) Recently Issued Accounting Standards

Financial Accounting Standards Board Interpretation No. 48

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

Statement of Financial Accounting Standards No. 155

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

Statement of Financial Accounting Standards No. 156

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

Statement of Financial Accounting Standards No. 157

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. Additionally, it establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. Downey is currently evaluating the impact, if any, that SFAS 157 will have on its financial condition and results of operations.

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Statement of Financial Accounting Standards No. 158

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), ("SFAS 158"), which requires employers to recognize the underfunded or overfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through accumulated other comprehensive income. Additionally, SFAS 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position. The new reporting requirements and related new footnote disclosure rules of SFAS No. 158 are effective for fiscal years ending after December 15, 2006. The new measurement date requirement applies for fiscal years ending after December 15, 2008. Adoption of SFAS 158 is not expected to have a material impact on Downey.

Staff Accounting Bulletin No. 108

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," ("SAB 108"), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 must be applied to annual financial statements for their first fiscal year ending after November 15, 2006.

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

Certain statements under this caption may constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995, which involve risks and uncertainties. Forward-looking statements do not relate strictly to historical information or current facts. Some forward-looking statements may be identified by use of terms such as expects, anticipates, intends, plans, believes, seeks, estimates, c similar meaning, or future or conditional verbs such as will, would, should, could or may. Our actual results may differ significantly fron results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation. For additional information concerning these factors, see Part II Other Information Item 1A. Risk Factors on page 55. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made.

OVERVIEW

Our net income for the third quarter of 2006 totaled $57.2 million or $2.05 per share on a diluted basis, down $2.6 million or 4.3% from $59.7 million or $2.14 per share in the third quarter of 2005.

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

- a $14.7 million decline in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans sold;
- a $10.4 million increase in provision for credit losses due to continuing signs of weakening in the California real estate market, continued increases in negative amortization and an upward trend in loan defaults; and
- a $2.5 million unfavorable change in income from loan servicing activities due primarily to changes in our valuation allowance for mortgage servicing rights.

Those unfavorable items were partially offset by:

- a $20.2 million or 18.4% increase in net interest income reflecting both higher average interest-earning assets and effective interest rate spread;
- a $2.0 million increase in income from real estate held for investment due to higher gains from sales; and
- a $1.6 million litigation award received in the current quarter.

Both the current and year-ago third quarters included reductions to income tax expense from the settlement of prior-year tax returns. However, the current quarter reduction of $3.6 million was above the $3.2 million reduction of a year ago.

For the first nine months of 2006, our net income totaled $151.5 million or $5.43 per share on a diluted basis, down $24.1 million or 13.7% from the $175.5 million or $6.30 per share for the first nine months of 2005. The decrease primarily reflected declines in net gains from sales of loans and mortgage-backed securities, an increase in provision for credit losses and higher operating expenses. Those unfavorable items were partially offset by higher net interest income.

For the third quarter, our return on average assets was 1.33%, down from 1.44% a year ago, while our return on average equity was 17.32%, down from 20.92% a year ago. For the first nine-month periods, our return on average assets declined from 1.41% a year ago to 1.16%, while our return on average equity declined from 21.56% to 15.87%.

At September 30, 2006, assets totaled $16.983 billion, up $415 million or 2.5% from a year ago but down $113 million or 0.7% from year-end 2005. During the current quarter, assets declined $482 million or 2.8% due primarily to declines of $709 million in loans held for investment and $94 million in loans held for sale, partially offset by a $270 million increase in securities available for sale. Included within loans held for investment at quarter end were $12.327 billion of one-to-four unit adjustable rate mortgages subject to negative amortization, down $895 million from June 30, 2006. The amount of negative amortization included in loan balances increased $48 million during the current quarter to $277 million or 2.25% of loans subject to negative amortization. During the current quarter, approximately 28% of loan interest income represented negative amortization, up from both 26% in the second quarter of 2006 and 18% in the year-ago third quarter. At origination, these loans had a weighted average loan-to-value ratio of 73%.

Loan originations (including purchases) totaled $1.605 billion in the current quarter, down $2.039 billion or 56.0% from $3.644 billion a year ago. Loans originated for sale declined $876 million or 51.5% to $824 million, while single family loans originated for portfolio declined $1.147 billion or 60.0% to $765 million. Of all loans originated for portfolio this quarter, $8 million represented subprime credits. At quarter end, the subprime portfolio totaled $692 million, with an average loan-to-value ratio at origination of 70% and, of the total, 97% represented "Alt. A and A-" credits. In addition to single family loans, $16 million of other loans were originated in the current quarter. For the first nine months of 2006, loan originations totaled $6.489 billion, down 46.0% from $12.026 billion in the same period a year ago.

Deposits totaled $11.946 billion at quarter end, up 1.6% from a year ago and up 0.6% from year-end 2005. At quarter end, the number of branches totaled 171 (167 in California and four in Arizona), unchanged from June 30, 2006. During the current quarter, one in-store branch was closed due to the closure of the store in which it was located and one traditional branch was opened. At quarter end, the average deposit size of our 81 traditional branches was $116 million, while the average deposit size of our 90 in-store branches was $28 million. Borrowings represented 19.7% of total assets at quarter-end and were down $413 million from year-end 2005.

Non-performing assets increased during the quarter by $27 million to $67 million and represented 0.39% of total assets, compared with 0.21% at year-end 2005. The increase occurred in both our prime and subprime residential loan categories.

At September 30, 2006, Downey Savings and Loan Association, F.A. (the Bank), our primary subsidiary, exceeded all regulatory capital requirements, with capital-to-asset ratios of 8.47% for both tangible and core capital and 17.05% for risk-based capital. These capital levels are significantly above the well capitalized standards defined by the federal banking regulators of 5% for core capital and 10% for risk-based capital.

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CRITICAL ACCOUNTING POLICIES

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey s Annual Report on Form 10-K for the year ended December 31, 2005. Certain accounting policies require us to make significant estimates and assumptions which could have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the future carrying value of assets and liabilities and our results of operations for the reporting periods. Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors.

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

- The valuation of interest rate lock commitments. We enter into commitments to make loans that we intend to sell to investors whereby the interest rate on the loan is set prior to funding. These interest rate lock commitments are considered to be derivatives and are recorded at fair value. This value is calculated using market sources, reduced by an anticipated fallout factor for interest rate lock commitments that are not expected to fund. At September 30, 2006, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of $236 million, with a change in fair value resulting in a gain of $0.1 million, compared to a notional amount of interest rate lock commitments of $513 million with a change in fair value resulting in a loss of $0.8 million at September 30, 2005. For further information, see Note 4 on page 9 of Notes to Consolidated Financial Statements.
- The allowance for credit and real estate losses. The allowance for credit losses, which includes an allowance for loan losses reported as a reduction of outstanding loans and an allowance for loan-related commitments included in accounts payable and accrued liabilities, and the allowance for real estate losses reported as a reduction to real estate held for investment are maintained at amounts management deems adequate to cover inherent losses in the portfolios. On March 31, 2006, we reclassified to accounts payable and accrued liabilities our allowance for loan-related commitments which was previously included with the allowance for loan losses. We use an internal asset review system and credit loss allowance methodology designed to provide for the detection of problem assets and an adequate allowance to cover credit losses. In determining the allowance for credit losses related to loan relationships of $5 million or more, we evaluate the loans on an individual basis, including an analysis of the borrower s creditworthiness, cash flows and financial status, and the condition and the estimated value of the collateral. Unless an individual loan or borrower relationship warrants separate analysis, we generally review all loans under $5 million by analyzing their performance and the composition of their collateral as a whole because of the relatively homogeneous nature of the loans. This allowance is determined by applying against asset and loan-related commitment balances the associated loss factors for each major credit type that consider past loss experience and asset duration, or loss statistics against current classified credit balances. Those amounts may be adjusted based upon an analysis of macro-economic and other trends that are likely to affect a borrower s ability to repay their loan according to their loan terms. The allowance for credit and real estate losses totaled $62 million at September 30, 2006, compared to $36 million at September 30, 2005. For further information, see Allowance for Credit and Real Estate Losses on page 47.
- The valuation of mortgage servicing rights (MSRs). The fair value of MSRs is measured using a discounted cash flow analysis based on available market quotes, anticipated prepayment speeds, a custodial account rate and market-adjusted discount rates. Market sources are used to determine prepayment speeds, the net cost of servicing per loan, inflation rate, and default and interest rates for mortgages. MSRs are reviewed for impairment based on their fair value. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, which include loans by loan term and coupon rate stratified at 50 basis point increments. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income. During the first quarter of 2006, the coupon rate strata was reduced, which did not have a significant impact on the valuation allowance. At September 30, 2006, the MSR valuation allowance totaled less than $1 million, compared to $2 million at September 30, 2005. For further information, see Note 3 on page 7 of Notes to Consolidated Financial Statements.

- The prepayment reserves related to sales of loans and MSRs. The gains on sales of loans and of MSRs are recorded net of reserves for anticipated prepayments. These sales contracts typically contain provisions to refund sale price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Loan and MSR sales reserves are estimated using the prepayment experience of similar products. The estimates are updated during the 120 day period for actual payoffs. The reserve was less than $1 million at both September 30, 2006 and September 30, 2005. For further information, see Note 3 on page 7 and Note 4 on page 9 of Notes to Consolidated Financial Statements and Secondary Marketing Activities on page 26.

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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 interest income totaled $130.2 million in the third quarter of 2006, up $20.2 million or 18.4% from a year ago. This increase reflected increases in both average interest-earning assets and the effective interest rate spread. Interest-earning assets averaged $16.789 billion in the current quarter, up $656 million or 4.1% from the same period a year ago. The effective interest rate spread averaged 3.10% in the current quarter, up 0.37% from 2.73% a year ago, and up 0.03% from 3.07% in the second quarter of 2006. The increase in the effective interest rate spread between third quarters primarily reflected two items. First, interest-earning assets in the current quarter were funded with a higher proportion of interest free funds (non-interest bearing checking accounts and the excess of interest-earning assets over deposits and borrowings), and the value of those funds was worth more due to the higher interest rate levels prevalent in the quarter. Second, loan prepayment fees covered a higher proportion of the deferred loan costs that were written-off as a result of those payoffs. For further information regarding a reclassification of certain prior period amounts, see Note 2 on page 6 of Notes to Consolidated Financial Statements.

For the first nine months of 2006, net interest income totaled $388.5 million, up $63.1 million or 19.4% from the year-ago period. The increase was due to higher interest-earning asset levels and a higher effective interest rate spread.

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

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

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

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

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

	Three Months Ended September 30,					
	2006			2005		
(Dollars in Thousands)	Average Balance	Interest	Average Yield/Rate	Average Balance	Interest	Average Yield/Rate
Average balance sheet data						
Interest-earning assets:						
Loans:						
Loan prepayment fees		$ 26,451	0.67 %		$ 21,947	0.57 %
Write-off of deferred costs and premiums from loan payoffs		(26,248)	(0.67)		(24,081)	(0.63)
All other		277,771	7.11		216,202	5.63
Total loans	$ 15,629,328	277,974	7.11	$ 15,370,378	214,068	5.57
Mortgage-backed securities	260	3	4.62	288	3	4.17
Investment securities [a]	1,159,674	13,823	4.73	762,543	7,705	4.01
Total interest-earnings assets	16,789,262	$ 291,800	6.95 %	16,133,209	$ 221,776	5.50 %
Non-interest-earning assets	451,281			435,116		
Total assets	$ 17,240,543			$ 16,568,325		
Transaction accounts:						
Non-interest-bearing checking	$ 764,207	$ -	- %	$ 833,616	$ -	- %
Interest-bearing checking [b]	487,811	426	0.35	527,892	474	0.36
Money market	153,777	404	1.04	161,275	425	1.05
Regular passbook	1,413,319	3,533	0.99	2,059,920	5,464	1.05
Total transaction accounts	2,819,114	4,363	0.61	3,582,703	6,363	0.70
Certificates of deposit	9,168,872	105,670	4.57	7,916,147	68,537	3.43
Total deposits	11,987,986	110,033	3.64	11,498,850	74,900	2.58
FHLB advances and other borrowings [c]	3,386,019	48,229	5.65	3,485,347	33,554	3.82
Senior notes	198,199	3,299	6.66	198,031	3,296	6.66
Total deposits and borrowings	15,572,204	161,561	4.12	15,182,228	111,750	2.92
Other liabilities	348,036			244,113		
Stockholders equity	1,320,303			1,141,984		
Total liabilities and stockholders equity	$ 17,240,543			$ 16,568,325		

Net interest income/interest rate spread		$ 130,239	2.83 %		$ 110,026	2.58 %
Excess of interest-earning assets over						
deposits and borrowings	$ 1,217,058			$ 950,981		
Effective interest rate spread			3.10			2.73

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

	Nine Months Ended September 30,					
	2006			2005		
(Dollars in Thousands)	*Average Balance*	*Interest*	*Average Yield/Rate*	*Average Balance*	*Interest*	*Average Yield/Rate*
Average balance sheet data						
Interest-earning assets:						
Loans:						
Loan prepayment fees		$ 73,810	0.61 %		$ 47,945	0.41 %
Write-off of deferred costs and premiums from loan payoffs		(74,311)	(0.62)		(55,877)	(0.48)
All other		809,053	6.74		611,954	5.30
Total loans	$ 16,016,713	808,552	6.73	$ 15,404,317	604,022	5.23
Mortgage-backed securities	268	9	4.48	295	9	4.07
Investment securities [(a)]	994,502	34,611	4.65	760,572	23,230	4.08
Total interest-earnings assets	17,011,483	$ 843,172	6.61 %	16,165,184	$ 627,261	5.17 %
Non-interest-earning assets	432,356			410,747		
Total assets	$ 17,443,839			$ 16,575,931		
Transaction accounts:						
Non-interest-bearing checking	$ 736,206	$ -	- %	$ 715,853	$ -	- %
Interest-bearing checking [(b)]	503,844	1,300	0.34	532,438	1,430	0.36
Money market	159,842	1,248	1.04	159,176	1,246	1.05
Regular passbook	1,568,114	11,857	1.01	2,328,477	18,759	1.08
Total transaction accounts	2,968,006	14,405	0.65	3,735,944	21,435	0.77
Certificates of deposit	9,035,528	287,261	4.25	6,951,553	163,450	3.14
Total deposits	12,003,534	301,666	3.36	10,687,497	184,885	2.31
FHLB advances and other borrowings [(c)]	3,654,092	143,109	5.24	4,368,285	107,106	3.28
Senior notes	198,156	9,895	6.66	197,989	9,887	6.66
Total deposits and borrowings	15,855,782	454,670	3.83	15,253,771	301,878	2.65
Other liabilities	315,311			236,472		
Stockholders equity	1,272,746			1,085,688		
Total liabilities and stockholders equity	$ 17,443,839			$ 16,575,931		

Net interest income/interest rate spread		$ 388,502	2.78 %	$ 325,383	2.52 %
Excess of interest-earning assets over					
deposits and borrowings	$ 1,155,701			$ 911,413	
Effective interest rate spread			3.05		2.68

[(a)] *Yields for securities available for sale are calculated using historical cost balances and do not give effect to changes in fair value that are reflected as a component of stockholders equity.*
[(b)] *Included amounts swept into money market deposit accounts.*
[(c)] *The impact of swap contracts was included, with notional amounts totaling $430 million of receive-fixed, pay-3-month 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 periods indicated. For each category of interest-earning assets and interest-bearing liabilities, we have provided information on changes attributable to:

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

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

	Three Months Ended September 30, 2006 Versus 2005 Changes Due To				*Nine Months Ended September 30, 2006 Versus 2005 Changes Due To*			
(In Thousands)	*Volume*	*Rate*	*Rate/ Volume*	*Net*	*Volume*	*Rate*	*Rate/ Volume*	*Net*
Interest income:								
Loans	$ 3,606	$ 59,301	$ 999	$ 63,906	$ 24,013	$ 173,615	$ 6,902	$ 204,530
Mortgage-backed securities	-	-	-	-	(1)	1	-	-
Investment securities	4,013	1,384	721	6,118	7,145	3,240	996	11,381
Change in interest income	7,619	60,685	1,720	70,024	31,157	176,856	7,898	215,911
Interest expense:								
Transaction accounts:								
Interest-bearing checking	(36)	(13)	1	(48)	(77)	(56)	3	(130)
Money market	(20)	(1)	-	(21)	4	(2)	-	2
Regular passbook	(1,715)	(315)	99	(1,931)	(6,125)	(1,153)	376	(6,902)
Total transaction accounts	(1,771)	(329)	100	(2,000)	(6,198)	(1,211)	379	(7,030)
Certificates of deposit	10,846	22,695	3,592	37,133	49,001	57,556	17,254	123,811
Total interest-bearing deposits	9,075	22,366	3,692	35,133	42,803	56,345	17,633	116,781
FHLB advances and other borrowings	(956)	16,090	(459)	14,675	(17,511)	63,973	(10,459)	36,003
Senior notes	3	-	-	3	8	-	-	8
Change in interest expense	8,122	38,456	3,233	49,811	25,300	120,318	7,174	152,792
Change in net interest income	$ (503)	$ 22,229	$ (1,513)	$ 20,213	$ 5,857	$ 56,538	$ 724	$ 63,119

Provision for Credit Losses

Provision for credit losses totaled $9.6 million in the third quarter of 2006, compared with a reversal of $0.8 million a year ago. During the current quarter, the California residential real estate market continued to show signs of weakening, with a decline in prices beginning to emerge in certain segments for the first time. In addition, there were continuing increases in both negative amortization and capitalized interest balances as well as an upward trend in loan defaults. In consideration of these trends, an increase in the allowance for credit losses was deemed appropriate.

For the first nine months of 2006, provision for credit losses totaled $26.4 million, compared to $1.9 million in the year-ago period. For further information, see Allowance for Credit and Real Estate Losses on page 47.

Other Income

Our total other income was $30.7 million in the current quarter, down $14.9 million from a year ago. Contributing to the decline between third quarters was:

- a $14.7 million decline in net gains from sales of loans and mortgage-backed securities; and
- a $2.5 million unfavorable change in loan servicing activities.

Those unfavorable items were partially offset by:

- a $2.0 million increase in income from real estate investment activities; and
- a $1.6 million litigation award received in the current quarter.

For the first nine months of 2006, other income totaled $74.9 million, down $74.8 million from the same period a year ago. The decline primarily reflected lower net gains from sales of loans and mortgage-backed securities.

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

Loan and Deposit Related Fees

Loan and deposit related fees totaled $9.3 million in the current quarter, down $0.3 million from a year ago. Loan related fees were down $0.6 million or 41.4%, while deposit related fees were up $0.3 million or 4.3%. Within deposit related fees, automated teller machine fees declined 12.7% primarily reflecting the removal of 200 standalone machines in the fourth quarter of 2005, while other fees increased 13.2%. For further information regarding a reclassification of certain prior period amounts, see Note 2 on page 6 of Notes to Consolidated Financial Statements.

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

(In Thousands)	*Three Months Ended* *September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Loan related fees	$ 901	$ 1,009	$ 1,066	$ 1,346	$ 1,538
Deposit related fees:					
Automated teller machine fees	2,419	2,410	2,149	2,453	2,770
Other fees	5,959	5,752	5,343	5,278	5,265
Total loan and deposit related fees	$ 9,279	$ 9,171	$ 8,558	$ 9,077	$ 9,573

For the first nine months of 2006, loan and deposit related fees totaled $27.0 million, down from $27.4 million from the same period of 2005.

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

(In Thousands)	*Nine Months Ended September 30,* *2006*	*2005*

Loan related fees	$ 2,976	$ 4,179
Deposit related fees:		
Automated teller machine fees	6,978	8,135
Other fees	17,054	15,105
Total loan and deposit related fees	$ 27,008	$ 27,419

Real Estate and Joint Ventures Held for Investment

Income from our real estate and joint ventures held for investment totaled $5.3 million in the current quarter, up $2.0 million from the year-ago quarter due primarily to higher gains from sales, which included joint venture project sales reported within the category equity in net income from joint ventures. The current quarter included gains of $5.7 million, compared to gains of $1.4 million a year ago.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Rental operations, net of expenses	$ 124	$ 240	$ 487	$ 387	$ 199
Net gains on sales of wholly owned real estate	3,051	-	-	-	407
Equity in net income (loss) from joint ventures	2,156	2,313	1,802	(1,268)	1,368
Reduction of losses on real estate and joint ventures	-	-	-	-	1,333
Total income (loss) from real estate and joint ventures held for investment, net	$ 5,331	$ 2,553	$ 2,289	$ (881)	$ 3,307

For the first nine months of 2006, income from real estate and joint ventures held for investment totaled $10.2 million, up $2.6 million from the same period of 2005 due primarily to higher gains from sales.

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Rental operations, net of expenses	$ 851	$ 955
Net gains on sales of wholly owned real estate	3,051	477
Equity in net income from joint ventures	6,271	4,850
Reduction of losses on real estate and joint ventures	-	1,333
Total income from real estate and joint ventures held for investment, net	$ 10,173	$ 7,615

Secondary Marketing Activities

We service loans for others and those activities generated a loss of $0.4 million in the current quarter, compared to income of $2.2 million in the year-ago quarter. The primary reason for the unfavorable change was that the prior year quarter included a $1.9 million recapture of the valuation allowance for MSRs, compared to a $0.1 million addition in the current quarter.

At September 30, 2006, MSRs, net of a $0.2 million valuation allowance, totaled $20.3 million or 0.87% of the $2.346 billion of associated loans serviced for others. That compares to MSRs in the year-ago quarter, net of a $1.8 million valuation allowance, of $19.1 million or 0.83% of the $2.311 billion of associated loans serviced for others. In addition to the loans we serviced for others with capitalized MSRs, at September 30, 2006, we serviced $4.249 billion of loans on a sub-servicing basis where we receive a fixed fee per loan, with no risk associated with changing MSR values.

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

(In Thousands)	September 30, 2006	June 30, 2006	March 31, 2006	December 31, 2005	September 30, 2005
	Three Months Ended				
Net cash servicing fees	$ 1,583	$ 1,574	$ 1,566	$ 1,743	$ 1,968
Payoff and curtailment interest cost [a]	(813)	(233)	(218)	(250)	(315)
Amortization of mortgage servicing rights	(1,056)	(1,029)	(1,198)	(1,252)	(1,346)
(Provision for) reduction of impairment of mortgage servicing rights	(91)	140	39	697	1,859
Total loan servicing income (loss), net	$ (377)	$ 452	$ 189	$ 938	$ 2,166

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

For the first nine months of 2006, income of $0.3 million was recorded from loan servicing activities, down from $1.1 million for the same period of 2005. The unfavorable change primarily related to a greater recapture of impairment of MSRs and a higher volume of loans serviced in the year-ago period than in the current quarter.

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Net cash servicing fees	$ 4,723	$ 5,348
Payoff and curtailment interest cost [a]	(1,264)	(797)
Amortization of mortgage servicing rights	(3,283)	(3,904)
Reduction of impairment of mortgage servicing rights	88	474
Total loan servicing income, net	$ 264	$ 1,121

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

For further information, see Note 3 on page 7 of Notes to Consolidated Financial Statements.

Sales of loans and mortgage-backed securities we originated for sale declined from $2.108 billion a year ago to $903 million in the current quarter. Due to the lower volume of loans sold, net gains associated with these sales declined $14.7 million from a year ago to $14.8 million in the current quarter. The current quarter included a $0.3 million loss due to the SFAS 133 impact of valuing derivatives associated with the sale of loans, compared with a SFAS 133 loss of $1.4 million in the year-ago quarter. Excluding the impact of SFAS 133, a gain equal to 1.68% on secondary market sales was realized in the current quarter, up from the year-ago gain of 1.47%.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Mortgage servicing rights	$ 837	$ 1,285	$ 1,022	$ 1,740	$ 1,858
All other components excluding SFAS 133	14,314	8,067	10,394	8,418	29,041
SFAS 133	(304)	(733)	238	841	(1,400)
Total net gains on sales of loans and mortgage-backed securities	$ 14,847	$ 8,619	$ 11,654	$ 10,999	$ 29,499
Secondary marketing gain excluding SFAS 133 as a percentage of associated sales	1.68 %	0.91 %	1.30 %	0.93 %	1.47 %

For the first nine months of 2006, sales of loans and mortgage-backed securities totaled $2.8 billion, down from $7.2 billion a year ago. Net gains associated with these sales totaled $35.1 million, $73.8 million lower than the prior year amount.

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Mortgage servicing rights	$ 3,144	$ 4,684
All other components excluding SFAS 133	32,775	101,507
SFAS 133	(799)	2,771
Total net gains on sales of loans and mortgage-backed securities	$ 35,120	$ 108,962
Secondary marketing gain excluding SFAS 133 as a percentage of associated sales	1.28 %	1.47 %

Operating Expense

Operating expense totaled $58.7 million in the current quarter, virtually unchanged from a year ago. Increases in most major categories of general and administrative expense were offset primarily by a decline in the other expense category, which was influenced by two special items. The current quarter included a reversal of a litigation reserve established in prior periods due to the successful outcome of a legal matter involving real estate investment activities, while the year-ago quarter included a contribution to the American Red Cross to help victims of Hurricane Katrina. Excluding the impact of these two items, our operating expense would have been up 3.8% between third quarters.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Salaries and related costs	$ 38,943	$ 40,873	$ 40,780	$ 37,397	$ 38,155
Premises and equipment costs	8,804	8,410	8,538	8,301	8,079
Advertising expense	1,211	1,879	1,242	1,610	1,557
Deposit insurance premiums and regulatory assessments	2,224	1,008	1,014	984	957
Professional fees	254	450	792	596	(69)
Other general and administrative expense	7,087	8,295	9,175	9,621	9,938
Total general and administrative expense	58,523	60,915	61,541	58,509	58,617
Net operation of real estate acquired in settlement of loans	166	28	(9)	(172)	91
Total operating expense	$ 58,689	$ 60,943	$ 61,532	$ 58,337	$ 58,708

For the first nine months of 2006, operating expense totaled $181.2 million, up $6.0 million or 3.4% from the same period of 2005, primarily reflecting higher salaries and related costs, premises and equipment costs as well as deposit insurance premiums and regulatory assessments.

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Salaries and related costs	$ 120,596	$ 116,352
Premises and equipment costs	25,752	23,970
Advertising expense	4,332	4,458
Deposit insurance premiums and regulatory assessments	4,246	2,811
Professional fees	1,496	612
Other general and administrative expense	24,557	26,935

Total general and administrative expense	180,979	175,138
Net operation of real estate acquired in settlement of loans	185	76
Total operating expense	$ 181,164	$ 175,214

Provision for Income Taxes

Income taxes for the third quarter totaled $35.4 million, down from $37.9 million in the year-ago quarter. Our effective tax rate was 38.24% for the current quarter, compared to 38.80% for the prior year quarter. The effective tax rates were affected by the settlement of prior-year tax returns which reduced tax expense by $3.6 million in the current quarter and $3.2 million in the year-ago third quarter. For the first nine months of 2006, income taxes totaled $104.4 million for an effective tax rate of 40.80%, compared to $122.5 million and 41.10% a year ago. For further information, see Note 5 of Notes to Consolidated Financial statements on page 12.

Business Segment Reporting

The previous discussion and analysis of the Results of Operations pertained to our consolidated results. This section discusses and analyzes the results of operations of our two business segments banking and real estate investment. For further information, see Note 8 of Notes to Consolidated Financial Statements on page 14.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Banking net income	$ 52,988	$ 47,810	$ 43,576	$ 43,054	$ 57,687
Real estate investment net income (loss)	4,188	1,730	1,181	(1,165)	2,049
Total net income	$ 57,176	$ 49,540	$ 44,757	$ 41,889	$ 59,736

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Banking net income	$ 144,374	$ 170,829
Real estate investment net income	7,099	4,716
Total net income	$ 151,473	$ 175,545

Banking

Net income from our banking operations for the current quarter totaled $53.0 million, down $4.7 million or 8.1% from a year ago. The decline between third quarters primarily reflected:

- a $14.7 million decline in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans sold;
- a $10.4 million increase in the provision for credit losses due to continuing signs of weakening in the California real estate market, continued increases in negative amortization and an upward trend in loan defaults; and
- a $2.5 million unfavorable change in income from loan servicing activities due primarily to changes in our valuation allowance for mortgage servicing rights.

Those unfavorable factors were partially offset by a $20.0 million or 18.2% increase in net interest income reflecting both higher average interest-earning assets and effective interest rate spread and a $1.6 million litigation award received in the current quarter.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Net interest income	$ 129,870	$ 132,021	$ 125,632	$ 110,749	$ 109,878
Provision for (reduction of) credit losses	9,640	6,662	10,057	393	(751)

Other income	25,090	18,188	20,671	20,743	41,881
Operating expense	59,801	60,652	60,797	56,632	58,426
Net intercompany income (expense)	(38)	(54)	87	(45)	29
Income before income taxes	85,481	82,841	75,536	74,422	94,113
Income taxes	32,493	35,031	31,960	31,368	36,426
Net income	$ 52,988	$ 47,810	$ 43,576	$ 43,054	$ 57,687
At period end					
Assets:					
Loans and mortgage-backed securities, net	$ 15,135,543	$ 15,938,573	$ 16,429,596	$ 15,821,923	$ 15,344,636
Other	1,838,950	1,517,582	1,364,430	1,265,220	1,214,285
Total assets	16,974,493	17,456,155	17,794,026	17,087,143	16,558,921
Equity	$ 1,352,229	$ 1,290,165	$ 1,249,403	$ 1,208,219	$ 1,171,528

For the first nine months of 2006, net income from our banking operations totaled $144.4 million, down $26.5 million or 15.5% from the same period a year ago. The decline primarily reflected lower net gains from sales of loans and mortgage-backed securities, an increase in provision for credit losses and higher operating expenses, partially offset by higher net interest income.

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Net interest income	$ 387,523	$ 325,022
Provision for credit losses	26,359	1,870
Other income	63,949	141,241
Operating expense	181,250	174,314
Net intercompany expense	(5)	(48)
Income before income taxes	243,858	290,031
Income taxes	99,484	119,202
Net income	$ 144,374	$ 170,829

Real Estate Investment

Net income from our real estate investment operations totaled $4.2 million in the current quarter, up from $2.0 million a year ago. The increase primarily reflected higher gains from sales of real estate, including sales in real estate joint ventures in which we participate. The current quarter included gains of $5.7 million, compared to gains of $1.4 million a year ago. Current quarter results also reflected a $1.2 million reversal of a litigation accrual within operating expense related to a settled legal matter.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Net interest income	$ 369	$ 326	$ 284	$ 241	$ 148
Other income (loss)	5,579	2,842	2,539	(553)	3,654
Operating expense	(1,112)	291	735	1,705	282
Net intercompany income (expense)	38	54	(87)	45	(29)
Income (loss) before income taxes (benefits)	7,098	2,931	2,001	(1,972)	3,491
Income taxes (benefits)	2,910	1,201	820	(807)	1,442
Net income (loss)	$ 4,188	$ 1,730	$ 1,181	$ (1,165)	$ 2,049
At period end					
Assets:					
Investments in real estate and joint ventures	$ 55,663	$ 49,237	$ 49,182	$ 49,344	$ 49,351

Other	28,978	31,541	29,974	28,418	29,429
Total assets	84,641	80,778	79,156	77,762	78,780
Equity	$ 76,341	$ 72,153	$ 70,423	$ 69,242	$ 70,407

For the first nine months of 2006, our net income from real estate investment operations totaled $7.1 million, up $2.4 million from the same period of 2005. The increase primarily reflected higher gains from sales.

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Net interest income	$ 979	$ 361
Other income	10,960	8,501
Operating expense	(86)	900
Net intercompany income	5	48
Income before income taxes	12,030	8,010
Income taxes	4,931	3,294
Net income	$ 7,099	$ 4,716

Our investments in real estate and joint ventures amounted to $56 million at September 30, 2006, up from $49 million at both December 31, 2005 and September 30, 2005.

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

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Loans and Mortgage-Backed Securities

Total loans and mortgage-backed securities, including those we hold for sale, declined $803 million during the current quarter to a total of $15.1 billion or 89.1% of total assets at September 30, 2006. The decline was associated with declines of $709 million in our loans held for investment and $94 million in loans held for sale due to payoffs and sales outpacing originations.

Our loan originations, including loans purchased, totaled $1.605 billion in the current quarter, down $2.039 billion or 56.0% from the $3.644 billion we originated in the year-ago third quarter and 22.5% below the $2.071 billion we originated in the second quarter of 2006. Loans originated for sale declined $876 million or 51.5% to $824 million, while single family loans originated for portfolio declined $1.147 billion or 60.0% to $765 million. Of all loans originated for portfolio this quarter, $8 million represented subprime credits. Our prepayment speed, which measures the annualized percentage of loans repaid, for one-to-four unit residential loans decreased from 44% a year ago to 39% in the current quarter and was up from 38% in the second quarter of 2006. During the current quarter, 86% of our residential one-to-four unit originations represented refinance transactions. This is unchanged from the second quarter of 2006 but up from 79% in the year-ago third quarter. In addition to single family loans, $16 million of other loans were originated in the current quarter.

Originations of adjustable rate one-to-four unit residential loans for portfolio, including loans purchased, totaled $765 million in the current quarter. Of those, 46% were monthly adjustable rate loans that provide for negative amortization, with the balance primarily adjustable rate loans with the initial interest rate fixed for the first three to five years. Of the monthly adjustable rate loans, the majority were tied to the FHLB Eleventh District Cost of Funds Index (COFI). The other adjustable rate loans were tied to the 12-month moving average of yields on actively traded U.S. Treasury securities adjusted to a constant maturity of one year (MTA), LIBOR or the Constant Maturity Treasury ("CMT") index. In the year-ago third quarter, virtually all were monthly adjustable rate loans that provide for negative amortization, of which 68% were tied to COFI with essentially the remainder tied to MTA.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Loans originated and purchased					
Investment portfolio:					
Residential one-to-four units:					
Adjustable by index:					
COFI	$ 339,128	$ 612,586	$ 1,309,298	$ 1,445,612	$ 1,309,055
MTA	11,820	3,206	209,134	526,811	602,125
LIBOR	69,768	77,753	11,396	1,540	880
CMT	53,633	43,975	-	-	-
Adjustable fixed for 3-5 years	290,397	392,126	189,385	5,827	-
Fixed	-	69	155	464	61
Total residential one-to-four units	764,746	1,129,715	1,719,368	1,980,254	1,912,121
Other	15,744	49,059	113,670	27,835	31,620
Total for investment portfolio	780,490	1,178,774	1,833,038	2,008,089	1,943,741
Sale portfolio [(a)]	824,072	892,314	980,164	1,067,861	1,699,900

Total for investment and sale portfolios	$ 1,604,562	$ 2,071,088	$ 2,813,202	$ 3,075,950	$ 3,643,641

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Loans originated and purchased		
Investment portfolio:		
Residential one-to-four units:		
Adjustable by index:		
COFI	$ 2,261,012	$ 4,133,294
MTA	224,160	954,828
LIBOR	158,917	12,648
CMT	97,608	-
Adjustable fixed for 3-5 years	871,908	-
Fixed	224	61
Total residential one-to-four units	3,613,829	5,100,831
Other	178,473	277,804
Total for investment portfolio	3,792,302	5,378,635
Sale portfolio [(a)]	2,696,550	6,647,339
Total for investment and sale portfolios	$ 6,488,852	$ 12,025,974

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

Our adjustable rate mortgages 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 spread, 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 incentive rate by more than six to ten 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 mortgages are option ARM products with an interest rate that adjusts monthly and a required minimum monthly loan payment that adjusts annually. The start rate of these option ARMs 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 initial start rate, however, is used to calculate the required minimum monthly loan payment for the first twelve months. The borrower is required to make the minimum monthly payment, but retains the option to make a larger payment to reduce loan principal and avoid negative amortization, or the addition to loan principal of accrued interest that exceeds the required monthly loan payment. If the borrower chooses to make the minimum required 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. During the first quarter of 2006, we ceased offering option ARM products to our subprime borrowers, but continue to offer them to our prime borrowers.

More particularly, these loans currently:

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

The maximum home loan we make, except for a limited amount related to Community Reinvestment Act activities, is equal to 97% of a property s appraised value; however, any loan in excess of 80% of appraised value generally requires private mortgage insurance. Typically, this insures the loan down to a 75% loan-to-value ratio, consistent with secondary marketing requirements. A loan-to-value ratio is the proportion of the principal amount of the loan to the lower of the sales

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price or appraised value of the property securing the loan at origination. If a loan incurs significant 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.

With the negative amortization and loan-to-value limitations currently in place, the loan-to-value ratio over the life of a portfolio option ARM could never exceed 88% of the original appraised value, assuming the loan reached 110% of the original loan balance and had an 80% loan-to-value ratio at origination (the maximum permitted without the borrower obtaining private mortgage insurance).

Our loan portfolio held for investment does contain loans previously originated with a limit on negative amortization of 125% of the original loan amount. At September 30, 2006, loans with the higher 125% limit on negative amortization represented 3% of our adjustable rate one-to-four unit residential loan portfolio, while those with the 110% limit represented 84% and those with the 115% limit represented less than 1%. We permit adjustable rate mortgages to be assumed by qualified borrowers.

While start rates of our loan products fluctuate with the market, we do not use them to qualify a loan applicant. Rather, we qualify applicants for interest-only loans at the interest-only payment amount and for other adjustable rate mortgages using a fully-amortizing payment calculated from the higher of the fully-indexed rate or, currently, for:

- prime borrowers:
    - 6.00% for owner occupied; or
    - 6.25% for non-owner occupied.
- subprime borrowers (Alt. A and A- only, for non-option ARM products):
    - 7.00% for owner occupied; or
    - 7.25% for non-owner occupied.

As set forth in the following table, $12.3 billion or 87% of our residential one-to-four unit adjustable rate loans held for investment were option ARMs subject to negative amortization at September 30, 2006, of which $277 million or 2.25% represented the amount of negative amortization included in the loan balance. At origination, these loans had a weighted average loan-to-value ratio of 73%. The amount of negative amortization had a net increase of $48 million during the current quarter, as borrowers took advantage of the flexibility of this product. During the current quarter, approximately 28% of our loan interest income represented negative amortization, up from 26% in the second quarter of 2006 and 18% in the year-ago third quarter. In addition, $1.4 billion or 10% of our residential one-to-four unit adjustable rate loans represented loans requiring interest-only payments over the initial terms of the loans, generally the first three to five years.

(Dollars in Thousands)	*September 30, 2006* Loan Balance	% of Total	Negative Amortization Included in Loan Balance	Loan to Value at Origination	Current Loan to Value [(a)]	Weighted Average Age (Months)
Prime loans subject to negative amortization						
With negative amortization:						
Balance less than or equal to original loan amount	$ 570,076	5 %	$ 2,135	70 %	69 %	26
Balance greater than original loan amount	9,488,704	81	263,770	73	75	18
Total with negative amortization	10,058,780	86	265,905	73	75	18
Not utilizing negative amortization	1,651,789	14	-	70	67	35
Total prime loans subject to negative amortization	11,710,569	100	265,905	73	74	21
Subprime loans subject to negative amortization						
With negative amortization:						
Balance less than or equal to original loan amount	40,439	7	134	71	70	34
Balance greater than original loan amount	494,937	80	10,908	71	72	23
Total with negative amortization	535,376	87	11,042	71	72	24
Not utilizing negative amortization	81,055	13	-	72	68	54
Total subprime loans subject to negative amortization	616,431	100	11,042	71	71	28
Total loans subject to negative amortization						
With negative amortization:						
Balance less than or equal to original loan amount	610,515	5	2,269	70	69	26
Balance greater than original loan amount	9,983,641	81	274,678	73	75	18
Total with negative amortization	10,594,156	86	276,947	73	75	19
Not utilizing negative amortization	1,732,844	14	-	70	67	36

Total loans subject to negative amortization	$ 12,327,000	100 %	$ 276,947	73 %	74 %	21
As a percentage of total residential one-to-four unit						
adjustable rate loans	87 %					
Total loans with interest-only payments						
Prime	$ 1,335,572	97 %	$ -	69 %	69 %	12
Subprime	40,438	3	-	67	67	16
Total loans with interest-only payments	$ 1,376,010	100 %	$ -	69 %	69 %	12
As a percentage of total residential one-to-four unit						
adjustable rate loans	10 %					

[(a)] *Based upon appraised value at time of origination.*

We have other credit risk elements within our real estate loans held for investment besides loans subject to negative amortization or loans with interest-only payments. At September 30, 2006, these other credit risks included:

- 89% of our real estate loans were concentrated and secured by properties located in California, principally in Los Angeles, San Diego, Orange, Santa Clara and Riverside counties;
- 79% of our residential one-to-four unit loans were underwritten based on borrower stated income and asset verification and an additional 10% were underwritten with no verification of either borrower income or assets; and
- loans that are relatively new and unseasoned, as 25% of our residential one-to-four unit loans were originated in 2006, with an additional 38% originated in 2005.

We mitigate those risks during loan underwriting through the establishment of various minimum borrower credit requirements and maximum loan-to-value limitations. In addition, the average loan-to-value ratio of our residential one-to-four unit loans was 72% at origination. Over the past several years, residential property values have increased thereby further reducing our exposure to credit risk. However, during the current quarter, the California residential real estate market continued to show signs of weakening, with a decline in prices beginning to emerge in certain segments for the first time.

While our historic credit experience has been good, option ARMs can present greater credit risk in sustained periods of rising interest rates, as borrowers may see their loan payments increase significantly when their payments recast to fully-amortizing payments. In addition, credit risk increases if home values decline. In light of continued increases in market interest rates and other unfavorable changes in the residential housing market, we increased the start rate on option ARM loans originated for portfolio beginning in March of this year in order to reduce the potential for negative amortization. Since our start rate remained higher than that of many of our competitors, our production of option ARM loans for portfolio did not offset loan payoffs for the last two quarters. In September, we increased the competitiveness of our option ARM pricing by lowering the start rate for borrowers who have high FICO credit scores and low loan-to-value ratios, with the goal of stimulating additional loan production for our portfolio, while at the same time limiting our portfolio credit exposure. However, we are not certain this pricing change will result in loan production completely offsetting portfolio payoffs, especially as we consider the implications of, and alternatives available to us in response to, the final guidance issued to depository institutions by banking regulators in September of 2006 entitled, "Interagency Guidance on Nontraditional Mortgage Product Risks," which addresses, among other matters, option ARM loans and interest-only loans.

Among other things, the guidance recommends that management should:

- ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower s repayment capacity;
- recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, warrant strong risk management standards, capital levels and an allowance for losses that reflects the collectability of the portfolio; and
- ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

More particularly, the guidance states that when an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower s capacity to repay when loan amortization begins. Consequently, an institution s analysis of a borrower s repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision. Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income, asset or outstanding liability verification in the underwriting process.

At this time, we are assessing what impact, if any, this new lending guidance will have on our loan underwriting guidelines and production volumes. We will continue to closely monitor trends in the residential housing and lending markets, and make adjustments as deemed appropriate.

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

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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.

	September 30, 2006		June 30, 2006		March 31, 2006		December 31, 2005		September 30, 2005	
(Dollars in Thousands)	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*	*Amount*	*% of Total*
Investment Portfolio										
Residential one-to-four units:										
Adjustable by index:										
COFI	$ 10,107,839	78 %	$ 10,770,739	77 %	$ 11,172,831	77 %	$ 10,733,770	76 %	$ 10,290,282	76 %
MTA	2,353,639	18	2,636,804	19	2,841,747	20	2,846,273	20	2,542,053	19
LIBOR	366,907	3	359,752	3	351,128	2	410,010	3	510,399	4
Other, primarily CMT	191,542	1	138,488	1	151,003	1	155,498	1	150,566	1
Total adjustable loans [a]	$ 13,019,927	100 %	$ 13,905,783	100 %	$ 14,516,709	100 %	$ 14,145,551	100 %	$ 13,493,300	100 %

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

We continue to originate residential fixed interest rate mortgage loans to meet consumer demand, but we intend to sell the majority of these loans. We expect to sell some of our production of adjustable rate loans into the secondary market to the extent we can do so profitably. We sold $903 million of loans and mortgage-backed securities in the current quarter, compared to $1.028 billion in the second quarter of 2006 and $2.108 billion in the year-ago third quarter. All amounts were secured by residential one-to-four unit property, and at September 30, 2006, loans held for sale totaled $323 million.

At September 30, 2006, our unfunded loan application pipeline totaled $1.1 billion. Within that pipeline, we had commitments to borrowers for short-term interest rate locks, before the reduction of expected fallout, of $508 million, of which $307 million were related to residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, at September 30, 2006, we had commitments on undrawn lines of credit of $323 million and loans in process of $47 million. We believe our current sources of funds will enable us to meet these obligations.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Investment Portfolio					
Loans originated:					
Loans secured by real estate:					
Residential one-to-four units:					
Adjustable	$ 465,137	$ 711,184	$ 1,462,892	$ 1,878,179	$ 1,800,460
Adjustable subprime	7,935	18,229	54,718	72,453	102,079
Adjustable fixed for 3-5 years	290,397	392,126	189,385	5,827	-
Fixed	-	-	155	464	61
Total residential one-to-four units	763,469	1,121,539	1,707,150	1,956,923	1,902,600
Home equity loans and lines of credit	6,388	8,313	8,793	9,408	6,108
Residential five or more units adjustable	560	525	68,583	-	-
Commercial real estate	-	-	630	-	-
Construction	7,516	4,458	19,863	17,361	23,421
Land	313	33,903	15,102	300	1,193
Non-mortgage:					
Commercial	-	-	-	200	-
Other consumer	967	1,860	699	566	898
Total loans originated	779,213	1,170,598	1,820,820	1,984,758	1,934,220
Real estate loans purchased:					
One-to-four units	1,277	8,176	11,601	22,965	9,296
One-to-four units subprime	-	-	617	366	225
Total real estate loans purchased	1,277	8,176	12,218	23,331	9,521
Total loans originated and purchased	780,490	1,178,774	1,833,038	2,008,089	1,943,741
Loan repayments	(1,563,517)	(1,596,002)	(1,393,957)	(1,596,505)	(1,691,123)
Other net changes [(a)]	74,266	70,033	71,575	102,833	113,889
Increase (decrease) in loans held for investment, net	(708,761)	(347,195)	510,656	514,417	366,507
Sale Portfolio					
Residential one-to-four unit loans originated	823,656	890,191	979,000	1,062,495	1,682,834
Loans purchased	416	2,123	1,164	5,366	17,066

Loans transferred to the investment portfolio [a]	(10,722)	(6,782)	(3,840)	(4,887)	(6,987)
Originated whole loans sold	(699,664)	(751,702)	(662,306)	(827,815)	(1,828,698)
Loans exchanged for mortgage-backed securities	(203,492)	(276,292)	(213,980)	(269,423)	(279,303)
Capitalized basis adjustment [b]	815	1,254	(1,066)	(313)	(234)
Other net changes [c]	(5,272)	(2,612)	(1,949)	(2,546)	(15,315)
Increase (decrease) in loans held for sale, net	(94,263)	(143,820)	97,023	(37,123)	(430,637)
Mortgage-backed securities, net:					
Received in exchange for loans	203,492	276,292	213,980	269,423	279,303
Sold	(203,492)	(276,292)	(213,980)	(269,423)	(279,303)
Repayments	(6)	(8)	(6)	(6)	(6)
Other net changes	-	-	-	(1)	(2)
Decrease in mortgage-backed securities available for sale	(6)	(8)	(6)	(7)	(8)
Increase (decrease) in loans held for sale and mortgage-backed securities available for sale	(94,269)	(143,828)	97,017	(37,130)	(430,645)
Total increase (decrease) in loans and mortgage-backed securities, net	$ (803,030)	$ (491,023)	$ 607,673	$ 477,287	$ (64,138)

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

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

(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Investment Portfolio					
Loans secured by real estate:					
Residential one-to-four units:					
Adjustable	$ 12,214,165	$ 12,959,502	$ 13,424,089	$ 12,968,647	$ 12,205,405
Adjustable subprime	682,187	815,402	951,583	1,046,261	1,159,701
Adjustable fixed for 3-5 years	1,233,166	1,008,867	715,453	598,102	707,331
Adjustable fixed for 3-5 years subprime	7,478	8,192	8,989	10,253	12,837
Fixed	44,150	45,447	48,304	49,030	52,124
Fixed subprime	2,059	2,069	2,311	2,397	2,505
Total residential one-to-four units	14,183,205	14,839,479	15,150,729	14,674,690	14,139,903
Home equity loans and lines of credit	211,713	232,746	250,804	274,014	300,300
Residential five or more units:					
Adjustable	115,174	117,060	134,340	68,390	69,052
Fixed	936	1,040	1,092	1,141	1,178
Commercial real estate:					
Adjustable	24,117	24,254	25,967	25,547	25,743
Fixed	2,793	2,837	2,879	3,244	3,280
Construction	58,157	67,609	78,095	82,379	89,337
Land	59,394	59,682	27,379	23,630	41,361
Non-mortgage:					
Commercial	3,400	3,400	3,481	3,981	4,223
Automobile	23	41	67	116	204
Other consumer	6,050	6,262	6,591	6,577	6,456
Total loans held for investment	14,664,962	15,354,410	15,681,424	15,163,709	14,681,037
Increase (decrease) for:					
Undisbursed loan funds	(48,635)	(58,390)	(59,222)	(51,838)	(65,214)
Net deferred costs and premiums	256,315	275,797	290,116	279,888	261,483
Allowance for losses	(60,784)	(51,198)	(44,504)	(34,601)	(34,565)
Total loans held for investment, net	14,811,858	15,520,619	15,867,814	15,357,158	14,842,741
Sale Portfolio					
Loans held for sale:					
Residential one-to-four units	318,414	411,086	556,365	459,081	495,156
Net deferred costs and premiums	4,445	6,851	6,646	5,841	6,576
Capitalized basis adjustment [(a)]	569	(246)	(1,500)	(434)	(121)
Total loans held for sale, net	323,428	417,691	561,511	464,488	501,611

Mortgage-backed securities available for sale:					
Adjustable	257	263	271	277	284
Fixed	-	-	-	-	-
Total mortgage-backed securities available for sale	257	263	271	277	284
Total loans held for sale and mortgage-backed securities available for sale	323,685	417,954	561,782	464,765	501,895
Total loans and mortgage-backed securities, net	$ 15,135,543	$ 15,938,573	$ 16,429,596	$ 15,821,923	$ 15,344,636

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

We carry loans for sale at the lower of cost or fair value. At September 30, 2006, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

At September 30, 2006, our residential one-to-four units subprime portfolio totaled $692 million and consisted of 97% Alt. A and A- credit, 2% B credit and 1% C credit loans. The average loan-to-value ratio at origination for these loans was 70%.

We carry mortgage-backed securities available for sale at fair value which, at September 30, 2006, was essentially equal to our cost basis.

Investment Securities

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

(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Federal funds	$ 1	$ 2	$ -	$ -	$ 2
Investment securities available for sale:					
U.S. Treasury	-	-	-	-	-
Government sponsored entities	1,162,551	892,109	730,338	626,249	550,557
Other	63	63	64	64	64
Total investment securities	$ 1,162,615	$ 892,174	$ 730,402	$ 626,313	$ 550,623

The fair value of temporarily impaired investment securities, the amount of unrealized losses and the length of time these unrealized losses existed as of September 30, 2006 are presented in the following table. The $7.7 million unrealized loss on securities is due to changes in market interest rates. We have the intent and ability to hold the securities until that temporary impairment is eliminated.

	Less than 12 months		*12 months or longer*		*Total*	
(In Thousands)	*Fair Value*	*Unrealized Losses*	*Fair Value*	*Unrealized Losses*	*Fair Value*	*Unrealized Losses*
Investment securities available for sale:						
U.S. Treasury	$ -	$ -	$ -	$ -	$ -	$ -
Government sponsored entities	618,370	1,665	494,182	5,986	1,112,552	7,651
Other	-	-	-	-	-	-
Total temporarily impaired securities	$ 618,370	$ 1,665	$ 494,182	$ 5,986	$ 1,112,552	$ 7,651

The following table sets forth the maturities of our investment securities and their weighted average yields at September 30, 2006.

	Amount Due as of September 30, 2006				
(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	$ 1	$ -	$ -	$ -	$ 1
Weighted average yield	4.88 %	- %	- %	- %	4.88 %
Investment securities available for sale:					
U.S. Treasury	-	-	-	-	-
Weighted average yield	- %	- %	- %	- %	- %

Government sponsored entities [a]	2,496	647,592	512,463	-	1,162,551
Weighted average yield	4.54 %	5.60 %	4.84 %	- %	5.26 %
Other	-	-	-	63	63
Weighted average yield	- %	- %	- %	6.25 %	6.25 %
Total investment securities	$ 2,497	$ 647,592	$ 512,463	$ 63	$ 1,162,615
Weighted average yield	4.54 %	5.60 %	4.84 %	6.25 %	5.26 %

[a] At September 30, 2006, 42% of our investment securities had step-up provisions that stipulate increases in the coupon rate ranging from 0.25% to 1.25% at various specified times over a range from October 2006 to December 2012. Yields for investment securities available for sale are calculated using historical cost balances and do not give effect to changes in fair value that are reflected as a component of stockholders equity.

Deposits

At September 30, 2006, our deposits totaled $11.9 billion, up $194 million or 1.6% from the year-ago level and $69 million or 0.6% from year-end 2005. Compared to the year-ago period, our certificates of deposit increased $953 million or 11.6%, which was partially offset by a decline in our transaction accounts *i.e.,* checking, money market and regular passbook of $759 million or 21.5%. As short-term market interest rates have continued to rise over the past year, our customers have moved monies from regular passbook accounts into certificates of deposit.

During the current quarter, one in-store branch was closed due to the closure of the store in which it was located and one traditional branch was opened. This leaves our total number of branches unchanged at 171, of which 90 were in-store and four were located in Arizona. A year ago, we had 172 branches, of which 92 were in-store and four were located in Arizona. At September 30, 2006, the average deposit size of our 81 traditional branches was $116 million, while the average deposit size of our 90 in-store branches was $28 million.

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

	September 30, 2006		June 30, 2006		March 31, 2006		December 31, 2005		September 30, 2005	
(Dollars in Thousands)	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*	*Weighted Average Rate*	*Amount*
Transaction accounts:										
Non-interest-bearing checking	- %	$ 776,696	- %	$ 751,446	- %	$ 758,055	- %	$ 705,077	- %	$ 857,875
Interest-bearing checking [(a)]	0.28	486,226	0.29	497,313	0.29	525,564	0.30	529,133	0.30	530,467
Money market	1.04	147,812	1.05	162,213	1.05	166,496	1.05	164,192	1.05	161,910
Regular passbook	0.98	1,355,595	1.00	1,483,890	1.02	1,652,549	1.04	1,816,635	1.05	1,975,209
Total transaction accounts	0.58	2,766,329	0.62	2,894,862	0.65	3,102,664	0.69	3,215,037	0.68	3,525,461
Certificates of deposit:										
Less than 2.00%	1.28	22,484	1.31	29,690	1.49	47,149	1.68	86,992	1.70	131,006
2.00-2.49	2.46	11,567	2.37	24,559	2.37	81,014	2.41	147,632	2.44	294,160
2.50-2.99	2.84	51,185	2.87	92,839	2.81	159,742	2.78	215,297	2.79	321,523
3.00-3.49	3.27	153,871	3.28	176,414	3.34	368,255	3.27	1,001,901	3.27	2,068,056
3.50-3.99	3.87	267,610	3.89	1,190,947	3.86	2,681,838	3.78	4,114,751	3.76	4,164,594
4.00-4.49	4.26	1,574,479	4.24	3,765,400	4.23	4,422,839	4.17	2,622,618	4.16	787,167
4.50-4.99	4.74	3,340,812	4.72	3,408,252	4.68	1,320,831	4.81	455,192	4.83	429,715
5.00 and greater	5.22	3,757,421	5.08	304,776	5.07	14,571	5.17	17,428	5.59	30,554
Total certificates of deposit	4.78	9,179,429	4.36	8,992,877	4.10	9,096,239	3.83	8,661,811	3.62	8,226,775
Total deposits	3.81 %	$ 11,945,758	3.45 %	$ 11,887,739	3.22 %	$ 12,198,903	2.98 %	$ 11,876,848	2.74 %	$ 11,752,236

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

Borrowings

At September 30, 2006, our borrowings totaled $3.3 billion, essentially unchanged from a year ago but down $413 million from year-end 2005. At quarter end, we borrowed $464 million of funds through transactions in which securities are sold under agreements to repurchase. These repurchase agreements are entered into with selected major securities dealers, using government sponsored entities securities from our portfolio as collateral.

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

(Dollars in Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Securities sold under agreements to repurchase	$ 463,678	$ 255,042	$ -	$ -	$ -
Federal Home Loan Bank advances [(a)]	2,680,546	3,499,450	3,825,811	3,557,515	3,162,808
Senior notes	198,216	198,172	198,129	198,087	198,045
Total borrowings	$ 3,342,440	$ 3,952,664	$ 4,023,940	$ 3,755,602	$ 3,360,853
Weighted average rate on borrowings during the quarter [(a)]	5.71 %	5.33 %	4.92 %	4.54 %	3.97 %
Total borrowings as a percentage of total assets	19.68	22.63	22.60	21.97	20.29

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

Navigation Links

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 our investment at cost. In the course of our business, we participate in real estate joint ventures through our wholly-owned subsidiary, DSL Service Company. Our real estate joint ventures do not require consolidation as a result of applying the provisions of Financial Accounting Standards Board Interpretation 46 (revised December 2003).

We also utilize financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers and to reduce our own exposure to fluctuations in interest rates. These financial instruments include commitments to originate fixed and variable rate mortgage loans held for investment, undisbursed loan funds, lines and letters of credit, commitments to purchase loans and mortgage-backed securities for our portfolio and commitments to invest in community development funds. The contract or notional amounts of these instruments reflect the extent of involvement we have in particular classes of financial instruments. For further information, see Asset/Liability Management and Market Risk on page 41 and Note 4 of Notes to the Consolidated Financial Statements on page 9.

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

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

Transactions with Related Parties

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

Asset/Liability Management and Market Risk

Market risk is the risk of loss from adverse changes in market prices and interest rates. Our market risk arises primarily from interest rate risk in our lending and deposit taking activities. Interest rate risk primarily occurs to the degree that our interest-bearing liabilities reprice or mature on a different basis 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 to manage interest rate risk is to emphasize the origination for investment of adjustable rate mortgages or loans with relatively short maturities. Interest rates on adjustable rate mortgages are primarily tied to the COFI, MTA, LIBOR and CMT indexes. 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 mortgages, impact the fair value of loans held for sale as well as our interest rate lock commitment derivatives, where we have committed to an interest rate with a potential borrower for a loan we intend to sell. Our objective is to hedge against fluctuations in interest rates through use of loan forward sale and purchase contracts with national investment banking firms and 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. We may use securities or derivatives, or a combination of both, to provide an economic hedge against value changes in our MSRs. In addition, the dollar amount used as an economic hedge may vary due to changes in the volume of MSRs or their sensitivity to changes in market interest rates.

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 September 30, 2006, as well as other information regarding the repricing and maturity differences between our interest-earning assets and total deposits and borrowings in future periods. We refer to these differences as gap. We have determined the repricing frequencies by reference to projected maturities, based upon contractual maturities as adjusted for scheduled repayments and repricing mechanisms provisions for changes in the interest and dividend rates of assets and liabilities. We assume prepayment rates on substantially all of our loan portfolio based upon our historical loan prepayment experience and anticipated future prepayments. Repricing mechanisms on a number of our assets are subject to limitations, such as caps on the amount that interest rates and payments on our loans may adjust, and accordingly, these assets do not normally respond to changes in market interest rates as completely or rapidly as our liabilities. The interest rate sensitivity of our assets and liabilities illustrated in the following table would vary substantially if we used different assumptions or if actual experience differed from the assumptions set forth.

	September 30, 2006					
(Dollars in Thousands)	*Within 6 Months*	*7 12 Months*	*1 5 Years*	*6 10 Years*	*Over 10 Years*	*Total Balance*
Interest-earning assets:						
Investment securities and stock [(a)]	$ 694,777	$ 143,453	$ 511,571	$ -	$ -	$ 1,349,801
Loans and mortgage-backed securities, net: [(b)]						
Loans secured by real estate:						
Residential one-to-four units:						
Adjustable	13,630,050	211,607	718,804	-	-	14,560,461
Fixed	105,556	3,509	19,571	11,413	7,613	147,662
Home equity loans and lines of credit	209,572	141	733	103	-	210,549
Residential five or more units:						
Adjustable	75,861	15,998	8,743	-	-	100,602
Fixed	104	98	481	200	46	929
Commercial real estate	17,547	2,851	5,584	40	-	26,022
Construction	36,298	-	-	-	-	36,298
Land	45,573	-	-	-	-	45,573
Non-mortgage loans:						
Commercial	1,404	-	-	-	-	1,404
Consumer	5,775	10	1	-	-	5,786
Mortgage-backed securities	257	-	-	-	-	257
Total loans and mortgage-backed	14,127,997	234,214	753,917	11,756	7,659	15,135,543

securities, net						
Total interest-earning assets	$ 14,822,774	$ 377,667	$ 1,265,488	$ 11,756	$ 7,659	$ 16,485,344
Transaction accounts:						
Non-interest-bearing checking	$ 776,696	$ -	$ -	$ -	$ -	$ 776,696
Interest-bearing checking [c]	486,226	-	-	-	-	486,226
Money market [d]	147,812	-	-	-	-	147,812
Regular passbook [d]	1,355,595	-	-	-	-	1,355,595
Total transaction accounts	2,766,329	-	-	-	-	2,766,329
Certificates of deposit [e]	6,432,565	2,295,798	451,066	-	-	9,179,429
Total deposits	9,198,894	2,295,798	451,066	-	-	11,945,758
FHLB advances and other borrowings	2,729,678	-	414,546	-	-	3,144,224
Senior notes	-	-	-	198,216	-	198,216
Impact of swap contracts hedging borrowings	430,000	-	(430,000)	-	-	-
Total deposits and borrowings	$ 12,358,572	$ 2,295,798	$ 435,612	$ 198,216	$ -	$ 15,288,198
Excess (shortfall) of interest-earning assets						
over deposits and borrowings	$ 2,464,202	$ (1,918,131)	$ 829,876	$ (186,460)	$ 7,659	$ 1,197,146
Cumulative gap	2,464,202	546,071	1,375,947	1,189,487	1,197,146	
Cumulative gap as a percentage of total assets:						
September 30, 2006	14.51 %	3.22 %	8.10 %	7.00 %	7.05 %	
December 31, 2005	23.22	11.19	7.08	5.80	5.82	
September 30, 2005	23.87	12.07	7.38	6.05	6.05	

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

Our six-month gap at September 30, 2006 was a positive 14.51%. This means that more interest-earning assets mature or reprice within six months than total deposits and borrowings. This compares to our positive six-month gap of 23.22% at December 31, 2005 and 23.87% a year ago, which reflected a larger repricing mismatch between interest-earning assets and deposits and borrowings.

We continue to emphasize the origination of adjustable rate mortgages for our investment portfolio. For the twelve months ended September 30, 2006, we originated and purchased for investment $5.8 billion of adjustable rate loans which represented essentially all of the loans we originated and purchased for investment during the period.

At September 30, 2006, December 31, 2005 and September 30, 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, and totaled $14.6 billion at September 30, 2006, compared to $15.1 billion at December 31, 2005 and $14.6 billion a year ago. During the current quarter, we continued to offer residential fixed rate loan products to our customers primarily for sale in the secondary market. We price and originate fixed rate mortgage loans for sale into the secondary market to increase opportunities to originate adjustable rate mortgages and to generate fees and servicing income. We also occasionally originate a small number of fixed rate loans for portfolio to facilitate the sale of real estate acquired in settlement of loans and which meet specific yield and other approved guidelines.

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

	September 30, 2006	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Weighted average yield: [a]					
Loans and mortgage-backed securities	7.38 %	6.99 %	6.52 %	6.10 %	5.69 %
Investment securities [b]	5.26	4.97	4.66	4.37	4.09
Interest-earning assets yield	7.22	6.88	6.44	6.04	5.63
Weighted average cost:					
Deposits	3.81	3.45	3.22	2.98	2.74
Borrowings:					
Federal Home Loan Bank advances and other borrowings [c]	5.68	5.56	4.94	4.71	4.15
Senior notes	6.50	6.50	6.50	6.50	6.50
Total borrowings	5.73	5.60	5.02	4.80	4.29
Combined funds cost	4.23	3.99	3.67	3.42	3.08
Interest rate spread	2.99 %	2.89 %	2.77 %	2.62 %	2.55 %

[a] Excludes adjustments for non-accrual loans, amortization of net deferred costs to originate loans, premiums and discounts, prepayment and late fees and FHLB stock dividends.
[b] Includes the yield on investment securities accounted for on a trade-date basis but for which interest income will not be recognized until settlement. Yields for investment securities available for sale are calculated using historical cost balances and do not give effect to changes in fair value that are reflected as a component of stockholders equity.
[c] Included the impact of swap contracts, with notional amounts totaling $430 million of receive-fixed, pay-3-month LIBOR variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.

The period-end weighted average yield on our loans and mortgage-backed securities increased to 7.38% at September 30, 2006, up from 6.10% at December 31, 2005 and 5.69% at September 30, 2005. At September 30, 2006, our adjustable rate mortgage portfolio of single family residential loans, including mortgage-backed securities, totaled $14.4 billion with a weighted average rate of 7.34%, compared to $15.2 billion with a weighted average rate of 6.05% at December 31, 2005, and $14.7 billion with a weighted average rate of 5.63% at September 30, 2005.

Problem Loans and Real Estate

Non-Performing Assets

Non-performing assets consist of loans on which we have ceased accruing interest (which we refer to as non-accrual loans), loans restructured at a below market rate and real estate acquired in settlement of loans. Our non-performing assets increased $27 million during the current quarter to $67 million or 0.39% of total assets. The increase occurred in both our prime and subprime residential loan categories.

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

(Dollars in Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Non-accrual loans:					
Residential one-to-four units	$ 46,589	$ 26,227	$ 26,102	$ 23,497	$ 18,373
Residential one-to-four units subprime	13,872	11,847	12,401	10,774	9,018
Other	306	-	1	42	634
Total non-accrual loans	60,767	38,074	38,504	34,313	28,025
Real estate acquired in settlement of loans	5,761	1,254	385	908	2,323
Total non-performing assets	$ 66,528	$ 39,328	$ 38,889	$ 35,221	$ 30,348
Allowance for loan losses:					
Amount	$ 60,784	$ 51,198	$ 44,504	$ 34,601	$ 34,565
As a percentage of non-accrual loans	100.03 %	134.47 %	115.58 %	100.84 %	123.34 %
Non-performing assets as a percentage of total assets	0.39	0.23	0.22	0.21	0.18

Delinquent Loans

Loans delinquent 30 days or more as a percentage of total loans was 0.68% at September 30, 2006, up from 0.36% at December 31, 2005, and from 0.30% a year ago. The increase primarily occurred in our residential one-to-four units category.

Navigation Links

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

	September 30, 2006				*June 30, 2006*			
ollars in Thousands)	*30-59 Days*	*60-89 Days*	*90+ Days [(a)]*	*Total*	*30-59 Days*	*60-89 Days*	*90+ Days [(a)]*	*Total*
ans secured by real estate:								
esidential:								
ne-to-four units	$ 37,140	$ 17,956	$ 31,243	$ 86,339	$ 23,577	$ 9,003	$ 18,807	$ 51,387
ne-to-four units subprime	5,382	2,916	5,971	14,269	4,430	2,874	5,072	12,376
ome equity loans and lines of credit	-	173	297	470	400	-	-	400
ive or more units	-	-	-	-	-	-	-	-
ommercial real estate	-	-	-	-	-	-	-	-
onstruction	-	-	-	-	-	-	-	-
nd	-	-	-	-	-	-	-	-
otal real estate loans	42,522	21,045	37,511	101,078	28,407	11,877	23,879	64,163
n-mortgage:								
ommercial	-	-	-	-	-	-	-	-
utomobile	47	-	-	47	-	-	-	-
her consumer	16	10	9	35	13	31	-	44
otal delinquent loans	$ 42,585	$ 21,055	$ 37,520	$ 101,160	$ 28,420	$ 11,908	$ 23,879	$ 64,207
linquencies as a percentage of total ns	0.28 %	0.14 %	0.25 %	0.68 %	0.18 %	0.08 %	0.15 %	0.41 %

	March 31, 2006				*December 31, 2005*			
ans secured by real estate:								
esidential:								
ne-to-four units	$ 20,663	$ 8,127	$ 17,714	$ 46,504	$ 19,183	$ 5,552	$ 19,587	$ 44,322
ne-to-four units subprime	6,006	2,364	4,396	12,766	5,919	1,645	4,221	11,785
ome equity loans and lines of credit	61	-	-	61	-	59	24	83
ive or more units	-	-	-	-	-	-	-	-
ommercial real estate	-	-	-	-	-	-	-	-
onstruction	-	-	-	-	-	-	-	-
nd	-	-	-	-	-	-	-	-
otal real estate loans	26,730	10,491	22,110	59,331	25,102	7,256	23,832	56,190
n-mortgage:								
ommercial	-	-	-	-	-	-	-	-
utomobile	49	-	1	50	-	3	-	3
her consumer	12	6	-	18	20	13	18	51

otal delinquent loans	$ 26,791	$ 10,497	$ 22,111	$ 59,399	$ 25,122	$ 7,272	$ 23,850	$ 56,244
linquencies as a percentage of total ns	0.17 %	0.06 %	0.14 %	0.37 %	0.16 %	0.05 %	0.15 %	0.36 %

	September 30, 2005			
ans secured by real estate:				
esidential:				
ne-to-four units	$ 16,631	$ 8,980	$ 10,295	$ 35,906
ne-to-four units subprime	3,602	1,213	4,414	9,229
ome equity loans and lines of credit	-	380	185	565
ive or more units	-	-	-	-
ommercial real estate	-	-	-	-
onstruction	-	-	-	-
nd	-	-	-	-
otal real estate loans	20,233	10,573	14,894	45,700
n-mortgage:				
ommercial	-	-	428	428
tomobile	7	1	-	8
her consumer	28	22	21	71
otal delinquent loans	$ 20,268	$ 10,596	$ 15,343	$ 46,207
linquencies as a percentage of total ns	0.13 %	0.07 %	0.10 %	0.30 %

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

Allowance for Credit and Real Estate Losses

We maintain a valuation allowance for credit and real estate losses to provide for losses inherent in those portfolios. The allowance for credit losses includes an allowance for loan losses reported as a reduction of loans held for investment and the allowance for loan-related commitments reported in accounts payable and accrued liabilities. On March 31, 2006, we reclassified to liabilities our allowance for loan-related commitments which was previously included with the allowance for loan losses. Previously reported periods were reclassified to conform to the current period presentation. Management evaluates the adequacy of the allowance quarterly to maintain the allowance at levels sufficient to provide for inherent losses at the balance sheet date.

We use an internal asset review system and loss allowance methodology to provide for timely recognition of problem assets and an adequate allowance to cover asset and loan-related commitment losses. The amount of the allowance is based upon the total of general valuation allowances, allocated allowances and an unallocated allowance. General valuation allowances relate to assets and loan-related commitments with no well-defined deficiency or weakness and take into consideration losses that are imbedded within the portfolio but have not yet been realized. Allocated allowances relate to assets with well-defined deficiencies or weaknesses. If we determine the carrying value of our asset exceeds the net fair value and no alternative payment source exists, then a specific allowance is recorded for the amount of that difference. The unallocated allowance is more subjective and is reviewed quarterly to take into consideration estimation errors and economic trends that are not captured in determining the general valuation and allocated allowances.

Provision for credit losses totaled $9.6 million in the third quarter of 2006, compared with a reversal of $0.8 million a year ago. During the current quarter, the California residential real estate market continued to show signs of weakening, with a decline in prices beginning to emerge in certain segments for the first time and and an increase in loan defaults. In addition, increases continued in both negative amortization and capitalized interest balances. If this tendency continues, certain borrowers may reach their limit of negative amortization permitted under the terms of their loan, thereby resulting in an increase in their minimum monthly loan payment and the potential for higher delinquencies. In consideration of these trends, an increase in the allowance for credit losses was deemed appropriate. The allowance was increased $9.4 million in the current quarter, reflecting increases of $8.1 million in the general valuation allowance and $1.3 million in the allocated allowance. At September 30, 2006, the allowance for credit losses was $62 million, comprised of $61 million for loan losses and $1 million for unfunded loan commitments which is reported in the category accounts payable and accrued liabilities. That compares to an allowance for credit losses of $36 million at year-end 2005, comprised of $35 million for loan losses and $1 million for loan-related commitments. There was no change in our unallocated allowance of $2.8 million.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Allowance for loan losses					
Balance at beginning of period	$ 51,198	$ 44,504	$ 34,601	$ 34,565	$ 34,561
Provision (reduction)	9,777	6,701	9,974	512	(365)
Charge-offs	(197)	(12)	(76)	(479)	(50)
Recoveries	6	5	5	3	419
Balance at end of period	$ 60,784	$ 51,198	$ 44,504	$ 34,601	$ 34,565
Allowance for loan-related commitments					
Balance at beginning of period	$ 1,358	$ 1,397	$ 1,314	$ 1,433	$ 1,819
Provision (reduction)	(137)	(39)	83	(119)	(386)
Charge-offs	-	-	-	-	-
Recoveries	-	-	-	-	-
Balance at end of period	$ 1,221	$ 1,358	$ 1,397	$ 1,314	$ 1,433
Total allowance for credit losses					
Balance at beginning of period	$ 52,556	$ 45,901	$ 35,915	$ 35,998	$ 36,380
Provision (reduction)	9,640	6,662	10,057	393	(751)
Charge-offs	(197)	(12)	(76)	(479)	(50)
Recoveries	6	5	5	3	419
Balance at end of period	$ 62,005	$ 52,556	$ 45,901	$ 35,915	$ 35,998

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Allowance for loan losses		
Balance at beginning of period	$ 34,601	$ 33,343
Provision	26,452	1,808
Charge-offs	(285)	(1,021)
Recoveries	16	435
Balance at end of period	$ 60,784	$ 34,565

Allowance for loan-related commitments		
Balance at beginning of period	$ 1,314	$ 1,371
Provision (reduction)	(93)	62
Charge-offs	-	-
Recoveries	-	-
Balance at end of period	$ 1,221	$ 1,433
Total allowance for credit losses		
Balance at beginning of period	$ 35,915	$ 34,714
Provision	26,359	1,870
Charge-offs	(285)	(1,021)
Recoveries	16	435
Balance at end of period	$ 62,005	$ 35,998

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

(Dollars in Thousands)	*Three Months Ended*					*Nine Months Ended*	
	September 30, 2006	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*	*September 30, 2006*	*September 30, 2005*
Gross loan charge-offs							
Loans secured by real estate:							
Residential:							
One-to-four units	$ 166	$ -	$ -	$ 20	$ 4	$ 166	$ 883
One-to-four units subprime	-	-	25	-	-	25	-
Home equity loans and lines of credit	-	-	-	-	-	-	-
Five or more units	-	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-	-
Construction	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-
Non-mortgage:							
Commercial	-	-	-	428	-	-	-
Automobile	-	1	-	-	-	1	9
Other consumer	31	11	51	31	46	93	129
Total gross loan charge-offs	197	12	76	479	50	285	1,021
Gross loan recoveries							
Loans secured by real estate:							
Residential:							
One-to-four units	-	-	-	-	410	-	410
One-to-four units subprime	-	-	-	-	-	-	-
Home equity loans and lines of credit	-	-	-	-	-	-	-
Five or more units	-	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-	-
Construction	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-
Non-mortgage:							
Commercial	-	-	-	-	-	-	-
Automobile	-	-	-	-	-	-	-
Other consumer	6	5	5	3	9	16	25
Total gross loan recoveries	6	5	5	3	419	16	435

Net loan charge-offs (recoveries)							
Loans secured by real estate:							
Residential:							
One-to-four units	166	-	-	20	(406)	166	473
One-to-four units subprime	-	-	25	-	-	25	-
Home equity loans and lines of credit	-	-	-	-	-	-	-
Five or more units	-	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-	-
Construction	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-
Non-mortgage:							
Commercial	-	-	-	428	-	-	-
Automobile	-	1	-	-	-	1	9
Other consumer	25	6	46	28	37	77	104
Total net loan charge-offs (recoveries)	$ 191	$ 7	$ 71	$ 476	$ (369)	$ 269	$ 586
Net loan charge-offs (recoveries) as a percentage of average loans	- %	- %	- %	0.01 %	(0.01)%	- %	0.01 %

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

(Dollars in Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Loans secured by real estate:					
Residential:					
One-to-four units	$ 49,339	$ 40,124	$ 31,608	$ 23,467	$ 21,538
One-to-four units subprime	4,579	4,394	6,266	5,127	6,190
Home equity loans and lines of credit	1,124	1,192	1,288	1,386	1,555
Five or more units	1,049	1,064	1,194	521	527
Commercial real estate	302	304	298	295	290
Construction	454	455	487	501	572
Land	838	570	251	175	358
Non-mortgage:					
Commercial	14	14	16	15	438
Automobile	-	1	2	3	3
Other consumer	285	280	294	311	294
Not specifically allocated	2,800	2,800	2,800	2,800	2,800
Total for loans held for investment	$ 60,784	$ 51,198	$ 44,504	$ 34,601	$ 34,565

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

(Dollars in Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Loans secured by real estate:					
Residential:					
One-to-four units	0.37 %	0.29 %	0.22 %	0.17 %	0.17 %
One-to-four units subprime	0.66	0.53	0.65	0.48	0.53
Home equity loans and lines of credit	0.53	0.51	0.51	0.51	0.52
Five or more units	0.90	0.90	0.88	0.75	0.75
Commercial real estate	1.12	1.12	1.03	1.02	1.00
Construction	0.78	0.67	0.62	0.61	0.64
Land	1.41	0.96	0.92	0.74	0.87
Non-mortgage:					
Commercial	0.41	0.41	0.46	0.38	10.37
Automobile	-	2.44	2.99	2.59	1.47
Other consumer	4.71	4.47	4.46	4.73	4.55
Total for loans held for investment	0.41 %	0.33 %	0.28 %	0.23 %	0.24 %

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

(Dollars in Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Loans secured by real estate:					
Residential:					
One-to-four units	92.00 %	91.27 %	90.48 %	89.79 %	88.31 %
One-to-four units subprime	4.72	5.38	6.14	6.98	8.00
Home equity loans and lines of credit	1.44	1.51	1.60	1.81	2.05
Five or more units	0.79	0.77	0.86	0.46	0.48
Commercial real estate	0.18	0.18	0.18	0.19	0.20
Construction	0.40	0.44	0.50	0.54	0.61
Land	0.41	0.39	0.18	0.16	0.28
Non-mortgage:					
Commercial	0.02	0.02	0.02	0.03	0.03
Automobile	-	-	-	-	-
Other consumer	0.04	0.04	0.04	0.04	0.04
Total for loans held for investment	100.00 %	100.00 %	100.00 %	100.00 %	100.00 %

At September 30, 2006, December 31, 2005, and September 30, 2005 there were no loans for which we recognized impairment; therefore, no allowance was recorded for losses related to impaired loans. Consequently, there was no interest recognized on impaired loans in the current quarter or the year-ago third quarter.

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

	Three Months Ended				
(In Thousands)	*September 30, 2006*	*June 30, 2006*	*March 31, 2006*	*December 31, 2005*	*September 30, 2005*
Balance at beginning of period	$ 103	$ 103	$ 103	$ 103	$ 1,436
Reduction	-	-	-	-	(1,333)
Charge-offs	-	-	-	-	-
Recoveries	-	-	-	-	-
Balance at end of period	$ 103	$ 103	$ 103	$ 103	$ 103

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

	Nine Months Ended September 30,	
(In Thousands)	*2006*	*2005*
Balance at beginning of period	$ 103	$ 1,436
Reduction	-	(1,333)
Charge-offs	-	-
Recoveries	-	-
Balance at end of period	$ 103	$ 103

Capital Resources and Liquidity

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

Our primary sources of funds generated in the third quarter of 2006 were:

- principal repayments of $1.4 billion including prepayments, but excluding refinances of our existing loans on loans and mortgage-backed securities;
- a net decline of $94 million in our loans held for sale; and
- a net increase of $58 million in deposits.

We used these funds to:

- originate and purchase $575 million of loans held for investment, excluding refinances of our existing loans;
- purchase investment securities of government sponsored entities of $275 million; and
- repay $617 million in FHLB advances and other borrowings.

Our principal source of liquidity is our ability to utilize borrowings, as needed. Our primary source of borrowings is the FHLB. At September 30, 2006, our FHLB borrowings totaled $2.7 billion, representing 15.8% of total assets. We currently are approved by the FHLB to borrow up to 50% of total assets to the extent we provide qualifying collateral and hold sufficient FHLB stock. That approved limit would have permitted us, as of quarter end, to borrow an additional $5.8 billion. To the extent deposit growth over the remainder of 2006 falls short of satisfying ongoing commitments to fund maturing and withdrawable deposits, repay maturing borrowings, fund existing and future loans and make investments, we may utilize the additional capacity from our FHLB borrowing arrangement or other sources. As of September 30, 2006, we had commitments to borrowers for short-term interest rate locks, before the reduction of expected fallout, of $307 million, undisbursed loan funds and unused lines of credit of $370 million and operating leases of $16 million. We believe our current sources of funds, including repayments of existing loans, enable us to meet our obligations while maintaining liquidity at appropriate levels.

The holding company currently has adequate liquid assets to meet its obligations and can obtain further funds by means of dividends from subsidiaries, subject to certain limitations, or issuance of further debt or equity. As of September 30, 2006, the Bank had the capacity to declare a dividend totaling $433 million subject to filing an application with the OTS at least 30 days prior to the distribution and the OTS does not communicate an objection. At September 30, 2006, the holding company s liquid assets, including due from Bank interest bearing balances, totaled $46 million.

Stockholders equity totaled $1.4 billion at September 30, 2006, up from $1.2 billion at December 31, 2005 and September 30, 2005.

Contractual Obligations and Other Commitments

Through the normal course of operations, we have entered into contractual obligations and other commitments. Our obligations generally relate to funding of our operations through deposits and borrowings as well as leases for premises and equipment, and our commitments generally relate to our lending operations. We have obligations under long-term operating leases, principally for building space and land. Lease terms generally cover a five-year period, with options to extend, and are non-cancelable. Currently, we have no material contractual vendor obligations.

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

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

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

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

Downey maintains an allowance for losses on loan-related commitments for undisbursed loan funds and unused lines of credit to provide for inherent losses. During the first quarter of 2006, the allowance for losses on loan-related commitments was reclassified from the allowance for loan losses to accounts payable and accrued liabilities. The allowance for losses on loan-related commitments is calculated using the same methodology as that used to determine the allowance for loan losses. Previously reported periods were reclassified to conform to the current period presentation. The reclassifications had no effect on the provision for credit losses, which continues to be comprised of the sum of the provision for loan losses and the provision for losses on loan-related commitments; thus, no effect was had on net income or stockholders equity. The allowance for losses on loan-related commitments was $1 million at September 30, 2006, December 31, 2005 and September 30, 2005.

We enter into derivative financial instruments as part of our interest rate risk management process, including loan forward sale and purchase contracts related to our sale of loans in the secondary market. The associated fair value changes to the notional amount of the derivative instruments are recorded on-balance sheet. The total notional amount of our derivative financial instruments do not represent future cash requirements. For further information, see Asset/Liability Management and Market Risk on page 41 and Note 4 of Notes to the Consolidated Financial Statements on page 9.

We sell all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty we made to the investor in connection with the sale. Identified defects, may require us to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, we have no commitment to repurchase the loan. During the first nine months of 2006, we recorded a $0.9 million repurchase loss related to defects in the origination process and repurchased $3 million of loans. These loan and servicing sale contracts typically contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. We reserved less than $1 million at September 30, 2006, December 31, 2005 and September 30, 2005 to cover the estimated loss exposure related to early payoffs. However, if all the loans related to those sales prepaid within the refund period, as of September 30, 2006, our maximum sales price premium refund would be $10.1 million. See Note 4 of Notes to the Consolidated Financial Statements on page 9.

At September 30, 2006, scheduled maturities of obligations and commitments were as follows:

(In Thousands)	*Within 1 Year*	*1 3 Years*	*4 5 Years*	*Over 5 Years*	*Total Balance*
Certificates of deposit	$ 8,728,363	$ 325,881	$ 125,185	$ -	$ 9,179,429
FHLB advances and other borrowings	2,729,678	414,546	-	-	3,144,224
Senior notes	-	-	-	198,216	198,216
Secondary marketing activities:					
Non-qualifying hedge transactions:					
Interest rate lock commitments [a]	236,435	-	-	-	236,435
Associated loan forward sale contracts	213,783	-	-	-	213,783
Qualifying cash flow hedge transactions:					
Loans held for sale, at lower of cost or fair value	323,428	-	-	-	323,428
Associated loan forward sale contracts	307,982	-	-	-	307,982
Qualifying fair value hedge transactions:					
Designated FHLB advances pay-fixed	-	430,000	-	-	430,000
Associated interest rate swap contracts					
pay-variable, receive-fixed	-	430,000	-	-	430,000
Commitments to originate adjustable rate loans held					
for investment	201,662	-	-	-	201,662
Undisbursed loan funds and unused lines of credit	26,658	15,472	-	328,029	370,159
Operating leases	5,005	7,181	3,180	987	16,353
Total obligations and commitments	$ 12,772,994	$ 1,623,080	$ 128,365	$ 527,232	$ 15,051,671

[a] *The notional amount before the reduction of expected fallout was $307 million.*

Regulatory Capital Compliance

The Bank s core and tangible capital ratios were both 8.47% and its risk-based capital ratio was 17.05% at September 30, 2006. The Bank s capital ratios compare favorably with the well capitalized standards of 5.00% for core capital and 10.00% for risk-based capital, as defined by regulation.

The following table is a reconciliation of the Bank s stockholder s equity to federal regulatory capital as of September 30, 2006.

	Tangible Capital		*Core Capital*		*Risk-Based Capital*	
(Dollars in Thousands)	*Amount*	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Stockholder s equity	$ 1,507,634		$ 1,507,634		$ 1,507,634	
Adjustments:						
Deductions:						
	(75,549)		(75,549)		(75,549)	

Investment in real estate subsidiary									
Excess cost over fair value of branch acquisitions	(3,150)			(3,150)			(3,150)		
Non-permitted mortgage servicing rights	(2,031)			(2,031)			(2,031)		
Additions:									
Unrealized losses on investment securities									
available for sale	4,516			4,516			4,516		
Allowance for credit losses, net of specific									
allowances [a]	-			-			60,734		
Regulatory capital	1,431,420	8.47 %		1,431,420	8.47 %		1,492,154	17.05 %	
Well capitalized requirement	253,525	1.50	(b)	845,083	5.00		875,353	10.00	(c)
Excess	$ 1,177,895	6.97 %		$ 586,337	3.47 %		$ 616,801	7.05 %	

[a] Limited to 1.25% of risk-weighted assets.
[b] Represents the minimum requirement for tangible capital, as no well capitalized requirement has been established for this category.
[c] A third requirement is Tier 1 capital to risk-weighted assets of 6.00%, which the Bank met and exceeded with a ratio of 16.35%.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For information regarding quantitative and qualitative disclosures about market risk, see Asset/Liability Management and Market Risk on page 41.

ITEM 4. CONTROLS AND PROCEDURES

As of September 30, 2006, Downey carried out an evaluation, under the supervision and with the participation of Downey s management, including Downey s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Downey s disclosure controls and procedures pursuant to Securities and Exchange Commission (SEC) rules. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that Downey s disclosure controls and procedures were effective as of the end of the period covered by this report. There have been no significant changes during the most recent quarter in Downey s internal controls over financial reporting or in other factors that could significantly affect these controls subsequent to the evaluation date.

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

Navigation Links

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

On June 21, 2005, a former loan underwriting employee brought an action in Contra Costa Superior Court, Case No. C05-01293, entitled Teresa Sims, et al. v. Downey Savings and Loan Association. The complaint seeks unspecified damages for alleged unpaid overtime wages and bonuses, inadequate meal and rest breaks, and related claims. The plaintiff is seeking class action status to represent all other current and former Downey Savings employees that held the position of loan underwriter, including, but not limited to, the job title of Senior Loan Underwriter within the State of California (a) at any time during the four years prior to June 21, 2005 and/or (b) who was employed by Downey Savings on or about September 30, 2002, when Downey Savings terminated an annual bonus program. Based on a review of the current facts and circumstances with retained outside counsel, (i) Downey Savings plans to oppose the claim and assert all appropriate defenses and (ii) management has provided for what is believed to be a reasonable estimate of exposure for this matter in the event of loss. While acknowledging the uncertainties of litigation, management believes that the ultimate outcome of this matter will not have a material adverse effect on its financial condition, results of operations or cash flows.

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 1A. Risk Factors

There have been no material changes in our risk factors since December 31, 2005.

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

None.

ITEM 3. Defaults Upon Senior Securities

None.

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

None

ITEM 5. Other Information

None.

ITEM 6. Exhibits

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

AVAILABILITY OF REPORTS

Corporate governance guidelines, charters for the audit, compensation, and nominating and corporate governance committees of the Board of Directors and codes of business conduct and ethics are available free of charge from our internet site, www.downeysavings.com by clicking on Investor Relations on our home page and proceeding to Corporate Governance. Annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are posted on our internet site as soon as reasonably practical after we file them with the SEC and available free of charge under Reports on our Investor Relations page.

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

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

SIGNATURES

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

DOWNEY FINANCIAL CORP.

/s/ Daniel D. Rosenthal

Date: November 1, 2006	Daniel D. Rosenthal President and Chief Executive Officer
	/s/ Brian E. Côté
Date: November 1, 2006	Brian E. Côté Chief Financial Officer

NAVIGATION LINKS

PART II OTHER INFORMATION