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

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

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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

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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