WESTCORP /CA/
Form 10-K
March 14, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2004

or

o **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 33-13646

Westcorp

(Exact name of registrant as specified in its Charter)

California	**51-0308535**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
23 Pasteur, Irvine, California	**92618-3816**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code (949) 727-1002

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $1 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the last 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934.) Yes þ No o

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2004:

Common Stock, $1.00 Par Value $1,051,217,868

The number of shares outstanding of the issuer s class of common stock as of February 28, 2005:

Common Stock, $1.00 Par Value 51,962,940

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the Annual Meeting of Shareholders to be held April 26, 2005 are incorporated by reference into Part III.

WESTCORP AND SUBSIDIARIES

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Forward-Looking Statements

This Form 10-K includes and incorporates by reference forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act, as amended. Forward-looking statements relate to analyses and other information that are based on forecasts of future results and estimates of amounts not yet determinable. These statements also relate to our future prospects, developments and business strategies. These statements are subject to uncertainties and factors relating to our operations and business environment, all of which are difficult to predict and many of which are beyond our control, that could cause actual results to differ materially from those expressed in or implied by these forward-looking statements.

These forward-looking statements are identified by their use of terms and phrases such as anticipate, believe, could, estimate, expect, i may, plan, predict, project, will, and similar terms and phrases, including references to assumptions. These statements are contained in sectio entitled Business, Management s Discussion and Analysis of Financial Condition and Results of Operations, and other sections of this Form 10-K and in the documents incorporated by reference.

The following factors are among those that may cause actual results to differ materially from the forward-looking statements:

- changes in general economic and business conditions;
- interest rate fluctuations, including hedging activities;
- our financial condition and liquidity, as well as future cash flows and earnings;
- competition;
- our level of operating expenses;
- the effect, interpretation or application of new or existing laws, regulations and court decisions;
- the exercise of discretionary authority by regulatory agencies;
- a decision to change our corporate structure;
- the availability of sources of funding;
- the level of chargeoffs on the automobile contracts that we originate; and
- significant litigation.

If one or more of these risks or uncertainties materialize, or if underlying assumptions as to these items prove incorrect, our actual results may vary materially from those expected, estimated or projected.

We do not undertake to update our forward-looking statements to reflect future events or circumstances.

INDUSTRY DATA

In this Form 10-K, we rely on and refer to information regarding the automobile lending industry from market research reports, analyst reports and other publicly available information. Although we believe that this information is reliable, we cannot guarantee the accuracy and completeness of this information, and we have not independently verified any of it.

Available Information

We provide access to all of our filings with the Securities and Exchange Commission on our Web site at http://www.westcorpinc.com free of charge on the same day that these reports are electronically filed with the Commission. The information contained in our Web site does not

constitute part of this filing.

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PART I

Item 1. *Business*

General

We are a financial services holding company that provides automobile lending services through our second-tier subsidiary, WFS Financial Inc, also known as WFS, and retail and commercial banking services through our wholly owned subsidiary, Western Financial Bank, which we refer to as the Bank. The Bank currently owns 84% of the capital stock of WFS. We primarily earn income by originating assets, including automobile contracts, that generate a yield in excess of the cost of the liabilities, including deposits, that fund these assets.

We have grown substantially over the past three years. As of December 31, 2004, we had $15.5 billion in total assets, $11.6 billion in automobile contracts and $1.5 billion in total equity excluding other accumulated comprehensive loss and including minority interest, representing a three-year compounded annual growth rate of 15.6%, 12.4% and 31.4%, respectively. For the year ended December 31, 2004, we originated $6.6 billion of automobile contracts and generated $208 million of net income and earnings per diluted share of $3.96. We achieved a return on average assets of 1.38%, 0.90% and 0.69% for the years ended December 31, 2004, 2003 and 2002, respectively.

Automobile Lending Operations

We are one of the nation s largest independent automobile finance companies with 32 years of experience in the automobile finance industry. We believe that the automobile finance industry is the second largest consumer finance industry in the United States with approximately $500 billion of loan originations during 2004. We originate installment contracts, otherwise known as contracts, secured by new and pre-owned automobiles through our relationships with franchised and independent automobile dealers nationwide. We originated $6.6 billion of contracts during 2004 and owned a portfolio of $11.6 billion contracts at December 31, 2004.

For the year ended December 31, 2004, approximately 34% of our contract originations were for the purchase of new automobiles and approximately 66% of our contract originations were for the purchase of pre-owned automobiles. Approximately 80% of our contract originations were what we refer to as prime contracts, and approximately 20% of our contract originations were what we refer to as non-prime contracts. Our determination of whether a contract is categorized as prime, non-prime or other is based on a number of factors including the borrower s credit history and our expectation of credit loss, and may differ from definitions of these categories utilized by others, including competitors and regulators. All references made throughout this document regarding prime, non-prime or subprime automobile contracts are based on our determination.

We underwrite contracts through a credit approval process that is supported and controlled by a centralized, automated front-end system. This system incorporates proprietary credit scoring models and industry credit scoring models and tools, which enhance our credit analysts ability to tailor each contract s pricing and structure to maximize risk-adjusted returns. We believe that as a result of our sophisticated credit and underwriting systems, we are able to earn attractive risk-adjusted returns on our contracts. For the year ended December 31, 2004, the average net interest spread on our automobile contract originations was 7.02% and the net interest spread on our managed automobile portfolio was 6.65% while net credit losses averaged 1.99% for the same period.

We structure our business to minimize operating costs while providing high quality service to our dealers. Those aspects of our business that require a local market presence are performed on a decentralized basis in our 42 offices. All other operations are centralized. We fund our purchases of contracts, on an interim basis, with deposits raised through our banking operations, which are insured by the Federal Deposit Insurance Corporation, also known as the FDIC, and other borrowings. For long-term financing, we issue automobile contract asset-backed securities. Since 1985, we have sold or securitized over $42.0 billion of contracts in 66

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public offerings of asset-backed securities, making us the fourth largest issuer of such securities in the nation. We have employed a range of securitization structures and our most recent $1.6 billion issuance of asset-backed securities was structured as a senior/subordinated transaction with a weighted average interest rate of 3.66%.

The following table presents a summary of our contracts purchased:

	For the Year Ended December 31,		
	2004	**2003**	**2002**
		(Dollars in thousands)	
New vehicles	$2,273,423	$1,928,268	$1,548,372
Pre-owned vehicles	4,361,447	4,050,308	3,867,362
Total volume	$6,634,870	$5,978,576	$5,415,734
Prime contracts	$5,324,206	$4,942,654	$4,346,212
Non-prime contracts	1,310,664	1,035,922	1,069,522
Total volume	$6,634,870	$5,978,576	$5,415,734

Bank Operations

The primary focus of our banking operations is to generate diverse, low-cost funds to provide the liquidity needed to fund our acquisition of contracts. The Bank has the ability to raise significant amounts of liquidity by attracting both short-term and long-term deposits from the general public, commercial enterprises and institutions by offering a variety of accounts and rates. These funds are generated through the Bank s retail and commercial banking divisions. The Bank also may raise funds by obtaining advances from the Federal Home Loan Bank, or FHLB, selling securities under agreements to repurchase and utilizing other borrowings. The Bank s retail banking division serves the needs of individuals and small businesses by offering a broad range of products through 20 retail branches located throughout Southern California. The Bank s commercial banking division focuses on medium-sized businesses in Southern California. At December 31, 2004, the total deposits gathered by both the retail and commercial banking divisions were $2.2 billion. Approximately 90% of these accounts were demand deposits, money market accounts and certificate of deposit accounts under $100,000 in principal, which we believe represents a stable and attractive source of funding.

The Bank also invests deposits generated by its retail and commercial banking divisions in mortgage-backed securities, also known as MBS. Our investment in MBS, together with the cash balances that we maintain, create a significant liquidity portfolio that provides us with additional funding security. Net interest income from Bank operations totaled $54.5 million, $32.9 million, and $57.6 million for the years ended December 31, 2004, 2003 and 2002, respectively. Net interest income from Bank operations represented 7%, 5% and 9% of our total net interest income on a consolidated basis for the same respective periods.

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The following table sets forth our loan origination, purchase and sale activity over the past five years:

	For the Year Ended December 31,				
	2004	2003	2002	2001	2000
	(Dollars in thousands)				
Loans originated:					
Consumer loans:					
Contracts(1)	$6,634,870	$5,978,576	$5,415,734	$4,863,279	$4,219,227
Other	5,068	4,916	3,562	6,691	12,888
Total consumer loans	6,639,938	5,983,492	5,419,296	4,869,970	4,232,115
Mortgage loans:					
Existing property	41,587	7,675	21,100	9,714	17,382
Construction	24,105	17,534	2,022	12,318	14,718
Equity	61	413	828	969	1,024
Total mortgage loans	65,753	25,622	23,950	23,001	33,124
Commercial loans	342,356	407,387	354,439	291,944	266,342
Total loans originated	7,048,047	6,416,501	5,797,685	5,184,915	4,531,581
Loans purchased:					
Mortgage loans on existing property			46	229	488
Total loans purchased			46	229	488
Loans sold:					
Contracts					660,000
Mortgage loans			554	3,382	3,394
Total loans sold			554	3,382	663,394
Principal reductions(2)	6,050,782	4,721,919	3,922,542	2,572,665	1,126,520
Increase in total loans	$ 997,265	$1,694,582	$1,874,635	$2,609,097	$2,742,155

(1) Includes contracts purchased from automobile dealers as well as leases.

(2) Includes scheduled payments, prepayments and chargeoffs.

The History of Westcorp

Western Thrift & Loan Association, a California-licensed thrift and loan association, was founded in 1972. In 1973, Western Thrift Financial Corporation was formed as the holding company for Western Thrift & Loan Association. It later changed its name to Westcorp. In 1982, Westcorp acquired Evergreen Savings and Loan Association, a California-licensed savings and loan association, which became its wholly owned subsidiary. The activities of Western Thrift & Loan Association were merged into Evergreen Savings and Loan Association in 1982. Evergreen Savings and Loan Association s name was changed ultimately to Western Financial Bank and the Bank ultimately became chartered as a federal savings institution.

Western Thrift & Loan Association was involved in automobile finance activities from its incorporation until its merger with Evergreen Savings and Loan Association. Since such time, the Bank continued the automobile finance activities of Western Thrift & Loan Association. In 1988, Westcorp Financial Services, Inc. was incorporated as a wholly owned consumer finance subsidiary of the Bank to provide non-prime

automobile finance services, a market not serviced by the Bank s automobile finance division.

In 1995, the Bank transferred its automobile finance division to Westcorp Financial Services, Inc., which changed its name to WFS Financial Inc. In connection with that restructuring, the Bank transferred to WFS

all assets relating to its automobile finance division, including the contracts held on balance sheet and all interests in the excess spread payable from outstanding securitization transactions. The Bank also transferred to WFS all of the outstanding stock of WFS Financial Auto Loans, Inc., also known as WFAL, and WFS Financial Auto Loans 2, Inc., also known as WFAL2, the securitization entities of the Bank, thereby making these companies subsidiaries of WFS. In 1995, WFS sold approximately 20% of its shares in a public offering. At December 31, 2004, the Bank owned 84% of the common stock of WFS.

Proposed Conversion and Merger

On May 23, 2004, we entered into a definitive agreement pursuant to which we will acquire the outstanding 16% common stock minority interest of WFS not already owned by our wholly owned subsidiary, the Bank. The transaction is structured as a merger of WFS with and into the Bank. If the merger is consummated, the public holders of WFS shares would receive 1.11 shares of our common stock for each share of WFS common stock held by them in a tax-free exchange. Based on the $42.60 closing price of our common stock on May 21, 2004, the last business day prior to the execution of the agreement, the transaction has an indicated value of $47.29 per share of WFS common stock.

In connection with the merger, the Bank has filed an application with the California Department of Financial Institutions, also known as the DFI, to convert its federal thrift charter to a California state bank charter. Among other things, the merger is conditioned upon the conversion of the charter and the transaction is subject to, among other closing conditions, the receipt of regulatory approvals and the approval of a majority of WFS s minority shareholders, other than shares controlled by us. The DFI and the Office of Thrift Supervision, also known as the OTS, have approved the Bank s application to convert from a federal savings bank to a California state commercial bank subject to receipt of all other required regulatory approvals. The FDIC approved the application to merge WFS into the Bank as part of the acquisition of the minority interest in WFS.

The conversion is still contingent upon the approval by the Board of Governors of the Federal Reserve, also known as the Federal Reserve, of our application to become a bank holding company, which process is taking longer than originally expected. As a result, we believe that the proposed conversion will not occur until the latter half of 2005, if at all. The Federal Reserve recently has raised some questions and potential concerns with our proposal and has requested additional information from us. Assembling the information and responding to the Federal Reserve s concerns and questions will take additional time. Those concerns and questions will need to be addressed to the Federal Reserve s satisfaction before the Federal Reserve will deem our application complete.

Although we intend to continue to pursue Federal Reserve approval, there can be no assurance that such approval will ultimately be granted or that any conditions to such approval imposed on the Bank will not affect the feasibility of moving forward with the proposed conversion and the related merger of WFS into the Bank. We are currently exploring other alternatives in the event that the proposed conversion and related merger cannot go forward as planned. In that regard, WFS has begun the process of filing for state licenses.

If the conversion is completed, we will be subject to the laws, regulation and oversight of the DFI, the FDIC and the Federal Reserve.

Market and Competition

The automobile finance industry is generally segmented according to the type of vehicle sold (new versus pre-owned) and the credit characteristics of the borrower (prime, non-prime or subprime). Based upon industry data, we believe that during 2004, prime, non-prime and subprime loan originations in the United States were approximately $350 billion, $100 billion and $50 billion, respectively. The United States captive automobile finance companies, General Motors Acceptance Corporation, Ford Motor Credit Company and Chrysler Financial Corporation, account for approximately 25% of the automobile finance market. We believe that the balance of the market is highly fragmented and that no other market participant has greater than a 6% market share. Other market participants include the captive automobile finance companies of other

manufacturers, banks, credit unions, independent automobile finance companies and other financial institutions.

Our dealer servicing and underwriting capabilities and systems enable us to compete effectively in the automobile finance market. Our ability to compete successfully depends largely upon our strong personal relationships with dealers and their willingness to offer us contracts that meet our underwriting criteria. These relationships are fostered by the promptness with which we process and fund contracts, as well as the flexibility and scope of the programs we offer. We purchase the full spectrum of prime and non-prime contracts secured by both new and pre-owned vehicles.

The competition for contracts available within the prime and non-prime credit quality contract spectrum is more intense when the rate of automobile sales declines. Although we have experienced consistent growth for many years, we can give no assurance that we will continue to do so. Several of our competitors have greater financial resources than we have and may have a lower cost of funds. Many of our competitors also have longstanding relationships with automobile dealers and may offer dealers or their customers other forms of financing or services not provided by us. The finance company that provides floor planning for the dealer s inventory is ordinarily one of the dealer s primary sources of financing for automobile sales. We do not currently provide financing on dealers inventories. We must also compete with dealer interest rate subsidy programs offered by the captive automobile finance companies. However, these programs are not generally offered on pre-owned vehicles and are limited to certain models or loan terms that may not be attractive to many automobile purchasers.

Competition in the retail banking business comes primarily from commercial banks, credit unions, savings and loan associations, mutual funds and corporate and government securities markets. Many of the nation s largest savings and loan associations and other depository institutions have locations in Southern California. We compete for deposits primarily on the basis of interest rates paid and the quality of service provided to our customers.

Competition in the commercial banking business comes primarily from other commercial banks that maintain a presence in Southern California. We have differentiated ourselves by providing high quality service, local relationship management, prompt credit decisions and competitive rates on both loans and depository products.

Our Business Strategy

Our business objective is to maximize long-term profitability by efficiently purchasing and servicing prime and non-prime contracts that generate strong and consistent risk-adjusted returns. We achieve this objective by employing our business strategy, which includes the following key elements:

- produce consistent growth through our strong dealer relationships;
- price contracts to maximize risk-adjusted returns by using advanced technology and experienced underwriters;
- create operating efficiencies through technology and best practices;
- generate low cost liquidity through our funding sources, including positive operating cash flows; and
- record high quality earnings and maintain a conservative, well-capitalized balance sheet.

Produce Consistent Growth Through Our Strong Dealer Relationships

Over the past five years, we have experienced a compounded annual growth rate in contract purchases of 15%. We believe we provide a high degree of personalized service to our dealer base by marketing, underwriting and purchasing contracts on a local level. Our focus is to provide each dealer superior service by providing a single source of contact to meet the dealer s prime and non-prime financing needs. We believe that the level of our service surpasses that of our competitors. We provide personalized, efficient, and consistently excellent service by making our business development representatives available when a dealer is open, making

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prompt credit decisions, negotiating credit decisions within available programs by providing structural alternatives, and funding promptly.

	At or For the Year Ended December 31,				
	2004	2003	2002	2001	2000
	(Dollars in thousands)				
Total automobile contract originations	$ 6,634,870	$ 5,978,576	$5,415,734	$4,863,279	$4,219,227
Percentage growth	11.0%	10.4%	11.4%	15.3%	26.3%
Total automobile contract portfolio managed	$11,560,890	$10,596,665	$9,389,974	$8,152,882	$6,818,182
Percentage growth	9.1%	12.9%	15.2%	19.6%	27.3%

Growth of originations is primarily through increased dealer penetration. We intend to increase contract purchases from our current dealer base as well as develop new dealer relationships. Although our presence is well-established throughout the country, we believe that we still have opportunities to build market share, especially in those states that we entered since 1994. In addition, we have improved our dealer education and delivery systems in order to increase the ratio of contracts purchased to the number of applications received from a dealer, thereby improving the efficiency of our dealer relationships. We are also seeking to increase contract purchases through new dealer programs targeting high volume, multiple location dealers. These programs focus on creating relationships with dealers to achieve higher contract originations and improving efficiencies. On a limited basis, we also originate loans directly from consumers and purchase loans from other automobile finance companies. Additionally, we continue to explore other distribution channels, including the Internet. In December 2001, we acquired an interest in DealerTrack Holdings, Inc., also known as DealerTrack, an Internet business-to-business portal that brings together finance companies and dealers. DealerTrack has signed up over 100 finance companies and approximately 24,000 dealers. As of December 31, 2004, we owned approximately 6.3% of DealerTrack. Currently, over 80% of our applications are processed through DealerTrack.

We currently have a 2% market share of the United States auto finance industry. However, we are the largest originator of pre-owned automobile contracts in California, by a two to one margin to our nearest competitor, with a 9% market share. Our leading market share in California enables us to earn a higher risk-adjusted margin in this market. We are seeking to expand our market share in other states to achieve similar returns.

Price Contracts to Maximize Risk-Adjusted Returns by Using Advanced Technology and Experienced Underwriters

Quality underwriting and servicing are essential to effectively assess and price for risk and to maximize risk-adjusted returns. We rely on a combination of credit scoring models, system-controlled underwriting policies and the judgment of our trained credit analysts to make risk-based credit and pricing decisions. We use credit scoring to differentiate applicants and to rank order credit risk in terms of expected default probability. Based upon this statistical assessment of credit risk, the underwriter is able to appropriately tailor contract pricing and structure.

To achieve the return anticipated at origination, we have developed a disciplined behavioral servicing process for the early identification and cure of delinquent contracts and for loss mitigation. In addition, we provide incentives to our associates based on credit performance and profitability measurements on both an individual and company level.

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The following table shows the risk-adjusted margins on automobile contracts originated over the past five years:

	For the Year Ended December 31,				
	2004	2003	2002	2001	2000
Weighted average coupon(1)	9.88%	10.03%	11.35%	12.74%	13.95%
Interest on borrowings(1)	3.17	2.70	3.74	5.37	6.74
Net interest margins	6.71	7.33	7.61	7.37	7.21
Credit losses(2)	1.99	2.60	2.77	2.27	1.91
Risk-adjusted margins	4.72%	4.73%	4.84%	5.10%	5.30%

(1) Represents the rate on contracts originated during the periods indicated.

(2) Represents the rate on managed contracts during the periods indicated.

Create Operating Efficiencies Through Technology and Best Practices

We evaluate all aspects of our operations in order to streamline processes and employ best practices throughout the organization. Our key technology systems implemented through this process include:

automated front-end loan origination system that calculates borrower ratios, maintains lending parameters and approval limits, accepts electronic applications and directs applications to the appropriate credit analyst, all of which have reduced the cost of receiving, underwriting and funding contracts;

custom designed proprietary scoring models that rank order the risk of loss occurring on a particular contract;

behavioral delinquency management system, which improves our ability to queue accounts according to the level of risk, monitor collector performance and track delinquent automobile accounts;

centralized and upgraded borrower services department, which includes remittance processing, interactive voice response technology and direct debit services;

centralized imaging system that provides for the electronic retention and retrieval of account records; and

data warehouse that provides analytical tools necessary to evaluate performance of our portfolio by multiple dimensions.

As a result of these efforts, over the last five years we have reduced our operating costs as a percent of managed contracts to 2.2% for 2004 from 3.1% in 2000. We will continue to evaluate new technology and best practices to further improve our operating efficiencies.

Generate Low Cost Liquidity Through Our Funding Sources, Including Positive Operating Cash Flows

Cash flows from our automobile operations provide a significant source of liquidity for us. In addition, we are able to raise additional liquidity through the asset-backed securities market. Over the last year we held an average of approximately $654 million of unencumbered automobile contracts on our balance sheet, which provides another source of liquidity. The Bank provides liquidity through its retail and commercial banking divisions in the form of deposits. At December 31, 2004, the Bank also had a $2.6 billion mortgage-backed securities portfolio that it can use to obtain advances from the FHLB and securities repurchase agreements. These sources of funds provide us with additional funding security.

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Record High Quality Earnings and Maintain a Conservative, Well-Capitalized Balance Sheet

Presenting high quality earnings and maintaining a conservative, well-capitalized balance sheet have been our focus since our founding in 1972. We believe this strategy ensures success over the long term, rather than providing extraordinary short-term results. Components of this strategy include accounting for our automobile securitizations as secured financings rather than sales, maintaining appropriate allowances for credit losses and holding a strong capital position.

Since March 2000, we have structured our automobile contract securitizations as secured financings. By accounting for these securitizations as secured financings, the contracts and asset-backed notes issued remain on our balance sheet with the earnings of the contracts in the trust and the related financing costs reflected over the life of the underlying pool of contracts as net interest income on our Consolidated Statements of Income. Additionally, no retained interest in securitized assets, also known as RISA, is recorded on the balance sheet and no corresponding non-cash gain on sale is recorded on the income statement. The RISA must be written off over the life of a securitization. This asset is subject to impairment if assumptions made about the performance of a securitization are not realized. At December 31, 2002, the RISA created from asset-backed securities issued prior to April 2000 had been fully amortized.

Our allowance for credit losses was $315 million at December 31, 2004 compared with $302 million at December 31, 2003. The increase in the allowance for credit losses was the result of a higher level of automobile contracts held on balance sheet. The allowance for credit losses as a percentage of owned loans outstanding was 2.6% at December 31, 2004 compared with 2.7% at December 31, 2003. Based on the analysis we performed related to the allowance for credit losses as described in Note 1 Summary of Significant Accounting Policies in our Consolidated Financial Statements, we believe that our allowance for credit losses is currently adequate to cover probable losses in our loan portfolio that can be reasonably estimated.

Total shareholders equity, excluding accumulated other comprehensive loss and including minority interest, was $1.5 billion or 9.9% of total assets at December 31, 2004. This compares with total shareholders equity of $1.3 billion or 9.0% of total assets at December 31, 2003.

Operations

Automobile Lending

Locations

We currently originate contracts nationwide through our 42 offices. Each regional business center manager is accountable for the performance of contracts originated in that office throughout the life of the contracts, including acquisition, underwriting, funding and collection. We have two national service centers located in California and Texas with functions including data verification, records management, remittance processing, customer service call centers, automated dialers and asset recovery. We also maintain four regional bankruptcy and remarketing centers. Our corporate offices are located in Irvine, California.

Business Development

Our business development representatives are responsible for improving our relationship with existing dealers and enrolling and educating new dealers to increase the number of contracts originated. Business development managers within each regional business center provide direct management oversight to each business development representative. In addition, the director of sales and marketing provides oversight management to ensure that all business development managers and representatives are following overall corporate guidelines.

Business development representatives target selected dealers within their territory based upon volume, potential for business, financing needs of the dealers, and competitors that are doing business with such dealers. Before we decide to do business with a new dealer, we perform a review process of the dealer and its business. If we then determine to proceed, we enter into a non-exclusive dealership agreement with the dealer. This agreement contains certain representations regarding the contracts the dealer will sell to us. Due to the

non-exclusive nature of our relationship with dealers, the dealers retain discretion to determine whether to sell contracts to us or another financial institution. The business development representative is responsible for educating the dealers finance managers about the types of contracts that meet our underwriting standards. We believe this educational process helps to minimize the number of applications we receive that are outside of our underwriting guidelines, thereby increasing our efficiency and lowering our overall cost to originate contracts.

After the dealer relationship is established, the business development representative continues to actively monitor the relationship with the objective of maximizing the overall profitability of each dealer relationship within his or her territory. This includes monitoring the number of approved applications received from each dealer that are converted into contracts, verifying that the contracts meet our underwriting standards, monitoring the risk-based pricing of contracts acquired and reviewing the actual performance of the contracts purchased. To the extent that a dealer does not meet minimum conversion ratios, lending volume standards or overall profitability targets, the dealer may be precluded from sending us applications in the future. Our dealer base increased during the year from approximately 8,000 to 8,200, primarily as a result of us expanding our nationwide presence. Our increase in volume is the result of this increase in our dealer base, in addition to funding more contracts from our existing dealers.

Underwriting and Purchasing of Contracts

The underwriting process begins when an application is sent to us via the Internet or fax. Internet applications are automatically loaded into our front-end underwriting computer system. Applicant information from faxed applications is manually entered into our front-end system. Once an application is in the front-end system, the system automatically obtains the applicant s credit bureau information and calculates our proprietary credit score.

We use credit scoring to differentiate credit applicants and to rank order credit risk in terms of expected default probabilities. This enables us to tailor contract pricing and structure according to our statistical assessment of credit risk. For example, a consumer with a lower score would indicate a higher probability of default; therefore, we would structure and price the transaction to compensate for this higher default risk. Multiple scorecards are used to accommodate the full spectrum of contracts we purchase. In addition to a credit score, the system highlights certain aspects of the credit application that have historically impacted the credit worthiness of the borrower.

Our credit analysts are responsible for properly structuring and pricing deals to meet our risk-based criteria. They review the applicant s information and the structure and price of an application and determine whether to approve, decline or make a counteroffer to the dealer. Each credit analyst s lending levels and approval authorities are established based on the individual analyst s credit experience and portfolio performance, credit manager audit results and quality control review results. Higher levels of approvals are required for higher credit risk and are controlled by system driven parameters and limits. System driven controls include limits on minimum contract buy rates, contract terms, contract advances, payment to income ratios, debt to income ratios, collateral values and low side overrides.

Once a credit decision has been made, the computer system automatically sends a response to the dealer through the Internet or via fax specifying approval, denial or conditional approval. Conditional approval is based upon modification to the structure, such as an increase in the down payment, reduction of the term, or the addition of a co-signer. As part of the approval process, the credit analyst may require that some of the information be verified, such as the applicant s income, employment, residence or credit history. The system increases efficiency by automatically denying approval in certain circumstances without additional underwriting being performed. These automated notices are controlled by parameters set by us, consistent with our credit policy.

If the dealer accepts the terms of the approval, the dealer is required to deliver the necessary documentation for each contract to us. Our funding group audits such documents for completeness and consistency with the application and provides final approval and funding of the contract. A direct deposit is made or a check is prepared and promptly sent to the dealer for payment. The dealer s proceeds may include

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dealer participation for consideration of the acquisition of the contract. The completed contract file is then forwarded to our records center for imaging.

Under the direction of the Credit and Pricing Committee, the Chief Credit Officer oversees credit risk management, sets underwriting policy, monitors contract pricing, tracks compliance to underwriting policies and re-underwrites select contracts. If re-underwriting statistics are unacceptable, a portion of quarterly incentives are forfeited by the office that originated the contracts. Our internal quality control group reviews contracts on a statistical sampling basis to ensure adherence to established lending guidelines and proper documentation requirements. Credit managers within each regional business center provide direct management oversight to each credit analyst. In addition, the Chief Credit Officer provides oversight management to ensure that all credit managers and analysts are following overall corporate guidelines.

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The following table sets forth information for contracts originated, contracts managed and the number of dealers in the states in which we operate our business:

	Contracts Originated For the Year Ended December 31,			At December 31, 2004	
State	2004	2003	2002	Managed Portfolio	Number of Dealers(1)
	(Dollars in thousands)				
California	$2,569,659	$2,228,877	$2,091,347	$ 4,298,323	2,973
Washington	393,675	373,111	310,189	649,237	517
Arizona	337,670	299,918	283,528	605,388	473
Texas	244,456	204,065	171,761	427,999	760
Oregon	219,666	206,875	214,683	373,529	476
Virginia	215,054	162,148	123,403	339,472	449
New York	174,508	117,377	63,519	255,041	360
Nevada	172,531	142,957	131,094	269,562	155
Illinois	167,334	147,635	104,576	274,709	508
Ohio	162,936	161,846	171,109	350,790	741
Florida	162,866	132,238	147,931	304,737	693
Colorado	161,998	248,667	200,153	356,970	316
North Carolina	142,731	148,786	144,859	293,720	524
Idaho	142,336	129,838	102,475	233,440	192
Georgia	134,693	98,224	77,294	224,316	424
Michigan	122,840	109,323	82,542	214,502	378
Maryland	118,727	100,620	62,145	189,374	251
Missouri	88,989	77,273	70,070	154,782	324
Tennessee	84,568	90,156	86,228	177,107	309
South Carolina	76,478	88,511	145,892	204,316	300
Utah	75,011	74,993	84,897	139,617	291
New Jersey	70,799	60,255	42,210	119,819	210
Massachusetts	69,999	69,343	39,086	117,625	185
Wisconsin	59,387	52,304	44,318	98,792	220
Pennsylvania	56,202	47,813	50,699	104,689	327
Minnesota	50,056	46,398	29,708	78,686	131
New Mexico	47,519	34,010	23,930	70,959	91
Connecticut	45,291	35,183	22,928	72,337	109
Alabama	38,027	43,343	36,570	82,461	183
Kentucky	37,242	23,112	41,754	70,836	187
Indiana	30,191	46,530	37,904	76,809	227
Delaware	29,195	32,750	26,697	62,396	74
New Hampshire	27,382	32,619	24,275	52,049	91
Kansas	26,386	26,398	19,448	48,139	123
Iowa	21,899	20,712	20,552	37,948	97
Mississippi	10,402	10,245	18,051	29,142	93
Rhode Island	7,126	5,170	4,385	11,204	33
Wyoming	6,848	8,105	12,507	14,884	37
Nebraska	6,839	8,165	9,824	14,471	57
Montana	5,684	3,590		7,085	6
Maine	5,172	3,782	492	7,138	18
Oklahoma	4,538	12,874	27,390	23,186	79
South Dakota	3,553	4,971	3,843	7,101	13
West Virginia	3,223	7,111	9,447	13,104	82
Vermont	3,184	355	21	3,071	10
Hawaii				28	12
Total	$6,634,870	$5,978,576	$5,415,734	$11,560,890	14,109

(1) Represents number of dealers from which contracts were originated that remain outstanding in our servicing portfolio at December 31, 2004.

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Servicing of Contracts

We service all of the contracts we purchase, both those held by us and those sold in automobile securitizations. The servicing process includes collecting and processing payments, responding to borrower inquiries, maintaining the security interest in the vehicle, maintaining physical damage insurance coverage and repossessing and selling collateral when necessary. We utilize a decision support system that incorporates behavioral scoring models and we purchase credit bureau information on all borrowers, which is updated each quarter. We believe these processes are the most efficient and effective collection methods.

We use monthly billing statements to serve as a reminder to borrowers as well as an early warning mechanism in the event a borrower has failed to notify us of an address change. Payments received in the mail or through our offices are processed by our centralized remittance processing center. To expedite the collection process, we accept payments from borrowers through automated payment programs including Internet banking, direct debits and third party payment processing services. Our customer service center uses interactive voice response technology to answer routine account questions and route calls to the appropriate service counselor.

Our fully integrated servicing, decision and collections system automatically forwards accounts to our automated dialer or regional collection centers based on the assessed risk of default or loss. Account assessment poses several courses of action, including delaying collection activity based on the likelihood of self curing, directing an account to the automated dialer for a predetermined number of days before forwarding it to a regional collections office, or directly forwarding to a loan service counselor in the regional office for accelerated collection efforts as early as when the contract is seven days past due. This process balances the efficiency of centralized collection efforts with the effectiveness of decentralized personal collection efforts. Our systems track delinquencies and chargeoffs, monitor the performance of our collection associates and assist in delinquency forecasting. To assist in the collection process, we can access original documents through our imaging system, which stores all the documents related to each contract. We limit deferments to a maximum of three over the life of the contract and rarely rewrite contracts.

If an account is delinquent and satisfactory payment arrangements are not made, the automobile is generally repossessed within 60 to 90 days of the date of delinquency, subject to compliance with applicable law. We use independent contractors to perform repossessions. The automobile remains in our custody for 10 days, or longer if required by applicable law, to provide the obligor the opportunity to redeem the automobile. If after the redemption period the delinquency is not cured, we write down the vehicle to fair value and reclassify the contract as a repossessed asset. After the redemption period expires, we prepare the automobile for sale. We sell substantially all repossessed automobiles through wholesale automobile auctions, subject to applicable law. We do not provide the financing on repossessions sold. We use regional remarketing departments to sell our repossessed vehicles. Once the vehicles are sold, we charge off any remaining deficiency balances. At December 31, 2004, repossessed automobiles outstanding managed by us were $8.0 million or 0.07% of the total managed contract portfolio, compared with $10.3 million or 0.10% of the total managed contract portfolio at December 31, 2003.

It is our policy to charge off an account when it becomes contractually delinquent by 120 days, except for accounts that are in Chapter 13 bankruptcy, even if we have not yet repossessed the vehicle. At the time that a contract is charged off, all accrued interest is reversed. After chargeoff, we collect deficiency balances through our centralized asset recovery center. These efforts include contacting the borrower directly, seeking a deficiency judgment through a small claims court or instituting other judicial action where necessary. In some cases, particularly where recovery is believed to be less likely, the account may be assigned to a collection agency for final resolution. For those accounts that are in Chapter 13 bankruptcy and contractually past due 120 days, we reverse all accrued interest and recognize income on a cash basis.

Retail Banking

Our retail banking operations are conducted through 20 branch offices located throughout Southern California. The total deposits gathered by the retail banking division were $1.4 billion at December 31, 2004 compared to $1.3 billion at December 31, 2003. Due to our limited number of branch offices, we have

historically focused on certificate of deposit accounts as the primary product offered by the retail banking division. More recently, we have focused on raising low cost demand deposits and money market accounts in order to lower our overall cost of deposits.

Demand deposits and money market accounts obtained through our retail banking operations totaled $799 million at December 31, 2004 compared with $608 million at December 31, 2003. At December 31, 2004, demand deposits and money market accounts represented 57% of our total retail banking deposits compared with 48% at December 31, 2003. In addition, demand deposits, money market accounts and certificate of deposit accounts of $100,000 or less in principal represented approximately 90% of our total deposit accounts.

Commercial Banking

We focus our commercial banking operations in Southern California, operating through our Irvine headquarters. We target commercial clients with sales between $10 million and $100 million. We offer our commercial clients a full array of deposit and loan products that are priced competitively and designed specifically for them. The commercial banking division s strategy is to generate deposits in excess of the loans it funds to provide another source of liquidity for us. Deposit products include money market, business checking and certificate of deposit accounts delivered either through direct contact or cash management services. Loan products include term loans, lines of credit, asset-based loans, construction loans and real estate loans. We also offer consumer deposit and money market accounts as well as consumer loans and lines of credit to the company owners, management and their associates. Loan products are generally priced on a floating rate basis, based on the prime rate or the London Interbank Offered Rate, also known as LIBOR. Fixed rate loans are generally limited to a one-year term or less.

Credit quality is managed by having each loan reviewed for approval by the Commercial Bank President, Chairman of the Board, Board members or other executive officers. In addition, account officers are assigned to specific accounts to maintain close contact with the customer. Such contact allows for greater opportunity to cross sell products, as well as to observe and continually evaluate customers for potential credit problems.

At December 31, 2004, the commercial banking division had $734 million in deposits compared with $638 million at December 31, 2003. Commercial loans outstanding totaled $166 million and $124 million at December 31, 2004 and 2003, respectively.

The following table presents information regarding total loans and deposits of our commercial banking operations:

	For the Year Ended December 31,		
	2004	**2003**	**2002**
		(Dollars in thousands)	
Average balance loans	$322,969	$377,848	$427,035
Average balance deposits	951,109	734,147	487,102
Interest income	17,217	19,957	28,516
Interest expense	6,992	5,478	6,615
Average interest rate earned on loans	5.33%	5.28%	6.68%
Average interest rate paid on deposits(1)	0.74%	0.75%	1.36%

(1) Excludes effect of hedging activities.

Mortgage Portfolios

We have from time to time originated mortgage products that were held on our balance sheet rather than selling such products into the secondary markets. Other than mortgage loans originated on a limited basis through the commercial banking division, we do not expect to add mortgage loans to our balance sheet.

Transactions with Related Parties

We believe that the transactions with or between our subsidiaries described below are on terms no less favorable to us than could be obtained from unaffiliated parties. These transactions were approved by our Board of Directors and the Boards of Directors of the Bank, WFS and other subsidiaries, including their respective independent directors. For accounting purposes, each of the transactions described below eliminates upon consolidation.

Intercompany Borrowings

WFS has various borrowing arrangements with the Bank, including long-term, unsecured debt and lines of credit designed to provide financing for WFS and its subsidiaries. These borrowings are the only source of liquidity WFS currently utilizes outside of the asset-backed securities market. These borrowing arrangements, on an unconsolidated basis, provide the Bank with what it believes to be a market rate of return.

WFS borrowed $150 million from the Bank under the terms of a $150 million note, as amended. This note s original maturity was August 1, 2007, although WFS paid off this note in the third quarter of 2004. Interest payments on the $150 million note were due quarterly in arrears, calculated at the rate of 8.875% per annum. Pursuant to the terms of this note, WFS could not incur any other indebtedness that was senior to the obligations evidenced by this note except for (i) indebtedness collateralized or secured under the $1.8 billion line of credit discussed below and (ii) indebtedness for similar types of warehouse lines of credit. WFS made principal payments on this note totaling $101 million and $7.2 million during the years ended December 31, 2004 and 2003, respectively. There was no amount outstanding on this note at December 31, 2004 compared with $101 million at December 31, 2003. Interest expense on this note totaled $5.0 million, $9.1 million and $12.4 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Additionally, WFS borrowed $300 million from the Bank under the terms of a $300 million note in May 2002. This note matures on May 15, 2012. Interest payments on the $300 million note are due semi-annually, in arrears, calculated at the rate of 10.25% per annum. Pursuant to the terms of this note, WFS may not incur any other indebtedness that is senior to the obligations evidenced by this note except for (i) indebtedness under the $150 million note, (ii) indebtedness collateralized or secured under the $1.8 billion line of credit and (iii) indebtedness for similar types of warehouse lines of credit. There was $300 million outstanding on this note at December 31, 2004 and 2003. Interest expense on this note totaled $30.8 million, $30.8 million and $20.3 million for the years ended December 31, 2004, 2003 and 2002, respectively.

WFS has a line of credit extended by the Bank permitting it to draw up to $1.8 billion as needed to be used in its operations. WFS does not pay a commitment fee for this line of credit. The line of credit terminates on December 31, 2009. There was $161 million outstanding at December 31, 2004 and no amount outstanding at December 31, 2003. The average amount outstanding on the line was $20.5 million for 2004 and $14.7 million for 2003. The $1.8 billion line of credit carries an interest rate based on the one-month LIBOR plus an interest spread of 125 basis points when unsecured and 90 basis points when secured. The Bank has the right under this line of credit to refuse to permit additional amounts to be drawn if, in the Bank s discretion, the amount sought to be drawn will not be used to finance the purchase of contracts or other working capital requirements.

Various subsidiaries of WFS have entered into lines of credit with the Bank. These lines permit these subsidiaries to draw up to a total of $320 million to fund activities related to securitizations. The $320 million in lines of credit terminate on January 1, 2010, although the terms may be extended by these subsidiaries for additional periods of up to 60 months. At December 31, 2004, the amount outstanding on these lines of credit totaled $52.7 million compared with $21.8 million at December 31, 2003. These lines of credit carry an interest rate based on the one-month LIBOR on the last day of the prior month plus an interest spread of 335 basis points when unsecured and 275 basis points when secured.

Interest on the amounts outstanding under the lines of credit is paid monthly, in arrears, and is calculated on the daily average amount outstanding that month. Interest expense for these lines of credit totaled $1.8 million, $1.0 million and $3.0 million for the years ended December 31, 2004, 2003 and 2002,

respectively. For the years ended December 31, 2004, 2003 and 2002, the weighted average interest rates for the lines of credit were 3.38%, 2.28% and 2.74%, respectively. At December 31, 2004, 2003 and 2002, the weighted average interest rates for the lines of credit were 3.65%, 2.28% and 2.55%, respectively.

Short-Term Investment

WFS invests its excess cash at the Bank under an investment agreement. The Bank pays WFS an interest rate on this excess cash equal to the one-month LIBOR. The weighted average interest rate was 1.37%, 1.23% and 1.77% for the years ended December 31, 2004, 2003 and 2002, respectively. WFS held no amount and $764 million excess cash with the Bank under the investment agreement at December 31, 2004 and 2003, respectively. The average investment during 2004 was $529 million compared with $660 million during 2003. Interest income earned by WFS under this agreement totaled $7.5 million, $8.2 million and $10.2 million for the years ended December 31, 2004, 2003 and 2002, respectively. The interest rate was 2.29% at December 31, 2004 compared with 1.17% at December 31, 2003.

Reinvestment Contracts

Pursuant to a series of agreements to which WFS, the Bank and WFAL2, among others, are parties, WFS has access to the cash flows of certain outstanding securitizations, including the cash held in the spread accounts for these securitizations. WFS is permitted to use that cash as it determines, including to originate contracts.

In certain securitizations, the Bank and WFAL2 have entered into a reinvestment contract that is deemed to be an eligible investment under the relevant securitization agreements. The securitization agreements require that all cash flows of the relevant trust and the associated spread accounts be invested in the applicable reinvestment contract. A limited portion of the invested funds may be used by WFAL2 and the balance may be used by the Bank. The Bank makes its portion available to WFS pursuant to the terms of the WFS Reinvestment Contract. Under the WFS Reinvestment Contract, WFS receives access to all of the cash available to the Bank under each trust reinvestment contract and is obligated to repay to the Bank an amount equal to the cash so used when needed by the Bank to meet its obligations under the individual trust reinvestment contracts. With the portion of the cash available to it under the individual trust reinvestment contracts, WFAL2 purchases contracts from WFS pursuant to the terms of a sale and servicing agreement.

In accordance with these agreements, the Bank and WFAL2 pledge property owned by each of them for the benefit of the trustee of each trust and the surety. WFS paid the Bank a fee equal to 55 basis points of the amount of collateral pledged by the Bank as consideration for the pledge of collateral and for WFS access to cash under the WFS Reinvestment Contract in 2004. Prior to January 1, 2004, this fee was 12.5 basis points. WFS paid the Bank $4.2 million, $1.2 million and $1.2 million for the years ended December 31, 2004, 2003 and 2002, respectively, for this purpose. As WFAL2 directly utilizes the cash made available to it to purchase contracts for its own account from WFS, no additional consideration from WFS is required to support WFAL2 s pledge of its property under the agreement with Financial Security Assurance Inc., also known as FSA. While WFS is under no obligation to repurchase contracts from WFAL2, to the extent WFAL2 needs to sell any such contracts to fund its repayment obligations under the trust reinvestment contracts, it is anticipated that WFS would prefer to purchase those contracts than for WFAL2 to sell those contracts to a third party. The WFS Reinvestment Contract, by its terms, is to remain in effect so long as any of the trust reinvestment contracts are an eligible investment for the related securitization. There was $465 million and $789 million outstanding on the trust reinvestment contracts at December 31, 2004 and 2003, respectively.

Whole Loan Sales

We purchased $1.5 billion and $1.7 billion of contracts from WFS in whole loan sales for the years ended December 31, 2004 and 2003, respectively. We purchased no contracts from WFS for the year ended December 31, 2002. In these transactions, WFS received cash for the amount of the principal outstanding on the contracts plus a premium of $48.5 million and $49.7 million for the years ended December 31, 2004 and 2003, respectively. These premiums were recorded by WFS as a cash gain on sale, net of the write-off of

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outstanding dealer participation balances and the effect of hedging activities. These contracts were subsequently securitized by us and continue to be managed by WFS under the terms of the transactions. These whole loan sale transactions are eliminated upon consolidation for accounting purposes.

Tax Sharing Agreement

We and our subsidiaries are parties to an amended tax sharing agreement pursuant to which a consolidated federal tax return is filed for all of the parties to the agreement. Under this agreement, the tax due by the group is allocated to each member based upon the relative percentage of each member s taxable income to that of all members. Each member pays us its estimated share of tax liability when otherwise due, but in no event may the amount paid exceed the amount of tax that would have been due if a member were to file a separate return. A similar process is used with respect to state income taxes for those states that permit the filing of a consolidated or combined return. Tax liabilities to states that require the filing of separate tax returns for each company are paid by each company. The term of the amended tax sharing agreement commenced on the first day of the consolidated return year beginning January 1, 2002 and continues in effect until the parties to the tax sharing agreement agree in writing to terminate it. See Note 22 Income Taxes in our Consolidated Financial Statements.

Management Agreements

We have entered into certain management agreements with WFS and the Bank pursuant to which we pay an allocated portion of certain costs and expenses incurred by WFS and the Bank with respect to services or facilities of WFS and the Bank used by us or our subsidiaries, including our principal office facilities, our field offices, and overhead and associate benefits pertaining to Bank and WFS associates who also provide services to us or our subsidiaries. Additionally, as part of these management agreements, WFS and the Bank have agreed to reimburse us for similar costs incurred. The management agreements may be terminated by any party upon five days prior written notice without cause, or immediately in the event of the other party s breach of any covenant, obligation, or duty contained in the applicable management agreement or for violation of law, ordinance, statute, rule or regulation governing either party to the applicable management agreement.

On January 1, 2004, WFS and the Bank entered into a services agreement with Western Financial Associate Solutions, also known as WFAS, a subsidiary of the Bank, pursuant to which they transferred their human resources function and the majority of their employees to WFAS, and WFAS provides employees to perform certain business functions and provides human resource functions for their remaining employees. This service agreement may be terminated by any party upon 30 days prior written notice without cause, or immediately in the event of the other party s breach of any covenant, obligation, or duty contained in the applicable management agreement or for violation of law, ordinance, statute, rule or regulation governing either party to the applicable management agreement.

Supervision and Regulation

General

The following discussion describes federal and state laws and regulations that have a material effect on our business. These laws and regulations generally are intended to protect consumers, depositors, federal deposit insurance funds and the banking system as a whole, rather than stockholders and creditors. To the extent that this section refers to statutory or regulatory provisions, it is qualified in its entirety by reference to these provisions. The federal banking regulatory agencies have substantial enforcement powers over the depository institutions that they regulate. Civil and criminal penalties may be imposed on such institutions and persons associated with those institutions for violations of laws or regulation. Further, these statutes and regulations are subject to change by Congress and federal or state regulators. A change in the laws, regulations or regulatory policies applicable to us could have a material effect on our business.

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Bank Operations

The Bank and its subsidiaries are subject to examination and comprehensive regulation and reporting requirements by the OTS, the Bank s primary federal regulator, as well as by the FDIC. The OTS is required to conduct a full scope, on-site examination of the Bank every twelve months, with the examination costs assessed against the Bank. In addition, the Bank is subject to regulation by the Board of Governors of the Federal Reserve System, which governs reserves required to be maintained against deposits and other matters. The Bank also is a member of the FHLB of San Francisco, one of twelve regional banks for federally insured savings and loan associations and banks comprising the FHLB System. The FHLB System is under the supervision of the Federal Housing Finance Board. In addition, various other laws and regulations, such as the Gramm-Leach-Bliley Financial Modernization Act, Federal Home Loan Bank Act, Community Reinvestment Act, Sarbanes-Oxley Act of 2002, and USA Patriot Act, directly or indirectly affect our business.

Since WFS is owned by the Bank, a federal savings association, it is subject to regulation and examination primarily by the OTS as well as by the FDIC. Our service corporation subsidiaries also are subject to regulation by the OTS and other applicable federal and state agencies. WFS and certain of our other subsidiaries are further regulated by various departments or commissions of the states in which they do business. This includes our insurance subsidiaries, which are subject to regulation by applicable state insurance regulatory agencies.

Automobile Lending Operations

We purchase automobile installment contracts in 45 states and are subject to both state and federal regulation of our automobile lending operations. We must comply with each state s consumer finance, automobile finance, licensing and titling laws and regulations to the extent those laws and regulations are not pre-empted by OTS regulations or federal law.

The contracts we originate and service are subject to numerous federal and state consumer protection laws, including the Federal Truth-in-Lending Act, the Federal Trade Commission Act, the Fair Credit Billing Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Fair and Accurate Credit Transactions Act, the California Rees-Levering Act, other retail installment sales laws and similar state laws. Most state consumer protection laws also govern the process by which we may repossess and sell an automobile pledged as security on a defaulted contract. We must follow those laws carefully in order to maximize the amount of money we can recover on a defaulted contract.

Affiliate Transaction Restrictions

The Home Owners Loan Act, also known as HOLA, and regulations of the OTS that incorporate Sections 23A and 23B of the Federal Reserve Act and Regulation W promulgated thereunder, limit the type of activities and investments in which the Bank or its subsidiaries may participate if the investment or activity involves an affiliate of the Bank. In addition, transactions between the Bank or its subsidiaries and an affiliate must be on terms that are at least as favorable to the Bank or its subsidiaries as are the terms of the transactions with unaffiliated companies. Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the benefits arising from the bank s access to insured deposits, the payment system and the discount window and other benefits of the Federal Reserve System. The statute and rule impose quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate (and a nonaffiliate if an affiliate benefits from the transaction). The OTS enforces Sections 23A and 23B and Regulation W to the extent applicable to the Bank. This permits the OTS to, as necessary, limit transactions between us, the Bank, our subsidiaries or affiliates and the subsidiaries or affiliates of the Bank, and limit any of Westcorp s activities that might create a serious risk that our liabilities and the liabilities of our affiliates may be imposed on the Bank.

Investment Restrictions

HOLA regulations limit certain of the Bank activities and the activities of our operating subsidiaries to a percentage of the Bank s total consolidated assets, excluding for these purposes, assets held by our service corporations. The Bank is precluded from holding consumer loans, including automobile contracts, on its consolidated balance sheet, in an aggregate principal balance in excess of 30% of its total consolidated assets. The limitation is increased to 35% of consolidated assets if all of the consumer loans in excess of the 30% limit are obtained by the Bank and its operating subsidiaries directly from consumers. Our securitization activities are structured to enable the Bank to remove securitized automobile contracts from the HOLA consumer loan limitation calculation. As a result, securitized automobile contracts are not included in the calculation of the percentage of the Bank s consolidated assets subject to either the 30% or 35% limitation on consumer loans. The Bank is precluded from holding commercial loans, including loans to our service corporations, on its consolidated balance sheet, in an aggregate principal balance in excess of 10% of its total consolidated assets. Commercial loans secured by real estate and small business loans with $2.0 million or less in outstanding principal are not included in the calculation of the percentage of commercial loans. The Bank is precluded from investing more than 2% of its consolidated assets in service corporations, although it may invest an additional 1% in service corporations devoted to community service activities as specified in the regulations. Retained earnings or losses from the operations of our service corporations are not included in the calculation of its investment in service corporations.

Capital Requirements

As a federally chartered savings bank, the Bank is subject to certain minimum capital requirements imposed by the Financial Institutions Reform, Recovery and Enforcement Act, also known as FIRREA, and the Federal Deposit Insurance Corporation Improvement Act, also known as FDICIA. FDICIA separates all financial institutions into one of five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. To be considered well capitalized, an institution must have a ratio of total risk-based capital to risk-weighted assets of 10.0% or greater, a Tier 1 risk-based capital ratio to risk-weighted assets of 6.0% or greater, a leverage ratio of 5.0% or greater and not be subject to any OTS order. To be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8.0%, a Tier 1 risk-based capital ratio of not less than 4.0% and a leverage ratio of not less than 4.0%. Any institution that is neither well-capitalized nor adequately capitalized will be considered undercapitalized. In addition, HOLA and the OTS regulations require savings associations to maintain tangible capital in an amount not less than 1.5% of adjusted total assets and core capital in an amount not less than 3% of adjusted total assets.

HOLA mandates that the OTS promulgate capital regulations that include capital standards no less stringent than the capital standards applicable to national banks. The OTS in its regulations has defined total risk-based capital as core capital plus supplementary capital less direct equity investments not permissible to national banks (subject to a phase-in schedule) and reciprocal holdings that other depository institutions may count in their regulatory capital. Supplementary capital is limited to 100% of core capital. Supplementary capital is comprised of permanent capital instruments not included in core capital, general valuation loan and lease loss allowance, and maturing capital instruments such as subordinated debentures. The amount of general valuation loan and lease allowance that may be included in supplementary capital is limited to 1.25% of risk-weighted assets. At December 31, 2004, there was one debenture issuance remaining with an outstanding balance, excluding discounts and issuance costs, of $300 million and an interest rate of 9.625% due in 2012. Pursuant to the approval from the OTS to treat those debentures as supplementary capital, the total amount of debentures issued by the Bank that may be included as supplementary capital may not exceed the total amount of the Bank s core capital. Presently, $296 million is included as supplementary capital. The 9.625% debentures will not begin to be phased out as supplementary capital until May 15, 2007.

The Bank currently meets all capital requirements to which it is subject and satisfies the requirements of a well capitalized institution. See Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity Capital Requirements for an analysis of the Bank s actual capital and required capital. Because the Bank is well capitalized, it may accept brokered

deposits without restriction. See Management s Discussion and Analysis of Financial Condition and Results of Operations Capital Resources and Liquidity Principal Sources of Cash Deposits. Federal regulators must take prompt corrective action to resolve the problems of insured depository institutions that fall below certain capital ratios.

Safety and Soundness Standards

The federal banking agencies have adopted guidelines establishing safety and soundness standards for all insured depository institutions. Those guidelines relate to internal controls, information systems, internal audit systems, loan underwriting and documentation, compensation and interest rate exposure. In general, the standards are designed to assist the federal banking agencies in identifying and addressing problems at insured depository institutions before capital becomes impaired. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan and institute enforcement proceedings if an acceptable compliance plan is not submitted.

Distributions

The OTS has adopted regulations for determining if capital distributions of a savings association are permitted. Capital distributions are permissible unless the Bank would be undercapitalized, the proposed distribution raises safety and soundness concerns, or violates a prohibition in any statute, regulation or agreement between the Bank and the OTS. The Bank also is subject to certain limitations on the payment of dividends by the terms of the indentures for its debentures. Those limitations are more severe than the OTS capital distribution regulations. Under the most restrictive of those limitations arising in connection with the Bank s sale of debentures, the greatest capital distribution that the Bank could currently make is $358 million. See Note 18 Dividends in our Consolidated Financial Statements for a more detailed description of limits on dividends the Bank is allowed to pay.

Insurance of Accounts

The FDIC administers the Savings Association Insurance Fund, also known as SAIF. Deposits with us are insured through the SAIF to the maximum amount permitted by law, which is currently $100,000. The FDIC may terminate the deposit insurance of any insured depository institution, including the Bank, if it determines after a hearing that the institution has either engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC.

Subprime Lending Programs

The OTS, along with other federal banking regulatory agencies, has adopted guidance pertaining to subprime lending programs. Pursuant to the guidance, lending programs that provide credit to borrowers whose credit histories reflect specified negative characteristics, such as recent bankruptcies or payment delinquencies, are deemed to be subprime lending programs. Many of the loans that we originate possess one or more of the factors identified in the guidance as indicative of a subprime loan. Pursuant to the guidance, examiners may require that an institution with a subprime lending program hold additional capital that ranges from one and one-half to three times the normal capital required for similar loans made to borrowers who are not subprime borrowers. Because many of the loans we originate possess one or more of the factors identified in the guidance as indicative of a subprime loan, the Bank maintains its capital levels higher than those otherwise required by the OTS. The maintenance of higher capital levels by the Bank may slow our growth, require us to raise additional capital or sell assets, all of which would negatively impact our earnings. We cannot predict whether the Bank will be required by the OTS to hold additional capital with respect to those automobile contracts we hold as to which the borrowers are deemed by the OTS to be subprime borrowers.

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Community Reinvestment Act

The Bank is subject to certain requirements and reporting obligations involving activities in connection with the Community Reinvestment Act, also known as the CRA. The CRA generally requires the federal banking agencies to evaluate the record of a financial institution in meeting the credit needs of its local communities, including low-and moderate-income neighborhoods. The CRA further requires the agencies to take into account a financial institution s record of meeting its community credit needs when evaluating applications for, among other things, domestic branches, consummating mergers or acquisitions, or holding company formations. In measuring a bank s compliance with its CRA obligations, the regulators utilize a performance-based evaluation system which bases CRA ratings on the bank s actual lending, service and investment performance, rather than on the extent to which the institution conducts needs assessments, documents community outreach activities or complies with other procedural requirements. In connection with its assessment of CRA performance, the FDIC assigns a rating of outstanding, satisfactory, needs to improve or substantial noncompliance. The Bank s most recent rating was satisfactory.

Other Consumer Protection Laws and Regulations

Examination and enforcement have become intense, and banks have been advised to monitor carefully compliance with various consumer protection laws and their implementing regulations. In addition to the other laws and regulations discussed herein, the Bank is subject to certain consumer and public interest laws and regulations that are designed to protect customers in transactions with banks and certain other financial services companies. While the list set forth below is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act and the Right to Financial Privacy Act, as well as various state consumer protection laws. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans, collecting loans and providing other services. We also are subject to the federal Servicemembers Civil Relief Act and similar state laws affecting enforcement of loans to those in military service. The Bank must comply with the applicable provisions of these laws and regulations as part of its ongoing customer relations. Failure to comply with these laws and regulations can subject the Bank to various penalties, including but not limited to enforcement actions, injunctions, fines or criminal penalties, punitive damages to consumers and the loss of certain contractual rights. The installment sales contracts purchased by WFS are typically subject to stringent state laws. Violations of these state laws by the sellers could subject WFS, as the holder of the contracts, to severe remedies, including, in some instances, the loss of the right to collect interest or principal.

Taxation

Federal Income Taxes

We file a calendar year consolidated federal income tax return with our subsidiaries. All entities included in the consolidated financial statements are included in the consolidated tax return.

The Bank is a savings and loan association for federal income tax purposes. Prior to 1996, savings and loan associations satisfying certain conditions were permitted under the Internal Revenue Code to establish reserves for bad debts and to make annual additions to these reserves, which qualified as deductions from income. However, in 1996 new legislation was enacted which eliminated the reserve method of accounting for bad debts for tax purposes for savings and loan associations and required the reserve balance to be recaptured. During 2003, the remaining $1.7 million of reserves were recaptured.

We will be subject to the alternative minimum tax if that tax is larger than the regular federal tax otherwise payable. Generally, alternative minimum taxable income is a taxpayer s regular taxable income, increased by the taxpayer s tax preference items for the year and adjusted by computing certain deductions in a special manner which negates the acceleration of such deductions under the regular federal tax. This amount is then reduced by an exemption amount and is subject to tax at a 20% rate. In the past, we have not generally paid alternative minimum tax and do not expect that we will in the current year.

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California Franchise Tax and Other State Provisions

At the end of 2004, we had a tax presence in approximately 39 states. However, we expect that approximately 50% of the activity of the group and the resulting income will be taxed as California source income, with the remaining amounts apportioned or allocated outside California.

The California franchise tax applicable to financial corporations such as the Bank is higher than the rate of tax applicable to non-financial corporations because it includes an amount in lieu of local personal property and business license taxes paid by non-financial corporations, but not generally paid by financial institutions such as the Bank. For taxable years ending on or after December 31, 1995, the tax rate for a financial corporation is equal to the tax rate on a regular corporation plus 2%. For income years beginning after January 1, 1997, the California regular corporate tax rate is 8.84% and the financial corporation tax rate is 10.84%.

We compute our taxable income for California purposes on a unitary basis, or as if we were one business unit, and file one combined California franchise tax return, excluding Westhrift Life Insurance Company, also known as Westhrift. The California Franchise Tax Board has completed an examination of tax years 1998 through 2001.

Subsidiaries

The following subsidiaries are included in our Consolidated Financial Statements.

WFS Receivables Corporation 2

WFS Receivables Corporation 2, also known as WFSRC2, is a wholly owned, Nevada based, limited purpose corporation. WFSRC2 was organized for the purpose of purchasing contracts from WFS and securitizing them in the asset-backed securities market. Securitizations originated by WFSRC2 are guaranteed under a financial guaranty insurance policy issued by FSA. Securitization transactions in which contracts are sold through WFSRC2 are treated as secured financings for accounting purposes. At December 31, 2004, WFSRC2 had $1.2 billion in notes payable on automobile secured financing outstanding.

WFS Receivables Corporation 4

WFS Receivables Corporation 4, also known as WFSRC4, is a wholly owned, Nevada based, limited purpose corporation. WFSRC4 was organized for the purpose of purchasing contracts from WFS and securitizing them in the asset-backed securities market. Securitizations originated by WFSRC4 include senior notes which are credit enhanced through the issuance of subordinated notes. Securitization transactions in which contracts are sold through WFSRC4 are treated as secured financings for accounting purposes. At December 31, 2004, WFSRC4 had $986 million in notes payable on automobile secured financing outstanding.

Westran Services Corp.

Westran Services Corp., also known as Westran, is a wholly owned, California based subsidiary, which provides travel-related services for us and our subsidiaries. Westran does not provide a significant source of revenues or expenses.

Western Consumer Products

Western Consumer Products, also known as WCP, is a wholly owned, California based subsidiary, which markets non-lending related products such as automobile warranties, maintenance agreements and vehicle security systems.

Western Financial Bank

The Bank is a wholly owned, federally chartered and federally insured savings bank. The Bank provides diversified financial services through its community banking operations, which include a retail banking division and a commercial banking division. Substantially all of our operations are conducted through the Bank and its subsidiary, WFS. The Bank s subsidiaries are WFS, which in turn owns all of the stock of WFAL2, WFS Funding, Inc., also known as WFSFI, WFS Receivables Corporation, also known as WFSRC, WFS Receivables Corporation 3, also known as WFSRC3 and WFS Web Investments, also known as WFSWEB. Other subsidiaries of the Bank include WFAS, Western Auto Investments, Inc., also known as WAI, Westfin Insurance Agency, also known as WFIA, Western Reconveyance Company, Inc., also known as RECON, Western Consumer Services, Inc., also known as WCS, and The Hammond Company, The Mortgage Bankers, also known as THCMB. WFAL, WFS Investments, Inc., also known as WFSII, Westhrift and WestFin Securities Corporation, also known as WestFin, were subsidiaries of the Bank or WFS but have been dissolved as of December 31, 2004. Each of these entities are described in further detail below.

WFS Financial Inc

WFS is an 84% owned operating subsidiary of the Bank that is in the business of financing contracts purchased from automobile dealers. The remaining interest is traded on the Nasdaq National Market® under the ticker symbol WFSI. Each of its offices is licensed to the extent required by law to conduct business in each respective state. The contracts that WFS originates are generally securitized by its subsidiaries, WFSFI, WFSRC, WFSRC3 and formerly by WFAL or are sold to WFSRC2 or WFSRC4 for securitization by those entities. See General Automobile Lending Operations. During 2004, WFS originated $6.6 billion of contracts.

WFS Financial Auto Loans, Inc.

WFAL was a wholly owned, Nevada based, limited purpose service corporation subsidiary of WFS. WFAL was organized primarily for the purpose of purchasing contracts from WFS and securitizing them in the asset-backed securities market. All sales to securitization trusts directly from WFAL were treated as sales for accounting purposes. WFAL has not purchased any automobile contracts since March 2000. In January 2003, we regained control over the assets of the outstanding securitization trusts accounted for as sales for accounting purposes and consolidated all remaining contracts and related notes payable on automobile secured financing outstanding under these trusts. At December 31, 2004, WFAL had been dissolved.

WFS Financial Auto Loans 2, Inc.

WFAL2 is a wholly owned, Nevada based, limited purpose operating subsidiary of WFS. WFAL2 purchases contracts that are then used as collateral for its reinvestment contract activities. See Transactions with Related Parties Reinvestment Contracts.

WFS Funding, Inc.

WFSFI is a wholly owned, Nevada based, limited purpose service corporation subsidiary of WFS. WFSFI was incorporated for the purpose of providing conduit financings.

WFS Investments, Inc.

WFSII was a wholly owned, California based, limited purpose operating subsidiary of WFS. WFSII was incorporated for the purpose of purchasing limited ownership interests in owner trusts in connection with securitization transactions. WFSII was limited by its Articles of Incorporation from engaging in any business activities not incidental or necessary to its stated purpose. At December 31, 2004, WFSII had been dissolved.

WFS Receivables Corporation

WFSRC is a wholly owned, Nevada based, limited purpose service corporation subsidiary of WFS. WFSRC was incorporated for the purpose of purchasing contracts from WFS and securitizing them in the asset-backed securities market. Securitizations originated by WFSRC are guaranteed under a financial guaranty insurance policy issued by FSA. Securitization transactions in which contracts are sold through WFSRC are treated as secured financings for accounting purposes. At December 31, 2004, WFSRC had $1.8 billion in notes payable on automobile secured financing outstanding.

WFS Receivables Corporation 3

WFSRC3 is a wholly owned, Nevada based, limited purpose service corporation subsidiary of WFS. WFSRC3 was organized for the purpose of purchasing contracts from WFS and securitizing them in the asset-backed securities market. Securitizations originated by WFSRC3 include senior notes that are credit enhanced through the issuance of subordinated notes. Securitization transactions in which contracts are sold through WFSRC3 are treated as secured financings for accounting purposes. At December 31, 2004, WFSRC3 had $6.3 billion in notes payable on automobile secured financing outstanding.

WFS Web Investments

WFSWEB is a wholly owned, California based, limited purpose service corporation subsidiary of WFS. WFSWEB was incorporated for the purpose of investing in an Internet service company called DealerTrack. Our investment in DealerTrack provides us with the opportunity to be involved with a company that provides a business-to-business Internet portal specifically designed for the indirect automobile lending market.

Western Financial Associate Solutions

WFAS is a wholly owned, California based, operating subsidiary of the Bank. WFAS provides employees and human resource functions to our subsidiaries.

Western Auto Investments, Inc.

WAI is a wholly owned, Nevada based, limited purpose operating subsidiary of the Bank. WAI was incorporated for the purpose of purchasing limited ownership interests in contract securitization transactions. WAI is limited by its articles of incorporation from engaging in any business activities not incidental or necessary to its stated purpose. WAI does not provide a significant source of revenues or expenses.

Westfin Insurance Agency

WFIA was a wholly owned, California based, insurance agency and service corporation subsidiary of the Bank. WFIA acts as an agent for independent insurers in providing property and casualty insurance and collateral protection insurance on contracts made by WFS. WFIA is also an insurance agency, which sells fixed annuities to the general public. WFIA s revenues consist primarily of commissions received on policies sold to customers.

Westhrift Life Insurance Company

Westhrift was a wholly owned, Arizona based, operating subsidiary of the Bank. Westhrift had a Certificate of Authority from the California Insurance Commissioner authorizing it to conduct insurance business in California. At December 31, 2004, Westhrift had been dissolved.

WestFin Securities Corporation

WestFin was a wholly owned service corporation subsidiary of the Bank. WestFin was a National Association of Securities Dealers licensed securities broker-dealer of the Bank. At December 31, 2004, Westfin had been dissolved.

Western Reconveyance Company, Inc.

RECON is a wholly owned, California based, service corporation subsidiary of the Bank. RECON acts primarily as the trustee under trust deed loans made by the Bank. RECON does not provide a significant source of revenues or expenses.

Western Consumer Services, Inc.

WCS is a wholly owned, California based, service corporation subsidiary of the Bank. WCS historically conducted real estate development activities through two California limited liability companies, also known as LLCs. The purpose of the LLCs was to acquire, develop and ultimately sell single family residences. WCS has also held properties that were prohibited to be held by the Bank due to regulatory guidelines. The Bank is required to hold dollar for dollar risk-based capital for its investment in WCS. WCS does not currently hold any real estate investments or conduct any real estate development activities.

The Hammond Company, The Mortgage Bankers

THCMB is a wholly owned, California based, operating subsidiary of the Bank. THCMB was acquired in 1995 for the purposes of providing retail mortgage banking services. In 1996, THCMB activities were moved into the Bank. THCMB does not currently conduct any business.

Associates

At December 31, 2004, we had 2,239 full-time and 116 part-time associates. None of our associates are represented by a collective bargaining unit or union. We believe we have good relations with our associates.

Item 2. ***Properties***

At December 31, 2004, we owned six properties in California and one property in Texas and leased 60 properties at various locations in various states.

Our executive offices are located at 23 Pasteur, Irvine, California. The remaining owned and leased properties are used as retail branch offices, automobile lending regional business centers and other operational centers. At December 31, 2004, the net book value of property and leasehold improvements was approximately $49.0 million. We lease space at one location from a company controlled by the Chairman of the Board of our company and our majority shareholder.

Item 3. ***Legal Proceedings***

We or our subsidiaries are involved as a party to certain legal proceedings incidental to our business, including *Lee, et al v. WFS Financial Inc*, United States District Court, Middle District of Tennessee at Nashville, No. 3-02-0570 filed June 17, 2002 (raising claims under the Equal Credit Opportunity Act) and *Thompson, et al v. WFS Financial Inc*, California Superior Court, County of Alameda Civil Action No. RG03088926, Court of Appeal No. A104967 (raising claims under California s Unfair Competition Law and related claims). We reached a settlement in the *Lee, et al v. WFS Financial Inc* and *Thompson, et al v. WFS Financial Inc* cases. The United States District Court, Middle District of Tennessee at Nashville, granted final approval of these settlements and entered judgment on November 15, 2004, and the settlement became effective on December 20, 2004 after the expiration of the time for appeal. The pending appeal in the *Thompson, et al v. WFS Financial Inc* case was dismissed on December 15, 2004, pursuant to the terms of the settlement.

Beginning on May 24, 2004 and continuing thereafter, a total of four separate purported class action lawsuits relating to the announcement by us and WFS that we were commencing an exchange offer for WFS outstanding public shares were filed in the Orange County, California Superior Court against us, WFS, our individual board members, and individual board members of WFS. On June 24, 2004, the actions were consolidated under the caption *In re WFS Financial Shareholder Litigation*, Case No. 04CC00559, also known as the Action. On July 16, 2004, the court granted a motion by plaintiff Alaska Hotel & Restaurant

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Employees Pension Trust Fund, in Case No. 04CC00573, to amend the consolidation order to designate it the lead plaintiff in the litigation. The lead plaintiff filed a consolidated amended complaint on August 9, 2004, and then filed the present corrected consolidated amended complaint on September 15, 2004. All of the shareholder-related actions allege, among other things, that the defendants breached their respective fiduciary duties and seek to enjoin or rescind the transaction and obtain an unspecified sum in damages and costs, including attorneys fees and expenses. The parties have tentatively agreed to a full and final resolution of the Action and, on January 19, 2005, the parties entered into a Memorandum of Understanding, also known as the MOU, concerning the terms of the tentative settlement. The parties are in the process of preparing a formal settlement agreement based on the terms of the MOU and will present it to the Court for approval. Pursuant to the terms of the MOU, the parties have agreed, among other things, that additional disclosures will be made in our Registration Statement on Form S-4 (as filed with the SEC on July 16, 2004), the claims asserted in the Action will be fully released, and the Action will be dismissed with prejudice. Further, pursuant to the MOU, WFS has agreed to pay plaintiffs attorneys fees and expenses in the amount of $675,000, or in such lesser amount as the Court may order.

We do not believe that the outcome of any of these proceedings will have a material effect upon our financial condition, results of operations and cash flows.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None.

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PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***
Price Range by Quarter

Our common stock has been publicly traded since 1986 and is currently traded on the New York Stock Exchange, also known as the NYSE, identified by the symbol, WES. The following table illustrates the high and low prices by quarter in 2004 and 2003, as reported by the NYSE, which prices are believed to represent actual transactions:

	2004		2003	
	High	Low	High	Low
First Quarter	$44.72	$35.07	$23.25	$18.30
Second Quarter	46.80	41.42	29.80	18.60
Third Quarter	46.10	39.51	36.86	27.30
Fourth Quarter	46.35	37.25	39.25	34.13

We had 3,139 shareholders of our common stock at February 28, 2005. The number of shareholders was determined by the number of record holders, including the number of individual participants, in security position listings.

Dividends

We paid cash dividends of $0.55, $0.51 and $0.47 per share for the years ended December 31, 2004, 2003 and 2002, respectively. On March 3, 2005, we declared a quarterly cash dividend of $0.15 per share for shareholders of record as of May 3, 2005. This dividend is payable on May 17, 2005. There are no restrictions on the payment of dividends by Westcorp.

The Bank is restricted by regulation and by the indenture relating to the subordinated debentures as to the amount of funds that can be transferred to us in the form of dividends or other capital distributions. See Note 18 Dividends in our Consolidated Financial Statements. Under the most restrictive of these terms, on December 31, 2004, the Bank s restricted shareholder s equity totaled $635 million with a maximum dividend of $358 million. The Bank must notify the OTS of its intent to declare cash dividends 30 days before declaration and may not pay a dividend or make a loan to us for any purpose to the extent we engage in any activities not permitted for a bank holding company.

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Item 6. ***Selected Financial Data***

The following table presents summary audited financial data for the years ended December 31, 2004, 2003, 2002, 2001 and 2000. Since this table is only a summary and does not provide all of the information contained in our financial statements, including the related notes, you should read our Consolidated Financial Statements contained elsewhere herein. Certain amounts from the prior years Consolidated Financial Statements have been reclassified to conform to the current year presentation.

	At or For the Year Ended December 31,				
	2004	2003	2002	2001	2000
	(Dollars in thousands, except per share amounts)				
Consolidated Statements of Operations:					
Interest income	$ 1,270,885	$ 1,245,017	$ 1,142,940	$ 962,627	$ 583,821
Interest expense	463,127	530,742	530,269	491,313	313,360
Net interest income	807,758	714,275	612,671	471,314	270,461
Provision for credit losses	235,248	294,006	306,233	196,977	82,133
Net interest income after provision for credit losses	572,510	420,269	306,438	274,337	188,328
Noninterest income	116,122	110,157	90,653	78,899	177,884
Noninterest expense	295,607	282,482	251,953	245,502	221,485
Income before income tax	393,025	247,944	145,138	107,734	144,727
Income tax	155,797	98,275	52,267	41,675	58,132
Income before minority interest	237,228	149,669	92,871	66,059	86,595
Minority interest in earnings of subsidiaries	29,266	26,064	13,153	10,369	11,852
Net income	$ 207,962	$ 123,605	$ 79,718	$ 55,690	$ 74,743
Weighted average number of shares and common share equivalents diluted	52,568,834	43,397,211	38,922,611	34,485,127	29,525,677
Earnings per common share diluted	$ 3.96	$ 2.85	$ 2.05	$ 1.61	$ 2.53
Dividends declared per common share	0.56	0.52	0.48	0.44	0.30
Dividend payout ratio	14.1%	18.2%	23.4%	27.3%	11.9%
Consolidated Statements of Financial Condition:					
Assets:					
Cash and due from banks	$ 218,510	$ 382,082	$ 84,215	$ 104,327	$ 128,763
Loans:					
Consumer(1)	11,756,178	10,777,829	9,063,755	7,092,959	4,309,317
Mortgage(2)	213,764	236,223	282,930	373,455	507,431
Commercial	165,806	124,431	97,216	85,312	107,586
Mortgage-backed securities	2,649,758	2,701,797	2,649,657	2,092,225	2,230,448
Investments and time deposits	537,644	363,148	128,529	74,957	35,101
Other assets	319,082	332,012	445,689	427,380	653,270
Less: Allowance for credit losses	315,402	301,602	269,352	178,218	104,006

Total assets	$15,545,340	$14,615,920	$12,482,639	$10,072,397	$ 7,867,910
Liabilities:					
Deposits	$ 2,183,499	$ 1,972,856	$ 1,974,984	$ 2,329,326	$ 2,478,487
Notes payable on automobile secured financing	10,242,900	10,254,641	8,494,678	5,886,227	3,473,377
FHLB advances and other borrowings	1,148,098	560,179	618,766	723,675	616,193
Subordinated debt	295,321	394,854	400,561	147,714	189,962
Amounts held on behalf of trustee			177,642	280,496	494,858
Other liabilities	170,362	179,471	101,145	85,994	71,221
Total liabilities	14,040,180	13,362,001	11,767,776	9,453,432	7,324,098
Minority interest in equity of subsidiaries	165,484	131,434	101,666	78,261	56,644
Shareholders equity	1,339,676	1,122,485	613,197	540,704	487,168
Total liabilities and shareholders equity	$15,545,340	$14,615,920	$12,482,639	$10,072,397	$ 7,867,910

	At or For the Year Ended December 31,				
	2004	2003	2002	2001	2000
	(Dollars in thousands, except per share amounts)				
Other Selected Financial Data:					
Average managed automobile contracts	$11,113,411	$10,051,754	$8,845,635	$7,576,681	$6,076,814
Average shareholders equity(3)	$ 1,277,781	$ 858,927	$ 654,109	$ 570,298	$ 450,323
Return on average shareholders equity(3)	16.28%	14.39%	12.19%	9.77%	16.60%
Total equity to assets(4)	9.92%	9.04%	6.54%	6.75%	7.10%
Book value per share(3)	$ 26.51	$ 23.00	$ 18.23	$ 16.80	$ 15.72
Originations:					
Consumer loans(1)	$ 6,639,938	$ 5,983,492	$5,419,296	$4,869,970	$4,232,115
Mortgage loans(2)	65,753	25,622	23,950	23,001	33,124
Commercial loans	342,356	407,387	354,439	291,944	266,342
Total loan originations	$ 7,048,047	$ 6,416,501	$5,797,685	$5,184,915	$4,531,581
Interest rate spread	5.05%	4.95%	5.14%	4.85%	4.37%

(1) Net of unearned discounts.

(2) Net of undisbursed loan proceeds.

(3) Excludes accumulated other comprehensive loss.

(4) Excludes accumulated other comprehensive loss and includes minority interest.

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and notes thereto and other information included or incorporated by reference herein.

Overview

Our primary sources of revenue are net interest income and noninterest income. Net interest income is the difference between the income earned on interest earning assets and the interest paid on interest bearing liabilities. We generate interest income from our loan portfolio, which consists of consumer, mortgage and commercial loans, and from investments in mortgage-backed securities and other short-term investments. We fund our loan portfolio and investments with deposits, advances from the FHLB, securities sold under agreements to repurchase, securitizations, other borrowings and equity.

Noninterest income is primarily made up of revenues generated from the sale and servicing of contracts and real estate loans. The primary components of noninterest income include late charges and other collection related fee income on managed contracts, sale of real estate loans, contractual servicing income on contracts in securitization transactions treated as sales for accounting purposes and retained interest income or expense. Since March 2000, we have structured our securitizations as secured financings and no longer record non-cash gain on sale at the time of each securitization or subsequent contractual servicing and retained interest income, the valuation of which is based upon subjective assumptions. Rather, the earnings of the contracts in the trust and the related financing costs are reflected over the life of the underlying pool of contracts as net interest income.

The following are highlights for 2004:

We produced record earnings of $208 million in net income, a 68% increase over 2003.

Earnings per share increased to a record $3.96 per share.

Net interest income rose 13% to $808 million while risk-adjusted spreads were nearly identical to 2003 at 5.05%.

Credit losses declined in 2004 to 1.99% of contracts.

Operating expenses represent 32% of total revenues, our most efficient year ever.

We originated $6.6 billion in automobile contracts through our relationships with 8,200 dealers throughout the country.

Our portfolio of automobile contracts of $11.6 billion consists of more than 80% prime credit quality contracts.

Delinquencies at year end were 2.24% of total outstanding contracts, which is 0.66% lower than a year earlier.

We maintained a successful securitization program by continuing to offer senior/subordinated securities on a regular basis.

We managed $10.3 billion of automobile-backed securities outstanding under our securitization program.

Business Risks

Our operating results and financial condition could be adversely affected by any of the following business risks. In addition to the risks described below, we may encounter risks that are not currently known to us or that we currently deem immaterial, which may also impair our business operations.

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Risks Related to the Merger

Anticipated benefits of the merger may not be realized.

WFS board of directors and our board of directors each believe that conversion of the Bank from a federal savings bank to a California state commercial bank and the merger of WFS with and into the Bank will yield certain benefits. These anticipated benefits are based on certain assumptions and, if the merger is consummated, the combined company may not realize the anticipated benefits of the merger to the extent or in the timeframe anticipated.

Our operating results may suffer as a result of purchase accounting treatment.

We will account for the merger, if consummated, using the purchase method of accounting under generally accepted accounting principles in the United States, also known as GAAP. Under the purchase method of accounting, we will record the market value of our common stock issued in connection with the merger and the amount of direct transaction costs as the cost of acquiring the minority interest of WFS. We will allocate that cost to the individual assets acquired and liabilities assumed. As a result, purchase accounting treatment of the merger could adversely impact our income, which could have an adverse effect on the market value of our common stock following completion of the merger.

If the conversion and merger are not completed, WFS and our stock prices and future business and operations could be harmed.

If the current market prices of WFS and our common stock reflect an assumption that the merger will be completed, the price of our respective securities may decline if the merger is not completed. In addition, WFS and our costs related to the merger, including legal, accounting and other fees, must be paid and expensed even if the merger is not completed.

The completion of the merger is subject to the satisfaction of conditions.

WFS obligation and our obligation to complete the merger are subject to the satisfaction or waiver, where permissible, of certain conditions set forth in the merger agreement. Some of these conditions cannot be waived, including obtaining the requisite approval of the WFS minority shareholders, and converting the Bank from a federal savings bank to a California state commercial bank. If the conditions of the merger are not satisfied or waived (to the extent any such conditions may be waived), the merger will not be completed. Among the conditions that cannot be waived is that we must be approved by the Federal Reserve to become a bank holding company. The Federal Reserve has not yet approved our application to become a bank holding company, and may impose conditions to such approval that are not acceptable to us.

In addition, pursuant to the terms of the merger agreement, because the merger was not consummated on or prior to February 28, 2005, any party to the merger agreement has the right to unilaterally terminate the agreement.

If the conversion and merger are not consummated, we may need to make significant changes in our operations or corporate structure.

If the conversion and merger are not consummated, the regulatory requirements imposed by HOLA, particularly the limitations on the percentage of the Bank s assets that may be invested in consumer loans and the guidance issued by the OTS as to the amount of capital that must be held with respect to loans which the OTS deems to be subprime, may cause significant changes in our operations or corporate structure. We may determine to separate our automobile finance business from our banking business, substantially reduce our automobile finance operations or cease operations as a regulated banking entity. It is uncertain whether one or more of these changes in our operations or corporate structure would be more or less profitable than the pending conversion and merger.

Regulatory Requirements May Restrict Our Ability to Do Business

The Bank and its subsidiaries are subject to inspection and regulation by the OTS pursuant to HOLA. The OTS is the primary federal banking agency responsible for its supervision and regulation. The OTS has the power to enforce HOLA and its regulations by a variety of actions ranging from a memorandum of understanding to cease and desist proceedings under the Federal Deposit Insurance Act. The OTS can take such action based solely upon its determination that we have violated one or more of the laws or regulations to which we are subject or that any aspect of our business is being conducted in an unsafe or unsound manner. As such, the OTS has broad powers to, among other things, require us to change our business practices, hold additional capital and change management. Such action could have a material adverse impact on our business and may impact the price of securities we issue, including our common stock, and access to the capital markets.

HOLA limits the amount of our consumer loans, commercial loans and investment in service corporations. See Business Supervision and Regulation - Investment Restrictions. Our securitization activities are structured to enable the Bank to remove securitized automobile contracts from the HOLA consumer loan limitation calculation. Changes in the OTS s interpretation of HOLA as it affects our securitization activities could cause us to change the manner in which we securitize automobile contracts or to limit our acquisition of such contracts, thereby negatively impacting the price of our common stock. Furthermore, if we are unable to continue to securitize the automobile contracts we purchase, this regulatory limitation may force us to limit our acquisition of new automobile contracts, thereby adversely affecting our ability to remain a preferred source of financing for the dealers from whom we purchase automobile contracts, or cause us to fail the regulatory limitations. Any such limitations may also have a material adverse effect on our financial position, liquidity and results of operations. In addition, other regulatory actions taken by the OTS could have a negative impact on the price of our common stock.

OTS Guidance Regarding Subprime Lending May Affect the Bank s Capital Requirements

The OTS, along with other federal banking regulatory agencies, has adopted guidance pertaining to subprime lending programs. Pursuant to the guidance, lending programs which provide credit to borrowers whose credit histories reflect specified negative characteristics, such as recent bankruptcies or payment delinquencies, are deemed to be subprime lending programs for regulatory purposes. Many of the contracts that we originate possess one or more of the factors identified in the guidance as indicative of a subprime loan for this purpose. Pursuant to the guidance, examiners may require that an institution with a lending program deemed to be subprime hold additional capital that ranges from one and one-half to three times the normal capital required for similar loans made to borrowers who are not deemed to be subprime borrowers.

Because many of the automobile contracts we originate possess one or more of the factors identified in the guidance as indicative of a subprime loan, the Bank maintains its capital levels higher than would otherwise be required by regulations. Maintenance of higher capital levels by the Bank may slow our growth, require us to raise additional capital or sell assets, all of which could negatively impact our earnings. We cannot predict to what extent the Bank may be required to hold additional capital with respect to those automobile contracts we hold as to which the borrowers are deemed by the OTS to be subprime borrowers.

Other Regulatory and Legislation Requirements May Affect Our Ability to Do Business

Our operations are subject to regulation, supervision and licensing under various federal, state and local statutes, ordinances and regulations. In most states in which we operate, a consumer credit regulatory agency regulates and enforces laws relating to consumer lenders and sales finance agencies such as WFS. These rules and regulations generally provide for licensing of sales finance agencies, limitations on the amount, duration and charges, including interest rates, for various categories of loans, requirements as to the form and content of finance contracts and other documentation, and restrictions on collection practices and creditors rights. So long as WFS is an operating subsidiary of the Bank, licensing and certain other of these requirements are not applicable to WFS due to federal preemption.

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We are also subject to extensive federal regulation, including the Truth in Lending Act, the Equal Credit Opportunity Act and the Fair Credit Reporting Act. These laws require us to provide certain disclosures to prospective borrowers and protect against discriminatory lending practices and unfair credit practices. The principal disclosures required under the Truth in Lending Act include the terms of repayment, the total finance charge and the annual percentage rate charged on each loan. The Equal Credit Opportunity Act prohibits creditors from discriminating against loan applicants on the basis of race, color, sex, age or marital status. Pursuant to Regulation B promulgated under the Equal Credit Opportunity Act, creditors are required to make certain disclosures regarding consumer rights and advise consumers whose credit applications are not approved of the reasons for the rejection. In addition, the credit scoring system we use must comply with the requirements for such a system as set forth in the Equal Credit Opportunity Act and Regulation B. The Fair Credit Reporting Act requires us to provide certain information to consumers whose credit applications are not approved on the basis of a report obtained from a consumer reporting agency. Additionally, we are subject to the Gramm-Leach-Bliley Act, which requires us to maintain privacy with respect to certain consumer data in our possession and to periodically communicate with consumers on privacy matters. We are also subject to the Servicemembers Civil Relief Act, and similar state laws, which requires us to reduce the interest rate charged on each loan to customers who have subsequently joined the military.

The dealers that originate automobile contracts we purchase also must comply with both state and federal credit and trade practice statutes and regulations. Failure of the dealers to comply with these statutes and regulations could result in consumers having rights of rescission and other remedies that could have an adverse effect on us.

We believe that we maintain all material licenses and permits required for our current operations and are in substantial compliance with all applicable local, state and federal regulations. There can be no assurance, however, that we will be able to maintain all requisite licenses and permits, and the failure to satisfy those and other regulatory requirements could have a material adverse effect on our operations. Other legislative and regulatory initiatives that could affect us, the Bank and the banking industry in general are pending, and additional initiatives may be proposed or introduced, before the U.S. Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject us and the Bank to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which our business would be affected, but a change in the laws, regulations or regulatory policies applicable to us could have a material effect on our business.

We are subject to routine periodic examinations by the OTS on a variety of financial and regulatory matters. The Bank s most recent annual safety and soundness examination by the OTS was completed in September 2004.

Adverse Economic Conditions May Impact Our Profitability

Delinquencies, defaults, repossessions and credit losses generally increase during periods of economic slowdown, recession or higher unemployment. These periods also may be accompanied by decreased consumer demand for automobiles and declining values of automobiles securing outstanding contracts, which weakens collateral coverage and increases the amount of loss in the event of default. Significant increases in the inventory of pre-owned automobiles during periods of economic recession also may depress the prices at which repossessed automobiles may be sold or delay the timing of these sales. Because a portion of our borrowers are considered non-prime borrowers, the actual rates of delinquencies, defaults, repossessions and credit losses on these contracts are higher than those experienced in the general automobile finance industry for borrowers considered to be prime borrowers and could be more dramatically affected by a general economic downturn. In addition, during an economic slowdown or recession, our servicing costs may increase without a corresponding increase in our servicing fee income. While we seek to manage the higher risk inherent in non-prime contracts through the underwriting criteria and collection methods we employ, we cannot assure you that these criteria or methods will afford adequate protection against these risks. Any

sustained period of increased delinquencies, defaults, repossessions, credit losses or servicing costs could adversely affect our financial position, liquidity and results of operations and our ability to enter into future securitizations.

Interest Rate Fluctuations May Impact Our Profitability

Our profitability may be directly affected by the level of and fluctuations in interest rates, which affects the gross interest rate spread we earn on our contracts. As interest rates change, our gross interest rate spread on new originations may increase or decrease depending upon the interest rate environment. In addition, the rates charged on the contracts originated or purchased from dealers are limited by statutory maximums, restricting our opportunity to pass on increased interest costs. We believe that our profitability and liquidity could be adversely affected during any period of changing interest rates, possibly to a material degree. We monitor the interest rate environment and employ our hedging strategies designed to mitigate the impact of changes in interest rates. We cannot assure you that our hedging strategies will mitigate the impact of changes in interest rates.

Wholesale Auction Values May Impact Our Profitability

We sell repossessed automobiles at wholesale auction markets located throughout the United States. Auction proceeds from the sale of repossessed vehicles and other recoveries usually do not cover the outstanding balance of the contracts, and the resulting deficiencies are charged off. Decreased auction proceeds resulting from the depressed prices at which pre-owned automobiles may be sold during periods of economic slowdown or recession will result in higher credit losses for us. Furthermore, depressed wholesale prices for pre-owned automobiles may result from significant liquidations of rental or fleet inventories and from increased volume of trade-ins due to promotional financing programs offered by new vehicle manufacturers. There can be no assurance that our recovery rates will stabilize or improve in the future.

The Ownership of Our Common Stock Is Concentrated, Which May Result in Conflicts of Interest and Actions That Are Not in the Best Interests of Our Other Stockholders

Ernest S. Rady is our founder, Chairman of the Board of Directors and Chief Executive Officer. Mr. Rady is also the Chairman of the Board of Directors and Chief Executive Officer of the Bank and the Chairman of the Board of Directors of WFS. Mr. Rady is the beneficial owner of approximately 53% of our outstanding shares of common stock and is able to exercise significant control over our company. The Westcorp common stock ownership of Mr. Rady enables him to elect all of our directors and effectively control the vote on all matters submitted to a vote of our shareholders, including mergers, sales of all or substantially all of our assets, going private transactions, conversions and other corporate restructurings or reorganizations. Because of the significant block of our common stock controlled by Mr. Rady, decisions may be made that, while in the best interest of Mr. Rady, may not be in the best interest of other stockholders.

We May Not Be Able to Generate Sufficient Operating Cash Flows to Run Our Automobile Finance Operations

Our automobile finance operations require substantial operating cash flows. Operating cash requirements include premiums paid to dealers for acquisition of automobile contracts, expenses incurred in connection with the securitization of automobile contracts, capital expenditures for new technologies and ongoing operating costs. Our primary source of operating cash is the excess cash flows received from securitizations and contracts held on the balance sheet. The timing and amount of excess cash flows from contracts varies based on a number of factors, including:

- the rates and amounts of loan delinquencies, defaults and net credit losses;
- how quickly and at what price repossessed vehicles can be resold;
- the ages of the contracts in the portfolio;
- levels of voluntary prepayments; and

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the terms of our securitizations, which include performance based triggers requiring higher levels of credit enhancements to the extent credit losses or delinquencies exceed certain thresholds. We have exceeded performance thresholds in the past and may do so again in the future.

Any adverse change in these factors could reduce or eliminate excess cash flows to us. Although we currently have positive operating cash flows, we cannot assure you that we will continue to generate positive cash flows in the future, which could have a material adverse effect on our financial position, liquidity and results of operations.

Changes in Our Securitization Program Could Adversely Affect Our Liquidity and Earnings

Our business depends on our ability to aggregate and sell automobile contracts in the form of asset-backed securities. These sales generate cash proceeds that allow us to repay amounts borrowed and to purchase additional automobile contracts. Changes in our asset-backed securities program could materially adversely affect our earnings or ability to purchase and resell automobile contracts on a timely basis. Such changes could include, among other things, a:

delay in the completion of a planned securitization;

negative market perception of us; and

failure of the automobile contracts we intend to sell to conform to insurance company and rating agency requirements.

If we are unable to effectively securitize our automobile contracts, we may have to reduce or even curtail our automobile contract purchasing activities, which would have a material adverse effect on our financial position, liquidity and results of operations.

We Expect Our Operating Results to Continue to Fluctuate, Which May Adversely Impact Our Business

Our results of operations have fluctuated in the past and are expected to fluctuate in the future. Factors that could affect our quarterly earnings include:

variations in the volume of automobile contracts originated, which historically tend to be lower in the first and fourth quarters of the year;

interest rate spreads;

the effectiveness of our hedging strategies;

credit losses, which historically tend to be higher in the first and fourth quarters of the year; and

operating costs.

Critical Accounting Estimates

Management s Discussion and Analysis of Financial Condition and Results of Operations, also known as MD&A, is based on our consolidated financial statements and accompanying notes that have been prepared in accordance with GAAP. Our significant accounting policies are described in Note 1 Summary of Significant Accounting Policies in our Consolidated Financial Statements and are essential in understanding our MD&A. The preparation of financial statements in accordance with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, income, and expenses in our Consolidated Financial Statements and accompanying notes. Actual results could differ from those estimates. We have identified accounting for the allowance for credit losses as the most critical accounting estimate to understanding and evaluating our reported financial results of operations. This estimate is critical because it requires us to make difficult, subjective and complex judgments about matters that are inherently uncertain and because it is possible that materially different amounts would be reported under different conditions or using different assumptions. Additionally, the accounting for derivative financial instruments and accrued taxes requires the use of assumptions and accounting estimates that are also inherently subjective.

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Allowance for Credit Losses

The allowance for credit losses is our estimate of probable losses in our loan portfolio as of the balance sheet date. Our determination of the amount of the allowance for credit losses was based on a review of various quantitative and qualitative analyses. Our process for determining the allowance for credit losses is discussed in detail in Note 1 Summary of Significant Accounting Policies in our Consolidated Financial Statements.

Key analyses considered in the process of establishing our allowance for credit losses include chargeoff trends by loan program, migration analysis of delinquent and current accounts by risk category, analysis of historical cumulative losses, econometric forecasts, the evaluation of the size of any particular asset group, the concentration of any credit tier, the percentage of delinquency, chargeoffs over various time periods and at various statistical midpoints and high points, the severity of depreciated values of repossessions, trends in the number of days repossessions are held in inventory, trends in the number of loan modifications, trends in delinquency roll rates, trends in deficiency balance collections both internally and from collection agencies, trends in custom scores and the effectiveness of our custom scores, and trends in the economy generally or in specific geographic locations. The process of determining the level of the allowance for credit losses based upon the foregoing analyses requires a high degree of judgment. It is possible that others, given the same information, may reach different conclusions and such differences could be material. To the extent that the analyses considered in determining the allowance for credit losses are not indicative of future performance or other assumptions used by us do not prove to be accurate, loss experience could differ significantly from our estimate, resulting in either higher or lower future provision for credit losses.

Derivative Financial Instruments

We use derivatives in connection with our interest rate risk management activities. We record all derivative instruments at fair value. Fair value information for our derivative financial instruments is reported using quoted market prices for which it is practicable to estimate that value. In cases where quoted market prices are not readily available, fair values are based on estimates using present value or other valuation techniques.

Some of our derivatives qualify for hedge accounting. To qualify for hedge accounting, we must demonstrate, on an ongoing basis, that our derivatives are highly effective in protecting us against interest rate risk. We employ regression analysis and discounted cash flow analysis to determine the effectiveness of our hedging activity.

The techniques used in estimating fair values and hedge effectiveness are significantly affected by the assumptions used, including the discount rates and estimates of future cash flows. It is possible that others, given the same information, may reach different conclusions and such differences could be material.

Accrued Taxes

We estimate tax expenses based on the amount we expect to owe various tax jurisdictions. We currently file tax returns in approximately 39 states. Our estimate of tax expense is reported in our Consolidated Statements of Income. Accrued taxes represent the net estimated amount due or to be received from taxing jurisdictions either currently or in the future and are reported as a component of other assets on our Consolidated Statements of Financial Condition. In estimating accrued taxes, we assess the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of our tax position.

Changes to our estimate of accrued taxes occur periodically due to changes in the tax rates, implementation of new tax planning strategies, resolution with taxing authorities of issues with previously taken tax positions, and newly enacted statutory, judicial and regulatory guidance. These changes, when they occur, affect accrued taxes and could be material. See Note 22 Income Taxes in our Consolidated Financial Statements for additional detail on our income taxes.

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Off Balance Sheet Arrangements

Prior to April 1, 2000, our securitization transactions were structured as sales for accounting purposes. Under this structure, the notes issued by our unconsolidated securitization trusts were not recorded as a liability on our Consolidated Statements of Financial Condition. Effective January 1, 2003, we regained control over assets of the securitization trusts for all of our outstanding securitization transactions treated as sales for accounting purposes. We recorded $525 million of automobile contracts and the related notes payable on automobile secured financing on our Consolidated Statements of Financial Condition and have eliminated all remaining off balance sheet amounts related to these transactions. At December 31, 2004, we had no off balance sheet arrangements.

Results of Operations

Net Interest Income

Net interest income is affected by our interest rate spread, which is the difference between the rate earned on our interest earning assets and the rate paid on our interest bearing liabilities, and the relative amounts of our interest earning assets and interest bearing liabilities. Net interest income totaled $808 million, $714 million and $612 million for the years ended December 31, 2004, 2003 and 2002, respectively. The increase in net interest income for the past three years is primarily the result of us holding a greater percentage of contracts on balance sheet.

The following table presents information relative to the average balances and interest rates on an owned basis for the periods indicated:

	For the Year Ended December 31,								
	2004			2003			2002		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
	(Dollars in thousands)								
Interest earning assets:									
Total investments:									
Mortgage-backed securities	$ 2,592,864	$ 98,430	3.80%	$ 2,528,870	$ 83,663	3.31%	$ 2,196,539	$ 113,154	5.15%
Other short-term investments	648,926	9,319	1.44	377,762	4,464	1.18	320,388	5,556	1.73
Investment securities	121,805	4,150	3.41	80,626	3,057	3.79	47,983	2,815	5.87
Interest earning deposits with others	5,637	51	0.90	7,869	65	0.83	7,106	98	1.38
Total investments	3,369,232	111,950	3.32%	2,995,127	91,249	3.05%	2,572,016	121,623	4.73%
Total loans:(1)									
Consumer loans	11,303,131	1,141,994	10.10%	10,225,488	1,134,294	11.09%	8,181,117	993,417	12.14%
Mortgage loans	197,888	9,959	5.03	249,905	13,577	5.43	321,742	22,501	6.99
Commercial loans	109,997	6,462	5.78	110,296	5,409	4.90	90,642	5,035	5.55
Construction loans	9,900	520	5.17	10,177	488	4.80	7,951	364	4.57
Total loans	11,620,916	1,158,935	9.97%	10,595,866	1,153,768	10.89%	8,601,452	1,021,317	11.87%
Total interest earning assets	14,990,148	1,270,885	8.48%	13,590,993	1,245,017	9.16%	11,173,468	1,142,940	10.23%
Noninterest earning assets:									
Amounts due from trusts							121,627		
Retained interest in securitized assets							15,888		
Premises and equipment, net	79,662			80,711			80,277		
Other assets	293,728			308,927			392,358		
Less: Allowance for credit losses	307,611			288,058			211,591		
Total	$ 15,055,927			$ 13,692,573			$ 11,572,027		
Interest bearing liabilities:									
Deposits	$ 2,052,754	58,055	2.83%	$ 1,982,205	64,634	3.26%	$ 2,196,262	80,015	3.64%
Securities sold under agreements to purchase	8,170	94	1.13	220,989	4,544	2.06	222,154	5,543	2.50
FHLB advances and other borrowings	635,337	9,499	1.47	430,372	5,527	1.26	234,779	4,634	1.97

Notes payable on automobile secured financing	10,453,952	360,625	3.45	9,592,483	416,577	4.34	7,426,265	406,851	5.48
Subordinated debentures	348,001	34,854	10.02	396,211	39,460	9.96	331,990	33,226	10.01
Total interest bearing liabilities	13,498,214	463,127	3.43%	12,622,260	530,742	4.21%	10,411,450	530,269	5.09%
Noninterest bearing liabilities:									
Amounts held on behalf of trustee							240,667		
Other liabilities	332,173			303,199			333,149		
Shareholders equity	1,225,540			767,114			586,761		
Total	$ 15,055,927			$ 13,692,573			$ 11,572,027		
Net interest income and interest rate spread		$ 807,758	5.05%		$ 714,275	4.95%		$ 612,671	5.14%
Net yield on average interest earning assets			5.39%			5.26%			5.48%

(1) For the purpose of these computations, nonaccruing loans are included in the average loan amounts outstanding.

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The total interest rate spread increased 10 basis points for 2004 compared with 2003 due to a decrease of 68 basis points in the yield on interest earning assets while the costs of funds decreased 78 basis points. The decrease in the yield on interest earning assets in 2004 was primarily due to a lower interest rate environment. The decrease in the cost of funds in 2004 was primarily due a lower interest rate environment, an improvement of credit spreads on our automobile secured financings and a shift to a higher concentration of low-cost core deposits.

The total interest rate spread decreased 19 basis points for 2003 compared with 2002 due to a decrease of 107 basis points in the yield on interest earning assets while the costs of funds decreased 88 basis points. The decrease in the yield on interest earning assets in 2003 was primarily due to our shift to originating a higher percentage of prime credit quality contracts and an overall lower interest rate environment. The decrease in the cost of funds in 2003 was primarily due to a declining interest rate environment moderated by the increase in the amount of subordinated debentures held by us during 2003 compared to 2002.

The following table sets forth the changes in net interest income attributable to changes in volume (change in average portfolio volume multiplied by prior period average rate) and changes in rates (change in weighted average interest rate multiplied by prior period average portfolio balance):

	2004 Compared to 2003(1)			2003 Compared to 2002(1)		
	Volume	Rate	Total	Volume	Rate	Total
	(Dollars in thousands)					
Increase (decrease) in interest income:						
Mortgage-backed securities	$ 2,156	$ 12,611	$ 14,767	$ 15,274	$ (44,765)	$ (29,491)
Other short-term investments	3,715	1,140	4,855	877	(1,969)	(1,092)
Investment securities	1,426	(333)	1,093	1,472	(1,230)	242
Interest earning deposits with others	(20)	6	(14)	10	(43)	(33)
Total loans:						
Consumer loans	113,783	(106,083)	7,700	232,283	(91,406)	140,877
Mortgage loans	(2,672)	(946)	(3,618)	(4,463)	(4,461)	(8,924)
Commercial loans	(14)	1,067	1,053	1,008	(634)	374
Construction loans	(11)	43	32	105	19	124
Total interest income	$118,363	$ (92,495)	25,868	$246,566	$(144,489)	102,077
Increase (decrease) in interest expense:						
Deposits	$ 2,224	$ (8,803)	(6,579)	$ (7,426)	$ (7,955)	(15,381)
Securities sold under agreements to repurchase	(3,030)	(1,420)	(4,450)	(29)	(970)	(999)
FHLB advances and other borrowings	2,942	1,030	3,972	2,950	(2,057)	893
Notes payable on automobile secured financings	34,962	(90,914)	(55,952)	104,511	(94,785)	9,726
Subordinated debentures	(4,842)	236	(4,606)	6,401	(167)	6,234
Total interest expense	$ 32,256	$ (99,871)	(67,615)	$106,407	$(105,934)	473
Increase in net interest income			$ 93,483			$101,604

(1) In the analysis of interest changes due to volume and rate, the changes due to the volume/rate variance (the combined effect of change in weighted average interest rate and change in average portfolio balance) were allocated proportionately based on the absolute value of the volume and rate variances. If there was no balance in the previous year, the total change was allocated to volume.

Provision for Credit Losses

We maintain an allowance for credit losses to cover probable losses that can be reasonably estimated for the loans held on the balance sheet. The allowance for credit losses is increased by charging the provision for

credit losses and decreased by actual losses on such loans. The level of allowance is based principally on the outstanding balance of loans held on balance sheet and historical loss trends. We believe that the allowance for credit losses is currently adequate to absorb probable losses in our owned loan portfolio that can be reasonably estimated.

The provision for credit losses was $235 million, $294 million and $306 million for the years ended December 31, 2004, 2003 and 2002, respectively. Net chargeoffs were $221 million, $262 million and $215 million for the same respective periods. The decrease in provision for credit losses from 2003 to 2004 was primarily a result of an improving economy as well as our continued emphasis on risk-focused underwriting. The reduction in the provision for credit losses from 2002 to 2003 was the result of holding a greater percentage of prime credit quality contracts, which require a lower percentage of allowance for credit losses.

Noninterest Income

Automobile Lending Income

Since the first quarter of 2000, we have not completed a securitization that has been accounted for as an off balance sheet arrangement. For transactions treated as off balance sheet arrangements prior to April 2000, we recorded a non-cash gain equal to the present value of the estimated future cash flows from the portfolio of contracts sold less the write-off of dealer participation balances and the effect of hedging activities. For these securitizations, net interest earned on the contracts sold was recognized over the life of the transactions as contractual servicing income and retained interest income or expense. Effective January 1, 2003, we regained control over assets of the securitization trusts for all of our outstanding securitization transactions treated as sales for accounting purposes. We no longer recognize retained interest income or expense or contractual servicing income for these securitization transactions on our Consolidated Statements of Income. Rather, we recognize interest income on automobile contracts held in these trusts and record interest expense on notes payable on automobile secured financings.

The components of automobile lending income were as follows:

	For the Year Ended December 31,		
	2004	**2003**	**2002**
		(Dollars in thousands)	
Fee income	$103,689	$90,511	$ 81,087
Contractual servicing income			10,735
Retained interest expense, net of RISA amortization			(29,490)
Total automobile lending income	$103,689	$90,511	$ 62,332

Fee income consists primarily of documentation fees, late charges and deferment fees on our managed portfolio, including contracts securitized in transactions accounted for as sales and secured financings, as well as contracts not securitized. The increase in fee income is due to the growth in our average managed portfolio to $11.1 billion in 2004 from $10.1 billion in 2003 and $8.8 billion in 2002.

There was no contractual servicing income for the years ended December 31, 2004 or 2003 due to our transition to treating our securitizations as secured financings rather than as sales as well as our regaining control over the assets of the trusts for all our outstanding securitization transactions previously treated as sales for accounting purposes. For securitization transactions previously treated as sales for accounting purposes, we earned contractual servicing income in 2002 on the outstanding balance of contracts serviced.

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There was no retained interest expense for the years ended December 31, 2004 or 2003 as a result of our reconsolidating all remaining off balance sheet trusts on January 1, 2003. For accounting purposes, this expense is recognized only on contracts sold through securitizations treated as sales. Retained interest expense is dependent upon the average excess spread on the contracts sold, credit losses, the size of the sold portfolio and the amount of amortization of the RISA. The retained interest expense recognized in 2002 was the result of higher chargeoffs on our sold portfolio as well as revised estimates of future chargeoffs due to continued slowing in the economy. Net chargeoffs on the sold portfolio were $30.4 million for the year ended December 31, 2002. The outstanding sold portfolio had a weighted average gross interest rate spread of 6.71% for the year ended December 31, 2002. The average balance of the sold portfolio was $840 million for the year ended December 31, 2002.

The following table sets forth our contract sales and securitizations and related gain on sales:

	For the Year Ended December 31,				
	2004	2003	2002	2001	2000
	(Dollars in thousands)				
Contract sales and secured financings:					
Secured financings(1)	$5,865,000	$5,889,375	$6,925,000	$4,220,000	$3,930,000
Sales to securitization trusts					660,000
Total sales and secured financings	$5,865,000	$5,889,375	$6,925,000	$4,220,000	$4,590,000
Gain on sale of contracts(2)					$ 7,719
Hedge gain on sale of contracts(3)					5,300
Gain on sale of contracts as a percent of total revenues					1.72%

(1) Information for 2002 and 2001 includes $775 million and $650 million, respectively, of contracts securitized in privately placed conduit facilities.

(2) Net of the write-off of outstanding dealer participation balances and the effect of hedging activities.

(3) Included in gain on sale of contracts.

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The following table lists each of our public securitizations:

Issue Number	Close Date	Original Balance	Remaining Balance at December 31, 2004(1)	Remaining Balance at December 31, 2004 as a Percent of Original Balance	Original Weighted Average APR	Original Weighted Average Securitization Rate	Gross Interest Rate Spread(2)
			(Dollars in thousands)				
1985-A	December, 1985	$ 110,000	Paid in full		18.50%	8.38%	10.12%
1986-A	November, 1986	191,930	Paid in full		14.20	6.63	7.57
1987-A	March, 1987	125,000	Paid in full		12.42	6.75	5.67
1987-B	July, 1987	110,000	Paid in full		12.68	7.80	4.88
1988-A	February, 1988	155,000	Paid in full		13.67	7.75	5.92
1988-B	May, 1988	100,000	Paid in full		14.01	8.50	5.51
1988-C	July, 1988	100,000	Paid in full		15.41	8.50	6.91
1988-D	October, 1988						