

OFFICE OF THRIFT SUPERVISION

Receivership Of A Federal Savings Association

Date: November 21, 2008
Order No.: 2008-49
OTS No.: 06189

The Director of the Office of Thrift Supervision (OTS), or his designee, in cooperation with the Federal Deposit Insurance Corporation (FDIC), has determined to appoint the FDIC as receiver of Downey Savings and Loan Association, F.A., Newport Beach, California (Institution).

GROUND FOR APPOINTMENT OF FDIC AS RECEIVER FOR THE INSTITUTION

The Director, or his designee, based upon the administrative record finds and determines the following:

The Institution has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the institution to become adequately capitalized without Federal assistance.

The Institution is a Federally chartered stock savings association, the accounts of which are insured by the Deposit Insurance Fund (DIF). The Institution has its home office in Newport Beach, California. As of September 30, 2008, the Savings Bank reported total assets of \$12.779 billion.

DISCUSSION OF GROUNDS FOR APPOINTMENT OF A RECEIVER FOR THE INSTITUTION

Section 5(d)(2)(A) of the Home Owners' Loan Act (HOLA), 12 U.S.C. § 1464(d)(2)(A), provides that the Director may appoint a receiver for any insured savings association if the Director determines that one or more grounds specified in section 11(c)(5) of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. § 1821(c)(5), exist.

Background

Downey Financial Corporation (DFC) operates as a shell holding company for the Institution. As of September 30, 2008, on an unconsolidated basis, DFC had approximately \$198 million of outstanding senior notes and \$14 million of cash. The OTS holding company examination of DFC dated July 30, 2008, significantly downgraded DFC's composite rating based on DFC's and the Institution's deteriorating

consolidated operating performance. DFC's composite rating was further downgraded on November 20, 2008, as a result of DFC's and the Institution's continuing deteriorating performance.

The Institution is a Federally chartered stock savings association headquartered in Newport Beach, California. The FDIC insures the Institution's deposits through its DIF. As of September 31, 2008, the Institution had 175 retail branches (170 branches operating in California and five in Arizona).

The record indicates the Institution's mortgage portfolio includes significant risks which are inherent in option adjustable rate mortgages (ARMs). The Institution's asset quality and earnings have declined over the last year. The Institution's significant concentration in nontraditional mortgage products combined with the substantial decline in real estate market values has caused a significant deterioration in its asset quality. In addition, the deterioration in performance of the portfolio of the Institution's loans has caused significant and continuing operating losses and serious reductions in the Institution's capital. The risk characteristics of the Institution's mortgage portfolio, combined with a collapse in real estate market values within the Institution's market area, have created heightened capital and credit risk exposure. The Institution posted a net loss of \$50.5 million for 2007 because of necessary provisioning for losses on loans. In 2008, the Institution posted net losses of \$246 million for first quarter, \$217 million for the second quarter and \$74 million in the third quarter. Also, the requirements to account and reserve for loan modifications as troubled debt restructurings (TDRs),¹ and the recording of a \$111.3 million valuation allowance against the Institution's deferred tax asset (due to questionable collectability) exacerbated its poor financial performance.

The Institution engages in real estate investment activities through DSL Service Company (DSL), a wholly owned non-includable subsidiary of the Institution. DSL is a diversified real estate development company established as a neighborhood shopping center and residential tract developer. It has assets of approximately \$3 million. DSL has few assets remaining at September 30, 2008: \$2.8 million in real estate held for development, \$0.3 million in real estate held for investment, and a \$35,000 net remaining investment in joint ventures. DSL has sold assets in recent quarters, the proceeds of which have helped to offset the Institution's losses and depletion of capital. As evident in the remaining balance, however, there is little left to sell.

OTS has taken a number of supervisory or enforcement actions with respect to the Institution. On September 5, 2008, OTS issued a cease-and-desist order against the Institution (C&D Order). The Institution submitted a Business Plan to OTS in response to the C&D Order. As part of that Business Plan, the Institution provided a quarterly

¹ See FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FAS 15) as amended by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114).

forecast of continuing its current operations. The Business Plan projects continuing losses and a continuing decline in capital through December 31, 2009 and beyond.

The Business Plan provides a quarterly forecast of the Institution's current operations. This forecast projects core capital will fall to 6.65 percent at December 31, 2008, which will cause the Institution to violate the minimum capital requirements set forth in Section II of the C&D Order. The forecast projects that the core capital ratio will fall to 3.67 percent, below the adequately capitalized threshold, at September 30, 2009. The core capital ratio is projected to fall to significantly undercapitalized, at 2.64 percent at yearend 2009. The forecast projects ongoing quarterly losses throughout 2009, and a trend in those losses that only slightly improves from quarter to quarter. On an annual basis the Institution projects losses of \$667.3 million for calendar year 2008 and \$536.9 million for calendar year 2009. The forecast further demonstrates that, if market conditions remain the same as current conditions or deteriorate further, losses are likely to continue thereafter.

This projection is consistent with other estimates of losses in this portfolio, including the Institution's own estimate of losses in subsequent years, and the estimate of the independent consultant retained by the Institution to perform a similar review. For example, the Institution's own analysis of loan and REO losses and required allowance for loan and lease losses as of December 31, 2010, would result in the Institution being deemed critically undercapitalized with Tier One Core Capital of 0.9 percent. A similar review by the independent consultant on behalf of the Institution over the same time frame results in the Institution being categorized as significantly undercapitalized with Tier One Core Capital of approximately 2 percent.

Moreover, recent market events have led analysts to revise significantly upward their estimates of probabilities of default of Option ARM loans and the cumulative loss and loss severity expectations for such loans. One company has recently revised its estimates for probabilities of default for 2006 vintage Option Arm securitizations to 28 percent and to 37 percent for 2007 vintage Option Arm securitizations. Another company estimates even higher levels of defaults on Option Arms. Applying such figures to the Institution's portfolio would result in projections of even higher losses going forward.

The Institution's Business Plan also indicates that the Institution is testing more aggressive loss mitigation strategies. These more aggressive strategies could reduce the cumulative loss estimate, but will likely require additional capital/reserves to absorb higher near-term losses than those forecast in the Business Plan. Thus, while potentially reducing ultimate losses for the Institution, such action will likely cause losses to exceed those projected in the quarterly forecast and deplete capital sooner than forecasted by the Institution.

Finally, potential further deterioration in market conditions, particularly with respect to home price depreciation, is not factored into the Institution's projections. These factors could add further to near-term losses.

The Institution has undertaken extensive efforts to attract buyers or investors. Beginning in July 2008, investment bankers widely marketed the institution, including creating an online data room that interested parties could utilize to get a snapshot of the current condition of the institution. A number of parties made use of the data room and a subset of those took the further step of performing due diligence on-site. Biweekly letters filed by the Institution with the OTS in compliance with the C&D Order have indicated that parties have not expressed interest in the Institution absent government assistance.

The Institution's Business Plan also concludes that there is little to no prospect of the Institution attracting a third party to invest in the Institution as a standalone entity. Moreover, while the Institution determined to seek an acquirer, to date, it has been unsuccessful. A whole-bank acquisition would be required to make the institution viable, as an acquirer would benefit from net operating loss carry-forwards and cost savings through consolidation. By letter dated November 14, 2008, the Institution stated that it has exhausted all potential leads.

Discussion of the Grounds for Appointment of a Receiver

Section 5(d)(2)(A) of the HOLA² provides that the Director may appoint a receiver for any insured savings association if the Director determines that one or more of the grounds specified in section 11(c)(5) of the FDIA, 12 U.S.C. § 1821(c)(5), exist. Under 12 U.S.C. § 1821(c)(5)(G), the Director may appoint a receiver if:

The Institution has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the institution to become adequately capitalized without Federal assistance.

Under section 11(c)(5)(G) of the FDIA, the Director may appoint a receiver if a savings association has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the institution to become adequately capitalized without Federal assistance. The Institution has significant problems relating to asset quality and net operating losses, and as a result of continuing loan losses has incurred and is likely to incur significant additional losses without the prospect of obtaining new capital in the foreseeable future.

If an institution's capital is likely to fall to the level where the institution would have substantially insufficient capital, then that institution will incur losses that deplete substantially all of its capital. OTS has previously determined that substantially insufficient capital for purposes of 12 U.S.C. § 1821(c)(5)(L)(ii) constituted less than two

² 12 U.S.C. § 1464(d)(2)(A).

thirds of any regulatory capital requirement.³ Here the Institution itself projects that, if market conditions remain constant,⁴ it will have less than two thirds of the core capital required by the year end of 2009 and that losses will continue thereafter.⁵ Moreover, extensive efforts have been made to obtain capital or an acquirer for the Institution and those efforts have been unsuccessful. Thus, there is no reasonable prospect for the institution to become adequately capitalized without Federal assistance.

Therefore, the Director concludes that the Institution has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the Institution to become adequately capitalized without Federal assistance.

The Director, or his designee, therefore, has determined that grounds for the appointment for a receiver for the Savings Bank exist under section 5(d)(2) of the HOLA, and sections 11(c)(5)(G) of the FDIA, 12 U.S.C. § 1821(c)(5)(G).

Therefore, the Director determines to appoint a receiver for the Institution under the circumstances described above.

ACTIONS ORDERED OR APPROVED

Appointment of a Receiver

The Director, or his designee, hereby appoints the FDIC as receiver for the Institution, for the purpose of liquidation, pursuant to section 5(d)(2) of the HOLA, and section 11(c)(6)(B) of the FDIA, 12 U.S.C. § 1821(c)(6)(B).

Delegation of Authority to Act for OTS

The Director, or his designee, hereby authorizes the OTS West Regional Director, or his designee, and the Deputy Chief Counsel for the Business Transactions Division of the Chief Counsel's office, or his designee, to: (i) certify orders; (ii) sign, execute, attest, or certify other documents of OTS issued or authorized by this Order; (iii) designate the persons or entity that will give notice of the appointment of a receiver for the Savings Bank and serve the Savings Bank with a copy of this Order pursuant to 12 C.F.R. § 558.2; and (iv) perform such other functions of OTS necessary or appropriate for implementation of this Order. All documents to be issued under the authority of this Order must be first approved, in form and content, by the Chief Counsel's Office. In addition, the Director, or his designee, hereby authorizes the Deputy Chief Counsel for the Business Transactions Division of the Chief Counsel's office, or his designee, to

³ See OTS Order 2008-33 (September 19, 2008), p. 4, and OTS Order 2007-43 (September 27, 2007), p. 3-4.

⁴ The Director concludes that economic conditions, particularly those relating to residential real estate, in the Institution's market area are unlikely to significantly improve before the end of 2009.

⁵ 12 C.F.R. § 567.2 and § 567.5(a) (2008).

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make any subsequent technical corrections, that might be necessary, to this Order, or any documents issued under the authority of this Order.

By Order of the Director of OTS, effective November 21, 2008.



John M. Reich
Director