

DOWNEY FINANCIAL CORP

Form 10-Q

November 10, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended **September 30, 2008**

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

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was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  
Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

At September 30, 2008, 29,080,777 shares of the Registrant's Common Stock, \$0.01 par value were outstanding.

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**DOWNEY FINANCIAL CORP.**

**September 30, 2008 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 (unaudited)**

(Dollars in Thousands, Except Per Share Data)

September 30,    December 31,    September 30,  
2008                      2007                      2007

**Assets**

Cash	\$ 451,815	\$ 83,840	\$ 86,072
Federal funds and interest earning due from banks	101,129	5,900	1,551
<hr/>			
Cash and cash equivalents	552,944	89,740	87,623
U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value	592,542	1,549,879	2,142,278
Loans held for sale, at lower of cost or fair value	7,673	103,384	90,228
Mortgage-backed securities available for sale, at fair value	104	111	112
Loans held for investment	11,511,330	11,381,327	11,744,063
Allowance for loan losses	(761,824 )	(348,167 )	(142,218 )
<hr/>			
Loans held for investment, net	10,749,506	11,033,160	11,601,845
Investments in real estate and joint ventures	15,606	68,679	58,715
Real estate acquired in settlement of loans, net	278,091	115,623	59,773
Premises and equipment, net	113,663	115,846	117,535
Federal Home Loan Bank stock, at cost	133,255	70,964	70,058
Mortgage servicing rights:			
Measured at fair value	22,814	-	-
Amortized	-	19,512	21,849
Other assets	161,884	113,761	130,889
Income tax receivable	133,852	6,312	27,900
Deferred tax asset	19,265	122,086	8,912
<hr/>			
	\$ 12,781,199	\$ 13,409,057	\$ 14,417,717

**Liabilities and Stockholders Equity**

Deposits	\$ 9,618,384	\$ 10,496,041	\$ 10,662,618
Securities sold under agreements to repurchase	-	-	566,350
Federal Home Loan Bank advances	2,110,061	1,197,100	1,308,867
Senior notes	198,593	198,445	198,398
Accounts payable and accrued liabilities	82,447	183,054	237,258
<hr/>			
Total liabilities	12,009,485	12,074,640	12,973,491

**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 29,080,777 shares at September 30, 2008 and 28,235,022 shares at December 31, 2007 and September 30, 2007; outstanding 29,080,777 shares at September 30, 2008 and 27,853,783 at December 31, 2007 and September 30, 2007	291	282	282
Additional paid-in capital	93,835	93,792	93,792
Accumulated other comprehensive income (loss)	(6,231 )	2,768	388
Retained earnings	683,819	1,254,367	1,366,556
Treasury stock, at cost, 381,239 at December 31, 2007 and September 30, 2007	-	(16,792 )	(16,792 )

Total stockholders equity	771,714	1,334,417	1,444,226
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	\$ 12,781,199	\$ 13,409,057	\$ 14,417,717
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*See accompanying notes to consolidated financial statements.*

**DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Statements of Income (Loss) (unaudited)**

	<i>Three Months Ended</i> <i>September 30,</i>		<i>Nine Months Ended</i> <i>September 30,</i>	
<i>(Dollars in Thousands, Except Per Share Data)</i>	<i>2008</i>	<i>2007</i>	<i>2008</i>	<i>2007</i>
<b>Interest income</b>				
Loans	\$ 154,479	\$ 208,314	\$ 493,193	\$ 690,869
U.S. Treasury and government sponsored entities securities	12,977	26,350	49,330	65,644
Mortgage-backed securities	2	3	8	9
Other investment securities	1,610	1,207	3,713	5,396
<b>Total interest income</b>	<b>169,068</b>	<b>235,874</b>	<b>546,244</b>	<b>761,918</b>
<b>Interest expense</b>				
Deposits	67,726	108,514	243,047	333,977
Federal Home Loan Bank advances and other borrowings	22,010	26,088	50,601	83,494
Senior notes	3,305	3,302	9,913	9,904
<b>Total interest expense</b>	<b>93,041</b>	<b>137,904</b>	<b>303,561</b>	<b>427,375</b>
<b>Net interest income</b>	<b>76,027</b>	<b>97,970</b>	<b>242,683</b>	<b>334,543</b>
<b>Provision for credit losses</b>	<b>130,291</b>	<b>81,562</b>	<b>626,035</b>	<b>91,684</b>
<b>Net interest income (loss) after provision for credit losses</b>	<b>(54,264 )</b>	<b>16,408</b>	<b>(383,352 )</b>	<b>242,859</b>
<b>Other income, net</b>				
Loan and deposit related fees	8,152	8,913	24,595	27,087
Real estate and joint ventures held for investment, net	(10,749 )	(7,892 )	(16,625 )	(7,527 )
Net gain on sale of real estate related contracts	69,972	-	69,972	-
Secondary marketing activities:				
Loan servicing income (loss), net	(56 )	(294 )	2,724	(1,519 )
Net gains on sales of loans and mortgage-backed securities	677	2,506	6,898	20,224
Net gains on sales of investment securities	-	-	837	-
Other	219	(197 )	817	(16 )
<b>Total other income, net</b>	<b>68,215</b>	<b>3,036</b>	<b>89,218</b>	<b>38,249</b>
<b>Operating expense</b>				
Salaries and related costs	37,611	36,699	118,197	119,931
Premises and equipment costs	9,224	9,736	27,402	27,667

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Advertising expense	1,473	1,400	2,750	4,469
Deposit insurance premiums and regulatory assessments	8,117	2,413	15,509	7,659
Professional fees	3,000	489	4,146	1,779
Impairment writedown of goodwill	-	-	3,149	-
Other general and administrative expense	11,802	8,275	29,256	24,271
<hr/>				
Total general and administrative expense	71,227	59,012	200,409	185,776
Net operation of real estate acquired in settlement of loans	31,428	3,664	79,763	4,903
<hr/>				
Total operating expense	102,655	62,676	280,172	190,679
<hr/>				
<b>Income (loss) before income taxes (tax benefits)</b>	(88,704 )	(43,232 )	(574,306 )	90,429
Income taxes (tax benefits)	(7,634 )	(19,871 )	(26,620 )	38,183
<hr/>				
<b>Net income (loss)</b>	\$ (81,070 )	\$ (23,361 )	\$ (547,686 )	\$ 52,246
<hr/>				
<b>Per share information</b>				
Basic	\$ (2.89 )	\$ (0.84 )	\$ (19.64 )	\$ 1.87
Diluted	\$ (2.89 )	\$ (0.84 )	\$ (19.64 )	\$ 1.87
Cash dividends declared and paid	\$ 0.01	\$ 0.12	\$ 0.25	\$ 0.36
<b>Weighted average shares outstanding</b>				
Basic	27,960,478	27,853,783	27,889,608	27,853,783
Diluted	27,960,478	27,853,783	27,889,608	27,882,804

See accompanying notes to consolidated financial statements.



**DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income (Loss) (unaudited)**

	<i>Three Months Ended</i>		<i>Nine Months Ended</i>	
	<i>September 30,</i>		<i>September 30,</i>	
<i>(In Thousands)</i>	<i>2008</i>	<i>2007</i>	<i>2008</i>	<i>2007</i>
<b>Net income (loss)</b>	\$ (81,070 )	\$ (23,361 )	\$ (547,686 )	\$ 52,246
<b>Other comprehensive income (loss), net of income taxes (tax benefits)</b>				
Unrealized gains (losses) on securities available for sale:				
U.S. Treasury, government sponsored entities and other investment securities available for sale, at fair value	(6,054 )	6,644	(9,113 )	5,926
Mortgage-backed securities available for sale, at fair value	-	1	-	1
Unrealized gains (losses) on cash flow hedges:				
Net derivative instruments	(175 )	(216 )	(390 )	609
Reclassification of realized amounts included in net income	302	27	504	(944 )
<b>Total other comprehensive income (loss), net of income tax benefits</b>	(5,927 )	6,456	(8,999 )	5,592
<b>Comprehensive income (loss)</b>	\$ (86,997 )	\$ (16,905 )	\$ (556,685 )	\$ 57,838

*See accompanying notes to consolidated financial statements.*

**DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (unaudited)**

*Nine Months Ended*  
*September 30,*

*(In Thousands)*

2008                      2007

**Cash flows from operating activities**

Net income (loss)	\$ (547,686 )	\$ 52,246
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Adjustments to reconcile net income (loss) to net cash provided by operating activities:

Depreciation	10,744	10,811
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Amortization	10,963	79,541
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Impairment writedown of goodwill	3,149	-
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Provision for losses on loans, loan-related commitments, investments in

real estate and joint ventures, mortgage servicing rights,

real estate acquired in settlement of loans, and other assets	699,465	94,833
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Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights,

investment securities, real estate and other assets	(84,947 )	(21,952 )
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Interest capitalized on loans (negative amortization)	(74,013 )	(199,382 )
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Changes in fair value of mortgage servicing rights due to:

Changes in valuation model inputs or assumptions	(536 )	-
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Other changes	2,095	-
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Federal Home Loan Bank stock dividends	(3,142 )	(5,185 )
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Loans originated or purchased for sale	(596,374 )	(1,380,371 )
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Proceeds from sales of loans held for sale, including those sold

as mortgage-backed securities	687,875	1,635,997
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Other, net	(157,175 )	(196,610 )
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Net cash provided by (used for) operating activities	(49,582 )	69,928
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**Cash flows from investing activities**