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8 UNITED STATES DISTRICT COURT  
9 CENTRAL DISTRICT OF CALIFORNIA  
10 SOUTHERN DIVISION

11 WATERFORD TOWNSHIP GENERAL )  
EMPLOYEES RETIREMENT )  
12 SYSTEM, Individually and On Behalf of )  
All Others Similarly Situated, )

13 Plaintiff, )

14 vs. )

15 DOWNEY FINANCIAL CORP., )  
16 DANIEL D. ROSENTHAL, MAURICE )  
L. McALISTER and BRIAN E. CÔTÉ, )

17 Defendants. )  
18

**VIA FAX**

No.

**CLASS ACTION**

**COMPLAINT FOR VIOLATION OF  
THE FEDERAL SECURITIES LAWS**

**DEMAND FOR JURY TRIAL**

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1 **JURISDICTION AND VENUE**

2 1. Jurisdiction is conferred by §27 of the Securities Exchange Act of 1934  
3 (“1934 Act”). The claims asserted herein arise under §§10(b) and 20(a) of the 1934  
4 Act and SEC Rule 10b-5. The amount in controversy, exclusive of interest and costs,  
5 exceeds the jurisdictional minimum of this Court.

6 2. Venue is proper here pursuant to §27 of the 1934 Act. Many of the false  
7 and misleading statements were made in or issued from this District. Downey  
8 Financial Corp. has a substantial presence in California and is headquartered in  
9 Newport Beach, California. Many of the acts and transactions giving rise to the  
10 violations of law complained of occurred here.

11 3. In connection with the acts alleged in this complaint, defendants, directly  
12 or indirectly, used the means and instrumentalities of interstate commerce, including,  
13 but not limited to, the mails, interstate telephone communications and the facilities of  
14 the national securities markets.

15 **INTRODUCTION**

16 4. This is a securities class action on behalf of all persons who purchased or  
17 otherwise acquired the common stock of Downey Financial Corp. (“Downey” or the  
18 “Company”) between October 16, 2006 and March 14, 2008 (the “Class Period”),  
19 against Downey and certain of its officers and/or directors for violations of the 1934  
20 Act. The adverse affects of the Company’s mortgage problems caused shrinking of its  
21 assets and credit-quality decay.

22 5. During the Class Period, defendants issued materially false and  
23 misleading statements regarding the Company’s business and financial results.  
24 Defendants engaged in improper behavior which harmed its customers and its  
25 investors in both its common stock and its mortgage-backed securities. These  
26 practices included lending to borrowers with little ability to repay the amount loaned,  
27 pushing solid borrowers into subprime loans due to the higher fees generated and  
28 pushing option adjustable-rate mortgages (“Option ARMs”), which would harm not

1 only the borrowers, but in the long-term the Company itself, so as to unjustly enrich  
2 themselves while in possession of material, adverse, non-public information  
3 concerning Downey's operations and unsound mortgage practices.

4 6. As a result of defendants' false statements, Downey's stock traded at  
5 artificially inflated prices during the Class Period, reaching a high of \$74.85 per share  
6 in June 2007.

7 7. In mid-July 2007, it became apparent to the market that banks, including  
8 Downey, would be adversely affected by the mortgage meltdown. As it relates to  
9 Downey, investors would have known this information at the beginning of the Class  
10 Period had defendants taken appropriate reserves for the large amount of securities  
11 linked to subprime mortgages in Downey's portfolio.

12 8. On October 10, 2007, Downey issued a press release entitled "Downey  
13 Announces Housing Environment Impacts Third Quarter," which stated in part:

14 Downey Financial Corp. announced today that it will report third quarter  
15 2007 financial results on October 17, 2007, and, subject to finalization of  
16 results, that it expects to incur an operating loss for the quarter of  
17 approximately \$23 million or \$0.84 per share on a fully diluted basis.  
18 This will reduce net income for the first nine months of 2007 to  
19 approximately \$52 million or \$1.87 per share on a fully diluted basis.

20 The third quarter results are adversely affected by the continued  
21 weakening in the housing market. More specifically, the quarter will  
22 include the following pre-tax amounts:

- 23 • An approximate \$82 million provision for credit losses,  
24 which will increase the allowance for loan losses to  
25 approximately \$144 million or 1.22% of loans held for  
26 investment.
- 27 • An approximate \$9 million valuation reduction to real  
28 estate held for development to reflect declines in the value

1 of single family home lots in which the company is a joint  
2 venture partner.

3 \* \* \*

4 Mr. Rosenthal further stated that, “In response to recent trends and  
5 events, we have further tightened our lending guidelines, activated a loan  
6 modification group to work with borrowers on a proactive basis, and  
7 provided the necessary resources to dispose of homes acquired through  
8 foreclosure on a timely basis. Finally, despite this quarter’s unfavorable  
9 results, Downey remains well positioned to continue funding quality  
10 loans because of our strong capital position and stable source of funds  
11 from our retail branch franchise.”

12 9. Before the market opened on March 17, 2008, Downey released its  
13 monthly selected financial results for the 13 months ended February 29, 2008. This  
14 showed a significant increase in non-performing assets (“NPA”) to almost 11% of  
15 total assets, up from 1.2% in May 2007. Downey had to restructure debt for many  
16 borrowers to avoid those loans from failing.

17 10. On this news, Downey’s stock dropped to close at \$18.82 per share on  
18 March 17, 2008, a decline from \$19.14 per share on March 14, 2008, and a decline of  
19 68% from \$59 per share on October 9, 2007.

20 11. The true facts, which were known by the defendants but concealed from  
21 the investing public during the Class Period, were as follows:

22 (a) Defendants’ portfolio of Option ARMs contained millions of  
23 dollars worth of impaired and risky securities, many of which were backed by  
24 subprime mortgage loans;

25 (b) Prior to the Class Period, Downey had seen Countrywide’s growth  
26 and had started to get more aggressive in acquiring loans from brokers such that the  
27 loans were extremely risky;

28

1 (c) Defendants failed to properly account for highly leveraged loans  
2 such as mortgage securities;

3 (d) Downey had very little real underwriting, which led to large  
4 numbers of bad loans that would cause huge numbers of defaults which would hurt  
5 borrowers and the Company itself; and

6 (e) Downey had not adequately reserved for Option ARM loans, the  
7 terms of which provided that during the initial term of the loan borrowers could pay  
8 only as much as they desired with any underpayment being added to the loan balance.  
9 These loans would become toxic (for both Downey and the borrowers) once housing  
10 prices stopped increasing at a rapid rate.

11 12. As a result of defendants' false statements, Downey's stock traded at  
12 inflated levels during the Class Period. However, after the above revelations seeped  
13 into the market, the Company's shares were hammered by massive sales, sending  
14 them down more than 68% from their price before these disclosures.

### 15 THE PARTIES

16 13. Plaintiff Waterford Township General Employees Retirement System  
17 purchased Downey common stock as described in the attached certification and was  
18 damaged thereby.

19 14. Defendant Downey is a savings and loan holding company. Downey  
20 Savings is the Company's wholly owned subsidiary. The Company is also involved in  
21 real estate investments. Downey is headquartered in Newport Beach, California, and  
22 has branch offices throughout the United States, including many in this District.

23 15. Defendant Daniel D. Rosenthal ("Rosenthal") is, and at all relevant times  
24 was, Vice Chairman of the Board of Directors and Chief Executive Officer ("CEO")  
25 of Downey and Downey Bank. Rosenthal served as President of Downey until  
26 October 2007. Rosenthal participated in the issuance of improper statements,  
27 including the preparation of the improper press releases and SEC filings.

28

1           16. Defendant Maurice L. McAlister (“McAlister”) is, and at all relevant  
2 times was, Chairman of the Board of Downey. McAlister co-founded Downey Bank.  
3 McAlister participated in the issuance of improper statements, including the  
4 preparation of the improper press releases and SEC filings.

5           17. Defendant Brian E. Côté (“Côté”) is, and at all relevant times was,  
6 Executive Vice President and Chief Financial Officer (“CFO”) of Downey. Côté  
7 participated in the issuance of improper statements, including the preparation of the  
8 improper press releases and SEC filings.

9           18. Defendants Rosenthal, McAlister and Côté (the “Individual  
10 Defendants”), because of their positions with the Company, possessed the power and  
11 authority to control the contents of Downey’s quarterly reports, press releases and  
12 presentations to securities analysts, money and portfolio managers and institutional  
13 investors, *i.e.*, the market. They were provided with copies of the Company’s reports  
14 and press releases alleged herein to be misleading prior to or shortly after their  
15 issuance and had the ability and opportunity to prevent their issuance or cause them to  
16 be corrected. Because of their positions with the Company, and their access to  
17 material non-public information available to them but not to the public, the Individual  
18 Defendants knew that the adverse facts specified herein had not been disclosed to and  
19 were being concealed from the public and that the positive representations being made  
20 were then materially false and misleading. The Individual Defendants are liable for  
21 the false statements pleaded herein at ¶¶21-23, 25-26, 28 and 30-31.

22                           **FRAUDULENT SCHEME AND COURSE OF BUSINESS**

23           19. Defendants are liable for: (i) making false statements; or (ii) failing to  
24 disclose adverse facts known to them about Downey. Defendants’ fraudulent scheme  
25 and course of business that operated as a fraud or deceit on purchasers of Downey  
26 common stock was a success, as it: (i) deceived the investing public regarding  
27 Downey’s prospects and business; (ii) artificially inflated the price of Downey  
28

1 common stock; and (iii) caused plaintiff and other members of the Class to purchase  
2 Downey common stock at inflated prices.

### 3 **BACKGROUND**

4 20. Downey operates as the holding company for Downey Savings, which  
5 provides various financial services to individual and corporate customers. Downey  
6 attracts funds from the general public and institutions; and originates and invests in  
7 loans, such as residential real estate mortgage loans, investment securities, and  
8 mortgage-backed securities; and originates and sells loans to investors in the  
9 secondary markets. The bank offers various deposit products, which include  
10 noninterest and interest-bearing checking accounts, money market accounts, and  
11 regular passbook accounts. It originates a portfolio of other loans, including  
12 multifamily loans, commercial real estate loans, construction and land loans to  
13 developers, residential lot loans, consumer loans, and loans to individuals for the  
14 construction and permanent financing of single family homes.

### 15 **DEFENDANTS' FALSE AND MISLEADING** 16 **STATEMENTS ISSUED DURING THE CLASS PERIOD**

17 21. On October 16, 2006, Downey reported its third quarter 2006 financial  
18 results, in a release that stated in part:

19 Downey Financial Corp. reported that net income for the third quarter of  
20 2006 totaled \$57.2 million or \$2.05 per share on a diluted basis, down  
21 \$2.6 million or 4.3% from the \$59.7 million or \$2.14 per share in the  
22 year-ago third quarter.

23 The decline in net income between third quarters primarily  
24 reflected:

- 25 • A \$14.7 million decline in net gains on sales of loans and  
26 mortgage-backed securities due to a lower volume of loans  
27 sold;

- 1                   • A \$10.4 million increase in the provision for credit losses;  
2                   and  
3                   • A \$2.5 million unfavorable change in income from loan  
4                   servicing activities due primarily to changes in our  
5                   valuation allowance for mortgage servicing rights.

6                   Those unfavorable items were partially offset by:

- 7                   • A \$20.2 million or 18.4% increase in net interest income  
8                   reflecting both higher average interest-earning assets and  
9                   effective interest rate spread;  
10                  • A \$2.0 million increase in income from real estate held for  
11                  investment due to higher gains from sales; and  
12                  • A \$1.6 million litigation award received in the current  
13                  quarter.

14                  Both the current and year-ago third quarters included reductions to  
15                  income tax expense from the settlement of prior-year tax returns.  
16                  However, the current quarter reduction of \$3.6 million was above the  
17                  \$3.2 million reduction of a year ago.

18                  For the first nine months of 2006, net income totaled \$151.5  
19                  million or \$5.43 per share on a diluted basis, down \$24.1 million or  
20                  13.7% from the \$175.5 million or \$6.30 per share for the first nine  
21                  months of 2005.

22                  Daniel D. Rosenthal, President and Chief Executive Officer,  
23                  commented, “Back in March of this year, we increased the start rate on  
24                  option ARMs originated for portfolio to reduce the potential for negative  
25                  amortization. We acknowledged at the time the possibility our loan  
26                  production might not fully offset payoffs, since our minimum start rate  
27                  might remain higher than those of competition, and that has been the  
28                  situation for the past two quarters. We also indicated that we would

1 continue to closely monitor trends in the residential housing and lending  
2 markets and would make further pricing adjustments as deemed  
3 appropriate. In September, we increased the competitiveness of our  
4 option ARM pricing by lowering the start rate for borrowers who have  
5 high FICO credit scores and low loan-to-value ratios, with the goal of  
6 stimulating additional loan production for our portfolio, while at the  
7 same time limiting our credit exposure. However, we are not certain this  
8 pricing change will result in loan production completely offsetting  
9 portfolio payoffs, especially as we consider the implications of, and  
10 alternatives available to us in response to, the final guidance recently  
11 issued to depository institutions by the banking regulators regarding so-  
12 called non-traditional mortgage products, of which option ARMs are an  
13 example. At this time, we are assessing what impact, if any, this new  
14 lending guidance will have on our loan production volumes.”

15 *Net Interest Income*

16 Net interest income totaled \$130.2 million in the third quarter of  
17 2006, up \$20.2 million or 18.4% from a year ago. This increase reflected  
18 increases in both average interest-earning assets and effective interest  
19 rate spread. Interest-earning assets averaged \$16.789 billion in the  
20 current quarter, up \$656 million or 4.1% from the same period a year  
21 ago. The effective interest rate spread averaged 3.10% in the current  
22 quarter, up 0.37% from 2.73% a year ago, and up 0.03% from 3.07% in  
23 the second quarter of 2006. The increase in the effective interest rate  
24 spread between third quarters primarily reflected two items. First,  
25 interest-earning assets in the current quarter were funded with a higher  
26 proportion of interest free funds (non-interest bearing checking accounts  
27 and the excess of interest-earning assets over deposits and borrowings),  
28 and the value of those funds was worth more due to the higher interest

1 rate levels prevalent in the quarter. Second, loan prepayment fees  
2 covered a higher proportion of the deferred loan costs that were written-  
3 off as a result of those payoffs.

4 For the first nine months of 2006, net interest income totaled  
5 \$388.5 million, up \$63.1 million or 19.4% from the year-ago period.

6 *Provision for Credit Losses*

7 Provision for credit losses totaled \$9.6 million in the third quarter  
8 of 2006, compared with a reversal of \$0.8 million a year ago. During the  
9 current quarter, the California residential real estate market continued to  
10 show signs of weakening, with a decline in prices beginning to emerge in  
11 certain segments for the first time. In addition, there were continuing  
12 increases in both negative amortization and capitalized interest balances  
13 as well as an upward trend in loan defaults. In consideration of these  
14 trends, an increase in the allowance for credit losses was deemed  
15 appropriate. At September 30, 2006, the allowance for credit losses was  
16 \$62 million, comprised of \$61 million for loan losses and \$1 million for  
17 unfunded loan commitments which is reported in the category accounts  
18 payable and accrued liabilities. That compares with an allowance for  
19 credit losses of \$36 million at year-end 2005. Net charge-offs totaled  
20 \$0.2 million in the current quarter, compared with a net recovery of \$0.4  
21 million a year ago.

22 For the first nine months of 2006, provision for credit losses  
23 totaled \$26.4 million and net charge-offs were \$0.3 million. That  
24 compares with a \$1.9 million provision for credit losses and net charge-  
25 offs of \$0.6 million a year ago.

26 \* \* \*

27 *Assets, Loan Originations and Deposits*

1           At September 30, 2006, assets totaled \$16.983 billion, up \$415  
2 million or 2.5% from a year ago but down \$113 million or 0.7% from  
3 year-end 2005. During the current quarter, assets declined \$482 million  
4 or 2.8% due primarily to declines of \$709 million in loans held for  
5 investment and \$94 million in loans held for sale, partially offset by a  
6 \$270 million increase in securities available for sale. Included within  
7 loans held for investment at quarter end were \$12.327 billion of one-to-  
8 four unit adjustable rate mortgages subject to negative amortization,  
9 down \$895 million from June 30, 2006. The amount of negative  
10 amortization included in loan balances increased \$48 million during the  
11 current quarter to \$277 million or 2.25% of loans subject to negative  
12 amortization. During the current quarter, approximately 28% of loan  
13 interest income represented negative amortization, up from both 26% in  
14 the second quarter of 2006 and 18% in the year-ago third quarter. At  
15 origination, these loans had a weighted average loan-to-value ratio of  
16 73%.

17           Loan originations (including purchases) totaled \$1.605 billion in  
18 the current quarter, down \$2.039 billion or 56.0% from \$3.644 billion a  
19 year ago. Loans originated for sale declined \$876 million or 51.5% to  
20 \$824 million, while single family loans originated for portfolio declined  
21 \$1.147 billion or 60.0% to \$765 million. Of all loans originated for  
22 portfolio this quarter, \$8 million represented subprime credits. At quarter  
23 end, the subprime portfolio totaled \$692 million, with an average loan-  
24 to-value ratio at origination of 70% and, of the total, 97% represented  
25 “Alt. A and A-” credits. In addition to single family loans, \$16 million of  
26 other loans were originated in the current quarter. For the first nine  
27 months of 2006, loan originations totaled \$6.489 billion, down 46.0%  
28 from \$12.026 billion in the same period a year ago.

\* \* \*

1  
2 *Non-Performing Assets*

3 Non-performing assets increased during the quarter by \$27 million  
4 to \$67 million and represented 0.39% of total assets, compared with  
5 0.21% at year-end 2005.

6 22. On January 18, 2007, Downey reported its full year and fourth quarter  
7 2006 financial results, in a release that stated in part:

8 Downey Financial Corp. reported net income for 2006 of \$205.2 million  
9 or \$7.36 per share on a diluted basis, down 5.6% from the record \$217.4  
10 million or \$7.80 per share in 2005.

11 The decline in net income between years was primarily due to:

- 12 • A \$76.3 million decrease in net gains on sales of loans and  
13 mortgage-backed securities, primarily due to a lower  
14 volume of loans sold and, to a lesser extent, a lower gain  
15 per dollar of loan sold;
- 16 • A \$24.3 million increase in provision for credit losses; and
- 17 • A \$9.3 million or 4.0% increase in general and  
18 administrative expense.

19 Those unfavorable items were partially offset by:

- 20 • A \$82.3 million or 18.9% increase in net interest income,  
21 primarily due to a higher effective interest rate spread of  
22 3.09% compared with 2.69% in 2005; and
- 23 • A \$4.2 million increase in income from real estate held for  
24 investment, primarily due to higher gains on sales.

25 For the fourth quarter of 2006, net income totaled \$53.7 million or  
26 \$1.93 per share on a diluted basis, up \$11.8 million or 28.2% from \$41.9  
27 million or \$1.50 per share for 2005.

1 Daniel D. Rosenthal, President and Chief Executive Officer,  
2 commented, “Downey had a good year in 2006, with earnings at their  
3 second highest level despite a challenging business environment  
4 characterized by a significant softening in the residential housing market.  
5 This factor contributed to a drop in loan production and a need to  
6 increase our allowance for credit losses, resulting in Downey’s earnings  
7 falling below 2005’s record level. While this same challenge confronts  
8 us as we enter 2007, *we enter the year with a strong capital position*  
9 *which will allow us to take advantage of any opportunities that may*  
10 *arise.”*

11 \* \* \*

12 *Provision for Credit Losses*

13 During the current quarter, the provision for credit losses totaled  
14 \$0.2 million, down \$0.1 million from a year ago. While the California  
15 residential real estate market continued to show signs of weakening  
16 during the current quarter, a \$956 million drop in the single-family  
17 residential loan portfolio mitigated the need to increase the allowance for  
18 loan losses. At year-end 2006, the allowance for credit losses was \$62  
19 million, comprised of \$61 million for loan losses and \$1 million for  
20 unfunded loan commitments which is reported in the category accounts  
21 payable and accrued liabilities. That compares with an allowance for  
22 credit losses of \$36 million at year-end 2005. Net charge-offs totaled  
23 \$0.3 million in the current quarter, compared with net charge-offs of \$0.5  
24 million a year ago.

25 For 2006, provision for credit losses totaled \$26.6 million and net  
26 charge-offs were \$0.5 million, compared with a \$2.3 million provision  
27 for credit losses and net charge-offs of \$1.1 million in 2005.

28 \* \* \*



1 0.21% at year-end 2005. Included within the current quarter increase was  
2 an \$11 million commercial real estate loan to develop residential lots.  
3 While this loan is deemed collateral dependent and value impaired, no  
4 significant loss is anticipated at this time.

5 23. On April 18, 2007, Downey reported its first quarter 2007 financial  
6 results, in a release that stated in part:

7 Downey Financial Corp. reported net income for the first quarter of 2007  
8 of \$42.9 million or \$1.54 per share on a diluted basis, down 1.9% from  
9 \$43.7 million or \$1.57 per share in the first quarter of 2006. . . .

10 The decline in net income between first quarters was primarily due  
11 to:

- 12 • A \$3.8 million or 6.2% increase in general and  
13 administrative expense;
- 14 • A \$2.9 million decline in net gains on sales of loans and  
15 mortgage-backed securities, primarily due to a lower  
16 volume of loans sold and, to a lesser extent, a lower gain  
17 per dollar of loan sold;
- 18 • A \$1.8 million decline in income from real estate and joint  
19 ventures held for investment;
- 20 • A \$0.8 million decline in net interest income due to a lower  
21 level of interest-earning assets; and
- 22 • A \$0.6 million unfavorable change in income from loan  
23 servicing activities.

24 Those unfavorable items were partially offset by a \$9.4 million  
25 decline in provision for credit losses.

26 Daniel D. Rosenthal, President and Chief Executive Officer,  
27 commented, "Last year's challenging business environment,  
28 characterized by a softening in the residential housing market and an

1 inverted yield curve, has carried into 2007 and contributed to further  
2 declines in our loan portfolio. In addition, there has been much publicity  
3 this year about credit quality issues associated with subprime lending  
4 that has lead to the closing of numerous subprime lenders and the  
5 declaring of bankruptcy by others. Downey has historically been  
6 involved in subprime lending and has had very few losses. Our subprime  
7 portfolio has declined and represents less than 6% of our loan portfolio.  
8 We continue to have a strong capital position which will allow us to take  
9 advantage of any opportunities that may arise.”

10 \* \* \*

11 *Provision for Credit Losses*

12 During the current quarter, the provision for credit losses totaled  
13 \$0.6 million, down \$9.4 million from a year ago. At March 31, 2007, the  
14 allowance for credit losses was the same as at year-end 2006, \$62  
15 million, comprised of \$61 million for loan losses and \$1 million for  
16 unfunded loan commitments which is reported in the category accounts  
17 payable and accrued liabilities. Although the California residential real  
18 estate market continued to show signs of weakening during the current  
19 quarter, a \$823 million or 6.2% drop in the single-family residential loan  
20 portfolio mitigated the need to increase the associated allowance for loan  
21 losses. Net charge-offs totaled \$0.7 million in the current quarter, up  
22 from \$0.1 million a year ago.

23 \* \* \*

24 *Assets, Loan Originations and Deposits*

25 At March 31, 2007, assets totaled \$15.238 billion, down \$2.565  
26 billion or 14.4% from a year ago. During the current quarter, assets  
27 declined \$970 million or 6.0 % due primarily to declines of \$865 million  
28 in loans held for investment and \$95 million in loans held for sale.

1 Included within loans held for investment at quarter end were \$10.055  
2 billion of one-to-four unit adjustable rate mortgages subject to negative  
3 amortization, down \$1.145 billion from year-end 2006. These loans  
4 comprised 81% of the one-to-four unit residential portfolio at quarter  
5 end, compared to 92% a year ago. The amount of negative amortization  
6 included in loan balances increased \$37 million during the current  
7 quarter to \$358 million or 3.56% of loans subject to negative  
8 amortization. During the current quarter, approximately 31% of loan  
9 interest income represented negative amortization, up from both 29% in  
10 the fourth quarter of 2006 and 25% in the year-ago first quarter.

11 Loan originations (including purchases) totaled \$1.261 billion in  
12 the current quarter, down \$1.552 billion or 55.2% from \$2.813 billion a  
13 year ago. Loans originated for sale declined \$339 million or 34.6% to  
14 \$641 million, while single family loans originated for portfolio declined  
15 \$1.116 billion or 64.9% to \$603 million. In addition to single family  
16 loans, \$17 million of other loans were originated in the current quarter.

17 \* \* \*

18 *Non-Performing Assets*

19 Non-performing assets increased during the quarter by \$33 million  
20 to \$143 million and represented 0.94% of total assets, compared with  
21 0.68% at year-end 2006 and 0.22% a year ago.

22 24. The true facts, which were known by the defendants but concealed from  
23 the investing public during the Class Period, were as follows:

24 (a) Defendants' portfolio of Option ARMs contained millions of  
25 dollars worth of impaired and risky securities, many of which were backed by  
26 subprime mortgage loans;

27  
28

1 (b) Prior to the Class Period, Downey had seen Countrywide's growth  
2 and had started to get more aggressive in acquiring loans from brokers such that the  
3 loans were extremely risky;

4 (c) Defendants failed to properly account for highly leveraged loans  
5 such as mortgage securities;

6 (d) Downey had very little real underwriting, which led to large  
7 numbers of bad loans that would cause huge numbers of defaults which would hurt  
8 borrowers and the Company itself; and

9 (e) Downey had not adequately reserved for Option ARM loans, the  
10 terms of which provided that during the initial term of the loan borrowers could pay  
11 only as much as they desired with any underpayment being added to the loan balance.  
12 These loans would become toxic (for both Downey and the borrowers) once housing  
13 prices stopped increasing at a rapid rate.

14 25. On July 18, 2007, Downey reported its second quarter 2007 financial  
15 results, in a release that stated in part:

16 Downey Financial Corp. reported net income for the second quarter of  
17 2007 of \$32.7 million or \$1.17 per share on a diluted basis, down 32.1%  
18 from \$48.2 million or \$1.73 per share in the second quarter of 2006.

19 The decline in net income between second quarters was due  
20 primarily to:

- 21 • A \$20.9 million decline in net interest income due to a  
22 lower level of interest-earning assets;
- 23 • A \$2.8 million increase in the provision for credit losses;
- 24 • A \$2.7 million decline in income from real estate and joint  
25 ventures held for investment;
- 26 • A \$1.2 million decline in income from loan servicing  
27 activities; and

28

- 1                   •     A \$0.9 million increase in the net operation of real estate  
2                                   acquired in settlement of loans.

3                   For the first six months of 2007, net income totaled \$75.6 million  
4                   or \$2.71 per share on a diluted basis, down 17.7% from the \$91.9 million  
5                   or \$3.30 per share for the first six months of 2006.

6                   Daniel D. Rosenthal, President and Chief Executive Officer,  
7                   commented, “The ongoing softening of the housing market, coupled with  
8                   a challenging interest rate environment, have contributed to continued  
9                   declines in our loan portfolio and increases in our non-performing loans.  
10                  However, *we continue to have a very strong capital position which will*  
11                  *allow us to take advantage of opportunities as they arise.”*

12                  *Net Interest Income*

13                  Net interest income totaled \$111.5 million in the second quarter of  
14                  2007, down \$20.9 million or 15.8% from a year ago. The decline  
15                  reflected a \$2.725 billion or 15.8% decline in average interest-earning  
16                  assets. However, the effective interest rate spread of 3.07% in the current  
17                  quarter remained unchanged from a year ago.

18                  Compared to a year ago, the current quarter effective interest rate  
19                  spread was unfavorably impacted by a lower proportion of loan  
20                  prepayment fees to the amount of deferred loan origination costs written-  
21                  off as a result of those payoffs, which declined to 72.3% in the current  
22                  quarter from 99.5% a year ago. This decline was the result of a higher  
23                  proportion of loans being repaid that were no longer subject to a  
24                  prepayment fee primarily due to the increasing age of the loan portfolio.  
25                  In addition, current quarter effective interest rate spread was unfavorably  
26                  impacted by a higher proportion of earning assets being comprised of  
27                  investment securities and hybrid adjustable rate mortgage loans, both of  
28                  which have lower yields than those of option ARM loans that comprised

1 a larger proportion of interest-earning assets a year ago. However, these  
2 unfavorable items were essentially offset by a higher proportion of  
3 interest-earning assets being funded with interest free funds (the excess  
4 of interest-earning assets over interest-bearing deposits and borrowings)  
5 and the value of those funds was worth more than a year ago due to the  
6 higher interest rates prevalent during the current quarter.

7 For the first six months of 2007, net interest income totaled \$236.6  
8 million, down \$21.7 million or 8.4% from the year-ago period.

9 *Provision for Credit Losses*

10 During the current quarter, the provision for credit losses totaled  
11 \$9.5 million, up \$2.8 million from a year ago. At June 30, 2007, the  
12 allowance for credit losses was \$70.4 million, comprised of \$69.1  
13 million for loan losses and \$1.3 million for unfunded loan commitments  
14 which is reported within accounts payable and accrued liabilities. The  
15 increase to the allowance this quarter reflected the continued weakness  
16 of the California residential real estate market. In addition, a shift in the  
17 yield curve has resulted in higher mortgage interest rates which  
18 negatively affects the ability of certain borrowers to refinance which, in  
19 turn, increases their probability of default. Net charge-offs totaled \$1.0  
20 million in the current quarter, compared to virtually none a year ago.

21 For the first six months of 2007, the provision for credit losses  
22 totaled \$10.1 million and net charge-offs were \$1.7 million. This  
23 compares with a \$16.7 million provision for credit losses and net charge-  
24 offs of \$0.1 million a year ago.

25 \* \* \*

26 *Assets, Loan Originations and Deposits*

27 At June 30, 2007, assets totaled \$14.903 billion, down \$2.562  
28 billion or 14.7% from a year ago and down \$1.304 billion or 8.0% from

1 year-end 2006. During the current quarter, assets declined \$335 million  
2 due primarily to declines of \$738 million in loans held for investment  
3 and \$80 million in loans held for sale. Those declines were partially  
4 offset by an increase of \$506 million in securities available for sale.  
5 Included within loans held for investment at quarter end were \$8.914  
6 billion of single family adjustable rate mortgages subject to negative  
7 amortization, down \$1.140 billion from March 31, 2007. These loans  
8 comprised 76% of the single family residential loan portfolio at quarter  
9 end, compared to 89% a year ago. The amount of negative amortization  
10 included in loan balances increased \$20 million during the current  
11 quarter to \$377 million or 4.23% of loans subject to negative  
12 amortization. During the current quarter, approximately 29% of loan  
13 interest income represented negative amortization, down from 31% in  
14 the first quarter of 2007 but up from 26% in the year-ago second quarter.

15 Loan originations (including purchases) totaled \$1.209 billion in  
16 the current quarter, down \$862 million or 41.6% from \$2.071 billion a  
17 year ago. Loans originated for sale declined \$397 million or 44.5% to  
18 \$495 million, while single family residential loans originated for  
19 portfolio declined \$431 million or 38.1% to \$699 million. In addition to  
20 single family residential loans, \$15 million of other loans were  
21 originated in the current quarter. For the first six months of 2007, loan  
22 originations totaled \$2.470 billion, down 49.4% from \$4.884 billion in  
23 the same period a year ago.

24 \* \* \*

25 *Non-Performing Assets*

26 Non-performing assets increased during the quarter by \$84 million  
27 or 58.5% to \$227 million and represented 1.53% of total assets,  
28 compared with 0.68% at year-end 2006 and 0.23% a year ago. Of the

1 increase in the current quarter, \$76 million was related to single family  
2 residential loans, while \$7 million represented a construction loan to  
3 build single family homes on which no significant loss is expected at this  
4 time.

5 26. On October 10, 2007, Downey issued a press release entitled “Downey  
6 Announces Housing Environment Impacts Third Quarter,” which stated in part:

7 Downey Financial Corp. announced today that it will report third quarter  
8 2007 financial results on October 17, 2007, and, subject to finalization of  
9 results, that it expects to incur an operating loss for the quarter of  
10 approximately \$23 million or \$0.84 per share on a fully diluted basis.  
11 This will reduce net income for the first nine months of 2007 to  
12 approximately \$52 million or \$1.87 per share on a fully diluted basis.

13 The third quarter results are adversely affected by the continued  
14 weakening in the housing market. More specifically, the quarter will  
15 include the following pre-tax amounts:

- 16 • An approximate \$82 million provision for credit losses,  
17 which will increase the allowance for loan losses to  
18 approximately \$144 million or 1.22% of loans held for  
19 investment.
- 20 • An approximate \$9 million valuation reduction to real  
21 estate held for development to reflect declines in the value  
22 of single family home lots in which the company is a joint  
23 venture partner.

24 Daniel D. Rosenthal, President and Chief Executive Officer,  
25 commented, “We are clearly disappointed with our third quarter results.  
26 The continued weakening and uncertainty relative to the housing market,  
27 coupled with the third-quarter disruption in the secondary mortgage  
28 markets, unfavorably impacted our borrowers and the value of their loan

1 collateral. This has been particularly true in certain geographic areas  
2 such as the greater Sacramento and Stockton areas of Northern  
3 California and San Diego County. As a result, single family loan  
4 delinquencies, as well as losses from foreclosures, rose significantly  
5 during the third quarter and led to this quarter's large increase to the  
6 allowance for losses."

7 Mr. Rosenthal further stated that, "In response to recent trends and  
8 events, we have further tightened our lending guidelines, activated a loan  
9 modification group to work with borrowers on a proactive basis, and  
10 provided the necessary resources to dispose of homes acquired through  
11 foreclosure on a timely basis. Finally, despite this quarter's unfavorable  
12 results, *Downey remains well positioned to continue funding quality*  
13 *loans because of our strong capital position and stable source of funds*  
14 *from our retail branch franchise."*

15 27. On this news, Downey's stock dropped to \$53.12 per share on October  
16 10, 2007, a one-day decline of 11%, on volume of 2.4 million. The stock continued to  
17 trade at artificially inflated levels, however, as defendants concealed the extent of  
18 problematic assets in Downey's portfolio.

19 28. On October 17, 2007, Downey issued its financial results for the third  
20 quarter of 2007, in a release which stated in part:

21 Downey Financial Corp. reported a net loss for the third quarter of 2007  
22 of \$23.4 million or \$0.84 per share on a diluted basis, compared to net  
23 income of \$55.6 million or \$1.99 per share in the third quarter of 2006.

24 The \$135.8 million unfavorable change in pre-tax income /(loss)  
25 between third quarters was due primarily to:

- 26 • A \$71.9 million increase in provision for credit losses;
- 27  
28

- 1           •     A \$32.3 million or 24.8% decline in net interest income due  
2                     to a lower level of interest-earning assets and, to a lesser  
3                     extent, a lower effective interest rate spread;
- 4           •     A \$13.2 million unfavorable change in income from real  
5                     estate and joint ventures held for investment, as the current  
6                     quarter included a writedown of \$9.0 million to reflect  
7                     declines in the value of single family home lots in which  
8                     the company is a joint venture partner and net gains from  
9                     sales were below a year ago; and
- 10          •     A \$12.3 million or 83.1% decline in net gains on sales of  
11                     loans and mortgage-backed securities due to both a lower  
12                     level of loans sold and gain per dollar of loan sold.

13                     For the first nine months of 2007, net income totaled \$52.2 million  
14                     or \$1.87 per share on a diluted basis, down 64.6% from the \$147.5  
15                     million or \$5.29 per share for the first nine months of 2006.

16                     Daniel D. Rosenthal, President and Chief Executive Officer, “We  
17                     are clearly disappointed with our third quarter results. The continued  
18                     weakening and uncertainty relative to the housing market, coupled with  
19                     the third-quarter disruption in the secondary mortgage markets,  
20                     unfavorably impacted our borrowers and the value of their loan  
21                     collateral. As a result, single family loan delinquencies, as well as losses  
22                     from foreclosures, rose significantly during the third quarter and led to  
23                     this quarter’s large increase to the allowance for loan losses. However,  
24                     despite this quarter’s unfavorable results, *Downey remains well*  
25                     *positioned to continue funding quality loans because of our strong*  
26                     *capital position and stable source of funds from our retail branch*  
27                     *franchise.”*

28                                     \*       \*       \*



1 \$485 million due primarily to declines of \$602 million in loans held for  
2 investment and \$98 million in loans held for sale. Those declines were  
3 partially offset by an increase of \$225 million in securities available for  
4 sale. Included within loans held for investment at quarter end were  
5 \$8.255 billion of single family adjustable rate mortgages subject to  
6 negative amortization, down \$659 million from June 30, 2007. These  
7 loans comprised 74% of the single family residential loan portfolio held  
8 for investment at quarter end, compared to 87% a year ago. The amount  
9 of negative amortization included in loan balances increased \$11 million  
10 during the current quarter to \$388 million or 4.70% of loans subject to  
11 negative amortization. During the current quarter, approximately 26% of  
12 loan interest income represented negative amortization, down from 29%  
13 in the second quarter of 2007 and 28% in the year-ago third quarter.

14 Loan originations (including purchases) totaled \$694 million in  
15 the current quarter, down \$911 million or 56.8% from \$1.605 billion a  
16 year ago. Loans originated for sale declined \$579 million or 70.3% to  
17 \$245 million, while single family residential loans originated for  
18 portfolio declined \$332 million or 43.5% to \$432 million. In addition to  
19 single family residential loans, \$17 million of other loans were  
20 originated in the current quarter, similar to the amount a year ago. For  
21 the first nine months of 2007, loan originations totaled \$3.164 billion,  
22 down 51.2% from \$6.489 billion in the same period a year ago.

23 29. On this news, Downey's stock dropped to \$45 per share as Downey's  
24 problems became more apparent. However, the extent of Downey's problems  
25 continued to be concealed, causing the stock price to remain inflated.

26 30. On January 14, 2008, Downey issued a press release entitled "Downey  
27 Announces Change in Previously Reported Non-Performing Assets," in a release  
28 which stated in part:

1 Downey Financial Corp. announced today changes to previously  
2 reported levels of non-performing assets. These changes pertain to non-  
3 performing asset levels since June 30, 2007.

4 Rick McGill, President, commented, “As previously reported, we  
5 implemented at the beginning of the third quarter of 2007 a borrower  
6 retention program to provide qualified borrowers with a cost effective  
7 means to change from an option ARM to a less costly financing  
8 alternative. We contacted borrowers whose loans were current and we  
9 offered them the opportunity to modify their loans into 5-year hybrid  
10 ARMs or ARMs with interest rates that adjust annually but do not permit  
11 negative amortization. The interest rates associated with these  
12 modifications were the same or no less than those rates afforded new  
13 borrowers but they were below the interest rates on the original loans.  
14 We initially did not consider these modifications of performing loans to  
15 be troubled debt restructurings, as the modification was only made to  
16 those borrowers who were current with their loan payments and the new  
17 interest rate was no less than those offered new borrowers. KPMG LLP,  
18 our independent registered public accounting firm, did not object to this  
19 assessment during its third quarter review.”

20 Mr. McGill continued, “During December 2007, KPMG advised  
21 us that upon further review of the modification program, it was likely the  
22 loan modifications should be recorded as troubled debt restructurings.  
23 After reassessing our initial analysis, we determined these modified  
24 loans should be accounted for as troubled debt restructurings. This  
25 conclusion was reached because in the current interpretation of GAAP,  
26 especially in the current housing market, there is a rebuttable  
27 presumption that if the interest rate is lowered in a loan modification, the  
28 modification is deemed to be a troubled debt restructuring unless the

1 modified loan can be proved to be at a market rate of interest based upon  
2 new underwriting, including an updated property valuation, credit report  
3 and income analysis. We did not perform these additional steps since  
4 borrowers who qualified for our retention program were current and we  
5 were trying to streamline the process for qualified borrowers to modify  
6 their loans at interest rates no less than that being offered to new  
7 borrowers. Inasmuch as we chose not to perform these additional  
8 measures, we are now required to make this reporting change and, as  
9 such, our non-performing assets will increase from what has been  
10 previously reported. While periods prior to the third quarter of 2007 are  
11 not impacted by this change, it will result in \$99 million of loans being  
12 classified as non-performing at September 30, 2007.”

13 Brian Côté, Chief Financial Officer, commented, “As required for  
14 all loans classified as troubled debt restructurings, loans modified as part  
15 of our borrower retention program must now be placed on non-accrual  
16 status but interest income will be recognized when paid. If borrowers  
17 perform pursuant to the modified loan terms for six months, the loans  
18 will be placed back on accrual status and, while still reported as troubled  
19 debt restructurings, they will no longer be classified as non-performing  
20 assets because the borrower has demonstrated an ability to perform and  
21 the interest rate was no less than those afforded new borrowers at the  
22 time of the modification.”

23 Mr. Côté further commented, “We believe that when loans  
24 modified under our borrower retention program are current, it is relevant  
25 to distinguish them from total non-performing assets because, unlike  
26 other loans classified as non-performing assets, these loans are  
27 effectively performing at interest rates no less than those afforded new  
28 borrowers. Accordingly, when performing troubled debt restructurings

1 are excluded from the revised ratio of non-performing assets to total  
2 assets, the revised ratio of all other non-performing assets to total assets  
3 is not materially different from that previously reported.”

4 \* \* \*

5 The table . . . provides the revised ratio of non-performing assets  
6 to total assets for each affected month of 2007, distinguishing from the  
7 total those troubled debt restructurings associated with Downey’s  
8 borrower retention plan wherein the loans are current but have not yet  
9 established six months of successful payment history so that they can be  
10 removed from non-accrual status.

11 Mr. Côté concluded by stating, “As of year-end 2007, the  
12 estimated level of non-performing assets as a percent of total assets  
13 increased to 7.8%. Of this total, about 40% represented modifications  
14 generated from our borrower retention program, of which an estimated  
15 95% have made all payments due. Those performing troubled debt  
16 restructurings represent about 3.0% of total assets. As yet, we have not  
17 determined the impact this reporting change may have on previously  
18 reported financial statements, if any, but we expect to complete this  
19 analysis soon.”

20 31. On January 23, 2008, Downey announced its financial results for fiscal  
21 2007, in a release which stated in part:

22 Downey Financial Corp. reported a net loss for 2007 of \$56.6 million or  
23 \$2.03 per share on a diluted basis, compared to net income of \$199.7  
24 million or \$7.16 per share in 2006.

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

- 27 • A \$283.5 million increase in provision for credit losses;

28

- 1           •     A \$94.8 million or 18.3% decline in net interest income due  
2                     to a lower level of interest-earning assets and a lower  
3                     effective interest rate spread;
- 4           •     A \$23.3 million or 53.4% decline in net gains on the sale of  
5                     loans and mortgage-backed securities due to both a lower  
6                     level of loans sold and gain per dollar of loan sold;
- 7           •     A \$17.8 million unfavorable change in income from real  
8                     estate and joint ventures held for investment, as the current  
9                     year included writedowns to reflect declines in the value of  
10                    single family home lots in which the company is a joint  
11                    venture partner and net gains from sales were below a year  
12                    ago; and
- 13          •     A \$14.8 million increase in operating expense, of which  
14                    \$9.2 million related to higher costs related to the operation of real estate  
15                    acquired in settlement of loans.

16                 Rick McGill, President, commented, “We are clearly disappointed  
17                    with our results. The continued weakening of the housing market and its  
18                    uncertain future have unfavorably impacted our borrowers and the value  
19                    of their loan collateral. As a result, single family loan delinquencies, as  
20                    well as losses from foreclosures, rose significantly during 2007 and led  
21                    to the large increase to the allowance for loan losses. While we expect  
22                    the environment to remain challenging in 2008, we enter the year with a  
23                    strong capital position and stable funding sources from our retail branch  
24                    franchise. As always, we remain committed to our heritage of providing  
25                    our customers with excellent service.”

26                 For the fourth quarter of 2007, a net loss of \$108.8 million or  
27                    \$3.90 per diluted share was recorded, compared to net income of \$52.1  
28                    million or \$1.87 per share in the fourth quarter of 2006. The \$274.4

1 million unfavorable change in pre-tax income/(loss) between fourth  
2 quarters primarily reflected:

- 3 • A \$218.2 million increase in provision for credit losses;
- 4 • A \$40.9 million decline in net interest income due to a  
5 lower level of interest-earning assets and a lower effective  
6 interest rate spread;
- 7 • A \$8.4 million decline in net gains on sales of loans and  
8 mortgage-backed securities due to both a lower level of  
9 loans sold and gain per dollar of loan sold; and
- 10 • A \$5.3 million increase operating expense, of which \$4.5  
11 million related to higher costs associated with the operation  
12 of real estate acquired in settlement of loans.

13 \* \* \*

14 *Provision for Credit Losses*

15 During the current quarter, the provision for credit losses totaled  
16 \$218.4 million, up \$218.2 million from a year ago. Of the current quarter  
17 provision for credit losses, \$39.5 million is related to the creation of a  
18 specific allowance associated with certain troubled debt restructurings  
19 resulting from a borrower retention program which is discussed more  
20 fully below in the section entitled “Non-Performing Assets.”

21 At December 31, 2007, the allowance for credit losses was \$349  
22 million, comprised of \$348 million for loan losses and \$1 million for  
23 unfunded loan commitments which is reported within accounts payable  
24 and accrued liabilities. The increase to the allowance this quarter  
25 reflected further increases in delinquent loans and declines in the value  
26 of underlying home collateral due to the continued weakening and  
27 uncertainty relative to the housing market. This has been particularly true  
28 in certain geographic areas such as the greater Sacramento, Stockton,

1 Modesto and Monterey areas of Northern California, the Inland Empire  
2 and San Diego County. Net loan charge-offs totaled \$12.2 million in the  
3 current quarter, compared to \$0.3 million a year ago. The current quarter  
4 net charge-offs are primarily related to residential one-to-four unit loans,  
5 with the annualized net charge-off ratio associated with these loans  
6 increasing to 0.43% from 0.01% a year ago.

7 For 2007, the provision for credit losses totaled \$310.1 million and  
8 net charge-offs were \$22.3 million. This compares with a \$26.6 million  
9 provision for credit losses and net charge-offs of \$0.5 million a year ago.

10 \* \* \*

11 *Assets, Loan Originations and Deposits*

12 At December 31, 2007, assets totaled \$13.409 billion, down  
13 \$2.798 billion or 17.3% from a year ago. During the current quarter,  
14 assets declined \$1.009 billion due primarily to declines of \$592 million  
15 in securities available for sale and \$569 million in loans held for  
16 investment, as loan payoffs exceeded originations. Included within loans  
17 held for investment at quarter end were \$7.531 billion of single family  
18 adjustable rate mortgages subject to negative amortization, down \$725  
19 million from September 30, 2007. These loans comprised 69% of the  
20 single family residential loan portfolio held for investment at quarter  
21 end, compared to 85% a year ago. The amount of negative amortization  
22 included in loan balances declined \$9 million during the current quarter  
23 to \$379 million or 5.03% of loans subject to negative amortization.  
24 During the current quarter, approximately 24% of loan interest income  
25 represented negative amortization, down from 26% in the third quarter of  
26 2007 and 29% in the year-ago fourth quarter.

27 Loan originations (including purchases) totaled \$618 million in  
28 the current quarter, down \$722 million or 53.9% from \$1.340 billion a

1 year ago. Loans originated for sale declined \$587 million or 75.3% to  
2 \$192 million, while single family residential loans originated for  
3 portfolio declined \$160 million or 28.9% to \$394 million. In addition to  
4 single family residential loans, \$32 million of other loans were  
5 originated in the current quarter, up from \$7 million a year ago. For  
6 2007, loan originations totaled \$3.782 billion, down 51.7% from \$7.829  
7 billion in the same period a year ago.

8 Not included in the above originations are loans in which we  
9 modify the terms of the note for borrowers. During the current quarter,  
10 we modified \$322 million of loans associated with the portfolio retention  
11 program, wherein the borrower was current with their loan payments and  
12 the new interest rate was no less than that afforded new borrowers, and  
13 \$9 million of loans at below market interest rates in loan workout  
14 situations. For 2007, we modified \$421 million associated with the  
15 portfolio retention program and \$12 million in loan workout situations.  
16 Most of the modifications related to option ARM loans were modified  
17 into hybrid ARMs where the interest rate is fixed for the first five years  
18 or ARMs with interest rates that adjust annually. Both of these products  
19 do not permit negative amortization.

20 Deposits totaled \$10.496 billion at quarter end, down \$1.289  
21 billion or 10.9% from a year ago. Although deposits declined during the  
22 year, the number of checking accounts increased 5.7%. At quarter end,  
23 the number of branches totaled 172 (168 in California and four in  
24 Arizona). At quarter end, the average deposit size of our 82 traditional  
25 branches was \$102 million, while the average deposit size of our 90 in-  
26 store branches was \$24 million. During the year, borrowings declined by  
27 \$1.413 billion and at year end represented 10.4% of total assets.

28 *Non-Performing Assets*

1 Non-performing assets increased during the quarter by \$618  
2 million to \$1.042 billion and represented 7.77% of total assets, compared  
3 with 0.68% at year-end 2006. Of the increase, \$321 million or about half  
4 represented loans modified as part of a borrower retention program  
5 initiated at the beginning of the third quarter of 2007 to provide  
6 borrowers who are current with their loan payments a cost effective  
7 means to change from an option ARM to a less costly financing  
8 alternative. Those loans are considered troubled debt restructurings and  
9 have been placed on non-accrual status even though the interest rate  
10 following modification was no less than that afforded new borrowers.  
11 The reason for this is because the modified interest rate was lower than  
12 the interest rate on the original loan and the loan was not re-underwritten  
13 to prove that the new interest rate was, in fact, a market interest rate for a  
14 borrower with similar credit quality. Interest income will be recorded as  
15 these borrowers make their loan payments. If these borrowers perform  
16 pursuant to the modified terms for six months, the loans will be placed  
17 back on accrual status and, while still reported as troubled debt  
18 restructurings, they will no longer be classified as non-performing assets  
19 because the borrower will have demonstrated an ability to perform in  
20 accordance with the loan modification and the interest rate was no less  
21 than those afforded new borrowers at the time of modification.

22 To the extent borrowers whose loans were modified pursuant to  
23 the borrower retention program are current with their loan payments, it is  
24 relevant to distinguish those from total non-performing assets because,  
25 unlike other loans classified as non-performing assets, these loans are  
26 paying interest at interest rates no less than those afforded new  
27 borrowers. At year-end 2007, approximately 95% of such borrowers had  
28 made all loan payments due. Accordingly, when those performing

1 troubled debt restructurings are excluded from the ratio of non-  
2 performing assets to total assets, the adjusted ratio drops to 4.78%  
3 compared to the actual ratio of 7.77%.

4 32. Later, on January 31, 2008, *Associated Press* issued an article entitled  
5 “S&P Reduces Downey Financial Ratings; Standard & Poor’s Cuts Downey Financial  
6 Ratings on Credit Performance, Profitability Worries,” which stated in part:

7 Standard & Poor’s Ratings Services said Thursday it has lowered  
8 its ratings on Downey Financial Corp. due to concerns about the  
9 company’s credit performance and profitability.

10 Downey Financial shares jumped \$3.21, or 9.9 percent, to \$35.65  
11 in afternoon trading. The stock dropped from a 52-week high of \$74.85  
12 in May to a low of \$21.64 on Jan. 22, before regaining some ground in  
13 the past week.

14 S&P cut Downey’s investment-grade long-term ratings to “BBB-”  
15 from “BBB.” The company’s short-term ratings were lowered to “A-3”  
16 from “A-2.”

17 “We took this action because of our increased concerns regarding  
18 Downey’s credit performance and our expectation that credit costs and a  
19 prolonged difficult operating environment will continue to make  
20 profitability a challenge in the near term,” said Standard & Poor’s credit  
21 analyst Robert Hoban.

22 At the same time, the ratings service revised its outlook on  
23 Downey to “Stable” from “Negative.”

24 The ratings service expects Downey to maintain very strong risk-  
25 adjusted capital measures, as well as good funding and liquidity.

26 S&P said it may reduce Downey’s ratings further if economic and  
27 home price trends deteriorate beyond current expectations and add  
28

1 further credit losses and stress to the company's banking results and  
2 capital.

3 33. In fact, Downey had been engaging substantially in Option ARM loans  
4 and borrowers were invariably paying the minimum payment or choosing to skip  
5 payments, leading to negatively amortizing loans. Beside the fact that these loans  
6 were increasingly risky, Downey reported revenue from these loans, further  
7 misleading investors about the health of its business. When a borrower chose to skip a  
8 payment, Downey would still act like it had received the payment. The Company  
9 would treat the negative amortization event as if it were revenue – since the balance of  
10 the loan (the asset) had been increasing. This actually increased the risk of non-  
11 payment which should have caused Downey to increase loan loss reserves by more  
12 than any increase in the loan balance.

13 34. On March 11, 2008, *The Motley Fool* issued an article that stated in part:  
14 Peeking over the shoulder

15 None of this group has been hit harder than Downey, the holding  
16 company of Downey Savings & Loan. Like a typical banking institution,  
17 it accepts deposits and makes loans, but it also engages in real estate  
18 development, construction, and property management in California and  
19 Arizona. Not two of the sweetest spots to be invested in real estate these  
20 days.

21 In a recently released report, Downey said its total nonperforming  
22 assets (NPAs) had grown from less than 1% a year ago to more than 9%,  
23 which would signal a seriously troubled institution. While it could be  
24 said to have a diversified asset base because it is also a savings and loan,  
25 should the housing crisis worsen as many expect it will, any signs of  
26 trouble at the bank could make its position even more precarious.

27 Yet is the situation as dire as it appears? Downey also reported  
28 that 94% of its loans were current in their payments, which would

1 suggest a seeming discrepancy with the numbers. *Not so fast. Back in*  
2 *January, the bank reported on its earlier efforts to assist borrowers*  
3 *who held option ARM mortgages.* The program was only offered to  
4 borrowers whose loans were current at the time, so the bank initially  
5 didn't include them as troubled debt restructurings (TDRs). However,  
6 upon further consideration, its accountants counseled that unless the new  
7 loan terms were accompanied by an updated property valuation, credit  
8 report, and income analysis, they had to be considered TDRs. As  
9 Downey hadn't performed those additional tasks, it had to reclassify  
10 them all as nonperforming assets, even though 94% of them are still  
11 current in their payments.

12 \* \* \*

13 In August their non performing assets on their  
14 portfolio was 1.96% up from .32% only a year ago. The  
15 current trend over the last several months puts their NPA's  
16 at almost 3% at years end. In August their interest rate  
17 spread was 2.95% ... NPA's are only going to get worse  
18 and interest rate spread is not going to get better either.  
19 They've also booked a huge amount of neg. am income and  
20 have lowered loan loss reserves to make their earnings look  
21 better than they are in the last two quarters.

22 35. Then, on March 17, 2008, before the market opened, Downey released its  
23 monthly selected financial results for the 13 months ended February 29, 2008,  
24 reporting \$13.4 billion in assets and \$75.7 million in home loans for the 13 months  
25 ended February. This was down from \$127.4 million for the 13 months ended January  
26 31, 2008.

27 36. One year prior, the Company had reported \$15.5 billion in assets, with  
28 less than 1% of its portfolio in default. In January the Company said it lost \$109

1 million in the fourth quarter compared to a profit of \$52 million a year earlier. The  
2 Company set aside \$218 million from earnings to cushion itself against future  
3 defaults.

4 37. As *Bloomberg* reported on March 17, 2008:

5 Downey Financial Corp., the California savings and loan company  
6 whose stock has lost 70 percent in 12 months, said nonperforming assets  
7 increased to 10.9 percent on Feb. 29 from 9.1 percent a month earlier.

8 Loans that have stopped collecting interest would have been about  
9 6.6 percent if Downey hadn't counted modified mortgages that allow  
10 some homeowners to restructure debt, the Newport Beach, California-  
11 based lender said today in a statement. If borrowers in the program  
12 make payments for six months, the loans will be removed from  
13 nonperforming status, Downey said.

14 38. The true facts, which were known by the defendants but concealed from  
15 the investing public during the Class Period, were as follows:

16 (a) Defendants' portfolio of Option ARMs contained millions of  
17 dollars worth of impaired and risky securities, many of which were backed by  
18 subprime mortgage loans;

19 (b) Prior to the Class Period, Downey had seen Countrywide's growth  
20 and had started to get more aggressive in acquiring loans from brokers such that the  
21 loans were extremely risky;

22 (c) Defendants failed to properly account for highly leveraged loans  
23 such as mortgage securities;

24 (d) Downey had very little real underwriting, which led to large  
25 numbers of bad loans that would cause huge numbers of defaults which would hurt  
26 borrowers and the Company itself; and

27 (e) Downey had not adequately reserved for Option ARM loans, the  
28 terms of which provided that during the initial term of the loan borrowers could pay

1 only as much as they desired with any underpayment being added to the loan balance.  
2 These loans would become toxic (for both Downey and the borrowers) once housing  
3 prices stopped increasing at a rapid rate.

4 39. On this news, Downey's stock dropped to close at \$18.82 per share on  
5 March 17, 2008, a decline from \$19.14 per share on March 14, 2008, and a decline of  
6 68% from \$59 per share on October 9, 2007. The stock subsequently continued to  
7 decline as the extent of the Company's problems were absorbed by the market.

#### 8 **LOSS CAUSATION/ECONOMIC LOSS**

9 40. By misrepresenting Downey's financial position, the defendants  
10 presented a misleading picture of the Company's business and prospects. Thus,  
11 instead of truthfully disclosing during the Class Period that Downey's business was  
12 not as healthy as represented, Downey falsely concealed the extent of its exposure to  
13 Option ARMs, including those with subprime debt.

14 41. These claims of profitability caused and maintained the artificial inflation  
15 in Downey's stock price throughout the Class Period and until the truth about its  
16 future earnings was revealed to the market.

17 42. Defendants' false and misleading statements had the intended effect and  
18 caused Downey's stock to trade at artificially inflated levels throughout the Class  
19 Period, reaching as high as \$74.85 per share in May 2007.

20 43. In July 2007, the market became aware of the problems the banks  
21 (including Downey) were having with subprime debt. In October 2007, Downey pre-  
22 announced disappointing results due to the housing market problems and the inflation  
23 began to come out of the stock price. As subsequent announcements divulged  
24 additional problems, non-inflation was removed. By the beginning of March 2008,  
25 Downey had announced it would have to write down billions of dollars of its debt  
26 securities.

27 44. As a result of defendants' false statements, Downey's stock traded at  
28 inflated levels during the Class Period. However, after the above revelations seeped

1 into the market, the Company's shares were hammered by massive sales, sending  
2 them down more than 68% from their price before these disclosures.

3 **COUNT I**

4 **For Violation of §10(b) of the 1934 Act and Rule 10b-5**  
5 **Against All Defendants**

6 45. Plaintiff incorporates ¶¶1-44 by reference.

7 46. During the Class Period, defendants disseminated or approved the false  
8 statements specified above, which they knew or deliberately disregarded were  
9 misleading in that they contained misrepresentations and failed to disclose material  
10 facts necessary in order to make the statements made, in light of the circumstances  
11 under which they were made, not misleading.

12 47. Defendants violated §10(b) of the 1934 Act and Rule 10b-5 in that they:

13 (a) employed devices, schemes and artifices to defraud;

14 (b) made untrue statements of material facts or omitted to state  
15 material facts necessary in order to make the statements made, in light of the  
16 circumstances under which they were made, not misleading; or

17 (c) engaged in acts, practices and a course of business that operated as  
18 a fraud or deceit upon plaintiff and others similarly situated in connection with their  
19 purchases of Downey common stock during the Class Period.

20 48. Plaintiff and the Class have suffered damages in that, in reliance on the  
21 integrity of the market, they paid artificially inflated prices for Downey common  
22 stock. Plaintiff and the Class would not have purchased Downey common stock at the  
23 prices they paid, or at all, if they had been aware that the market prices had been  
24 artificially and falsely inflated by defendants' misleading statements.

25 **COUNT II**

26 **For Violation of §20(a) of the 1934 Act**  
27 **Against All Defendants**

28 49. Plaintiff incorporates ¶¶1-48 by reference.



1 (f) the extent of damage sustained by Class members and the  
2 appropriate measure of damages.

3 54. Plaintiff's claims are typical of those of the Class because plaintiff and  
4 the Class sustained damages from defendants' wrongful conduct.

5 55. Plaintiff will adequately protect the interests of the Class and has retained  
6 counsel who are experienced in class action securities litigation. Plaintiff has no  
7 interests which conflict with those of the Class.

8 56. A class action is superior to other available methods for the fair and  
9 efficient adjudication of this controversy.

10 **PRAYER FOR RELIEF**

11 WHEREFORE, plaintiff prays for judgment as follows:

12 A. Declaring this action to be a proper class action pursuant to Fed. R. Civ.  
13 P. 23;

14 B. Awarding plaintiff and the members of the Class damages, including  
15 interest;

16 C. Awarding plaintiff's reasonable costs and attorneys' fees; and

17 D. Awarding such equitable/injunctive or other relief as the Court may deem  
18 just and proper.

19 **JURY DEMAND**

20 Plaintiff demands a trial by jury.

21 DATED: May 16, 2008

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DAVID C. WALTON

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