Date: April 6, 2009

To: National Credit Union Administration

From: Ed Casanova
Vice President, Aerospace Federal Credit Union

Re: Comments on Advanced Notice of Proposed Rulemaking for Part 704

The Corporate Credit Union system is an amalgamation of wholesale credit unions that provide and ensure liquidity for natural person credit unions and supply a broad range of financial services, products, information, guidance, and assistance. The system was established to allow the credit union system to function independently of the US banking system.

Corporate Credit Unions help natural person credit unions meet member needs by being:

- a functional and timely provider of liquidity
- an efficient and cost effective priced supplier of products and services, including but not limited to:
  - investment and risk management services and solutions
  - cash-management services and solutions
  - lending products and solutions
  - funds transfer, item processing, and payment and settlement services
  - currency, safekeeping, and custody services

Corporate Credit Unions exist to serve and benefit their member owners (i.e., natural person credit unions). They are supposed to operate in a safe and sound manner in order to protect their member and the funds their members entrust to them.

While market forces may have put some or many Corporate Credit Unions in jeopardy, these forces are not the reason for the Corporate Credit Union dilemma; the cause of the Corporate Credit Unions problem is the system under which they operate. This system:

- allows Corporate Credit Unions to function independently—while the NCUA has supervision and examination responsibility for Corporate Credit Unions, it does not have the centralized authority or governing mechanisms of the Federal Reserve
- fosters (and with current regulations, appears to promote) competition among Corporate Credit Unions
- lets Corporate Credit Unions make investments with no centralized oversight or approval mechanism—this permits and can lead to:
  - concentration risk as Corporate Credit Unions can select the same type of investments (see the securities that Wescorp, US Central, and other Corporate Credit Unions have in portfolio)
  - asset / liability risk (i.e., longer term obligations with higher yields are supported by short term lower cost liabilities—wider spreads are valued over matching maturities)
  - yield risk (i.e., higher yielding investments are value over the lower yielding securities—yield does equate to risk as the Corporate Credit Unions have learned)

- cultivates a risk culture over safety and soundness
  - investment policies are crafted, recommended and executed by Investment professionals (i.e., while Corporate Credit Union Boards of Directors approve such plans, the level of knowledge and expertise Directors have regarding investment securities and the policies required to effectively and prudently manage and monitor such securities is usually limited or lacking)
  - expanded authorities, granted by the NCUA but with no centralized oversight, allows "(Corporate Credit Unions who meet certain criteria to) set (their) own limits on investments and (are) free to invest in non-secured obligations, long-term investments, and asset-backed securities…enter into eurodollar and derivatives transactions with foreign banking/financial counterparties and to invest in U.S. dollar-denominated foreign debt securities...(see Wescorp web site)

In addition, the following contribute to an overburdened and under-regulated system:

- the current Corporate Credit Unions set-up requires a replication of staff, services, and operations when a Corporate Credit Union offers cash-management, funds transfer, item processing, payment / settlement, currency, safekeeping, and /or custody services to it members—this in turn produces inefficiency, varying levels of service, and duplicative costs for natural person credit unions
- Corporate Credit Unions with significant investment operations have:
  - varying grades of professional staff as no centralized requirements exist for experience or expertise
  - their own compensation programs, which may produce unintended consequences: bonuses for current earnings without regard to long term results, bonuses directed at bettering competition, etc.
  - different investment policies and requirements—there is no requirement for a centralized or coordinated investment policy or structure even though it is recognized (and now documented that) the actions of a few can imperil the many (something the Credit Union system is now experiencing)
- NCUA investment regulations promote credit ratings as a credit management and decision tool (i.e., Part 704.6d requires "at the time of purchase, investments with long-term ratings must be rated no lower than AA–…and investments with short-term ratings must be rated no lower than A–1")—this needs to be modified to ensure that credit ratings are not used as an investment determinant
- the Central Liquidity Facility (CLF), whose intended function is to improve the general financial stability of credit unions by serving as a liquidity lender to credit unions experiencing unusual or unexpected liquidity shortfalls, should be incorporated under and made part of the proposed, newly formed Corporate Credit Union (see System section)—the CLF should not be a standalone operation.

In order to revamp the Corporate Credit Union system into a functional, properly managed, and fully operational system, the following changes should be made.

Many of the suggested changes are from a report that was prepared for several natural person credit unions that are members of Wescorp. The report is attached and incorporated as part of this proposal. The report was prepared prior to the Conservatorship of Wescorp; however, the information is timely to the suggested changes and to the problems that exist at US Central, Wescorp, other Corporate Credit Unions, and the Pimco report (the Risk Models section is most apropos to this report).

These proposed changes will take some time; they should be made based on and subject to a comprehensive plan that is agreed to by a substantial percentage (i.e., two-thirds or more) of natural person credit unions.

System

Establish a single, centralized Corporate Credit Union (CCU) responsible for the management and supervision of investments, liquidity, share deposits, products, and services. The CCU would be established through required membership from all natural person credit unions that are insured by the National Credit Union Share Insurance Fund (NCUSIF).

Natural person credit unions (NPCU) would invest in the CCU as they do now in their own Corporate Credit Union (i.e., through Member Capital Accounts or MCAs). NPCUs would be required to hold MCAs equal to one half of one percent (0.50%) of their total share deposits (as part of the establishment of the new CCU and liquidation of current Corporate Credit Unions, any paid-in capital, retained earnings, or MCAs remaining in a liquidating Corporate Credit Union would returned to the NPCUs—these funds will not be used to capitalize the new CCU).

Incorporate within the CCU the CLF. It should be not a stand alone facility; it should be a tool that the CCU can use as needed. The CCU should have the ability to tap all liquidity resources necessary; the CCU should not have to seek special approvals or be subject to other liquidity providers—for this privilege, the CCU will be restricted in the type of investments it can make (see CCU Investment Powers and Requirements section).

Reduce the number of Corporate Credit Unions to no more than eight (8) regional operations (district CCUs). Re-incorporate the Corporate Credit Unions selected as subsidiaries of the CCU; the capital and net worth requirements for the district CCUs would be similar to that of a Credit Union Service Organization (CUSO). The district CCUs would be managed by and report to the CCU. State charted Corporate Credit Unions that object to the new CCU would not be allowed to operate under the umbrella of or have access to programs offered by the CCU.

The purpose of these district CCUs:

- administer and facilitate the use products and services offered by the CCU, including but not limited to cash-management, funds transfer, item processing, payment / settlement services, currency, safekeeping, and /or custody services (i.e., similar to what regional federal reserve banks do)

  These services will initially remain within the current Corporate Credit Unions to ensure a smooth transition to an eventual single corporate site. A plan that includes how and when to transition these services and operations should be prepared and readied for execution within 12 months of adoption of this new Corporate Credit Union format. Consolidating these operations will eliminate duplicative staffing, provide uniform service, and reduce costs to NPCUs.

- monitor and manage liquidity needs of natural member credit unions on behalf of the CCU and report any problems, issues, or results to the CCU (i.e., similar to what regional federal reserve banks do)
- monitor the regions economy and inform the CCU of economic problems or issues in the region (i.e., similar to what regional federal reserve banks do)
- administer, manage and facilitate lending programs offered by CCU (see CCU authority and powers)
- administer, manage and facilitate investment and deposit / share programs offered to NPCUs by the CCU (see CCU authority and powers).

CCU Capital and Fields of Membership

As discussed above, the new CCU would be capitalized through MCAs. While some exiting NCUA regulations may be used for setting, monitoring, and managing the newly formed CCU's capital and net worth requirement, some changes will be needed, including:

- the MCA capitalization percentage to 0.50%

- MCAs should be considered permanent capital; only the ***voluntary*** liquidation of a NPCU should require repayment of a MCA (i.e., eliminated the three year notice period for withdrawal)
- dividends may only be paid from current earnings

Additionally, no risk based capital changes will be required since changes in the CCU's investment authority will be made to ensure that the capital level proposed is adequate and not subject to impairment by higher risk investments.

Finally, the establishment of the single, centralized Corporate Credit Union removes the need to regulate fields of membership rules since all natural person credit unions, insured by the NCUSIF, will be required to belong to the CCU.

CCU Lending and Depository Authority

The CCU will be solely responsible for all lending and share deposit programs, including setting guidelines and interest rates for all lending and share deposits programs (i.e., district CCUs may not set guidelines or interest rates or compete for loans or deposits). Loans and deposits shall be housed, funded, and maintained at and by the CCU. The district CCUs shall administer, manage and facilitate the CCU programs.

To ensure that all natural person credit unions are treated fairly and impartially (and to eliminate and prevent any competition by and/or between district CCUs:

- only the CCU shall set interest rates for loans and share deposits
- interest rates for loans and share deposits shall be the same for all NPCUs (with an exception for risk adjustments based on a NPCU's regulatory capital ratios and examination)
- CCU will publish its interest rates for loan and share deposit programs daily
- CCU will establish and publish guidelines and requirements for all lending programs (including any adjustments for risk and NPCU regulatory capital ratios)
- CCU will establish and publish guidelines and requirements for all share deposit programs.

CCU Investment Authority, Powers, and Requirements

To promote the CCU's focus on liquidity, services, and a safe and sound operation and to prevent problems such as those currently imperiling the Corporate Credit Union system, the newly formed CCU's investment authority should be set up and limited as follows (see Wescorp report attached):

- the CCU may only invest in or purchase low and/or medium risk investment securities but may not invest in or purchase high risk investments (see definitions)
  - low risk investments include and are limited to Treasury Bonds, Fannie Mae and Freddie Mac mortgage backed securities (provided they have the implicit or explicit guarantee of the Federal government), Ginnie Mae mortgage backed bonds (provided FHA's insurance fund remains solvent), and money market funds guaranteed by the Federal government
  - medium risk investments should include and are limited to securities backed by commercial mortgages, automobile loans, credit cards, and student loans provided such investments have short durations and excellent credit quality (i.e., more than just a credit grade—this requires an analysis of the underlying loans, see "hands-on" evaluation below)
  - high risk investments should include:

- any mortgage securities backed by jumbo loans (i.e., loans with amounts that exceed Fannie Mae/Freddie Mac conforming loan limits) or any other type of “non-conforming” mortgage loans
- second mortgages, including home equity lines of credit
- collateralized debt obligations or collateralized debt securities
- any other investments not listed as low risk investment or medium risk investments

- the following concentration limits should be place on the types of securities and/or amount of risk the CCU can purchase:
  - a minimum of 80% of all investments must be in low risk securities with the following guidelines and restrictions
    - Treasuries may be the sole investment under this concentration limit provided such Investments meet liquidity, laddering, and yield requirements
    - no more than half of the investments under this requirement (i.e., up to 40% under the 80% guideline) should be in Fannie Mae or Freddie Mac mortgage backed securities or Ginnie Mae mortgage backed securities
    - no more than 15% of the investments under this requirement should be in money market funds
  - a maximum of 15% of all investments may be in medium risk securities
  - no investments are allowed high risk securities
  - any security deemed to be other than a low risk (as defined above) requires:
    - the unanimous vote by the CCU Board of Directors prior to its purchase
    - a clear explanation of why it is being purchased and how CCU will be protected in the event the security do not perform as expected (unforeseen risks are not acceptable)
- require that all investment securities be highly liquid (i.e., salable at any time)
- require duration limits on all investments with such limits matched to share deposits maturities (eliminates purchasing long term securities with short term liabilities to gain spread)—minimize the need for hedging by matching investment and deposit maturities along with yields and costs
- use credit ratings as a part of an investment definition and comprehensive investment decision but do not allow credit rating to a key determinant of an investment definition or decision (see “hands-on”)

Ratings and Rating Agencies

As defined by Standard & Poor, Moody’s and Fitch (i.e., Rating Agencies), credit ratings are an evaluation of a security to meet its financial commitment (i.e., for timely payments and pay offs)—they are an indication of credit risk but not a predictor of loss. The Rating Agencies perform their evaluation based on data supplied by those responsible for the securitization; they do not validate data they receive—instead, they rely on representations and warranties from those who supply it.

Based on statements from Rating Agency staffers, the Rating Agencies repeatedly reduced credit rating standards to gain business (or market share) in 2004, 2005, and 2006. As some former staffers said (including a Managing Director), it was “market-share war…criteria (used) was relaxed...let's hope we are all wealthy and retired by the time this house of cards falters.”

By relaxing standards and not informing anyone they did this, the Rating Agencies breached their fiduciary responsibility, betrayed the trust of Investors, and put Investors at substantial risk. The Securities and Exchange Commission said that S&P and Moody's violated internal procedures and improperly managed conflicts of interest when providing ratings to the Issuers that paid them—they allowed profits to replace integrity.

- require a "hands on" evaluation of the underlying collateral for any security purchased (i.e., this can be done through independent third parties, if necessary)—credit ratings can be used to corroborate these evaluations but they may not be used as proxies for these evaluations
- ensure that safety and soundness is foremost to the Investment operation—there should never be an emphasis put on or need to provide NPCUs with high interest rates
- expand the CCU's staff and broaden the experience required for its Investment operation
  - investment professionals are securities specialists; most do not have the same expertise in evaluating loans, including making a determination if borrowers can or will pay, assessing underwriting, reviewing appraisals, or validating loan data—information Lenders use to make informed decisions and determine loan performance
  - require lending experts (i.e., those familiar with mortgage loans, commercial loans, student loans, auto loans, and credit cards along with the risks each has) be included as part of the CCU's Investment staff and part of the "team" that evaluates and decides if a security should be purchased
  - provide the lending experts with the right to reject any security deemed too risky (as a result of the underlying collateral) without having the decision overridden by an investment professional.

Risk Models

The use of Risk Models is an important tool in managing the CCU. However, it is only a tool and is subject to the constraints of its inputs (i.e., assumptions). As US Central, Wescorp, and others have learned, while Risk Models may be efficient and reliable, they are only as good as their assumptions. If unforeseen events are not included, Risk Models cannot anticipate or consider the effect they may have. Thus, Risk Models should be used but they should not be a key determinant of the CCU's operation or strategy.

CCU Governance

Given the complexity of the Corporate Credit Unions current balance sheets and investment operations, the complexity of the new CCU's balance sheet and operations, and the lack of investment expertise most NPCU professionals have, the following board composition is recommend:

- Establish the new CCU Board of Directors with eleven (11) new Directors. The new CCU Board of Directors should be comprised of:
  - Number of Directors appointed or elected from natural person credit unions with:
    - assets over $10 billion: 2
    - assets over $1 billion but less than $10.0 billion: 2
    - assets over $500 million but less than $1 billion: 2
    - assets under $500 million: 1
  - Director from NCUA Board of Directors: 1
  - Independent, non Credit Union Directors 3
- Board of Directors responsibilities as defined in 704.4 should be retained along with those responsibilities to manage and supervise the new CCU, as listed above, be added.

The independent, non Credit Union Directors should have expertise and experience in investment and risk analysis and managing a large portfolio of collateralized securities—at least one of these Directors should have a strong background in residential and commercial lending. The new members, including their companies, should not be allowed to perform any services for CCU or any NPCUs. Additionally, if these independent, non Credit Union Directors are from an Investment Bank, the Investment Bank should be prohibited from selling any securities or services to any NPCU (this avoids any conflict of interest which may be real or perceived).

CCU Board members should be required to have a minimum number of formal training hours in Investment securities management and loan underwriting. Such training should include complex securities analysis, security trading operations, risk assessment, and residential, commercial, auto, student and credit card lending. This training should be an on-going and annual requirement.

Western Corporate Federal Credit Union's (Wescorp)

Investment Portfolio and Policy Review: September 30, 2008

By: Ed Casanova

Introduction

The following reviews the results of Western Corporate Federal Credit Union's (Wescorp or Credit Union) Investment operation, its liquidity sources, the potential of "temporary impairments" becoming "real" losses, its investment risk management and oversight, and changes Wescorp should make to its Investment operation processes and policies.

Investment Portfolio

The importance of Wescorp's Investment Portfolio to its operations is confirmed by its Balance Sheet and Income Statement. Wescorp's Investment Portfolio equaled 89.9% of Total Assets at September 2008 (see below and Exhibit 1), about the same percentage as it has been for past few years; it produced 82% of Wescorp's total income in the first nine months of 2008, up from 80% of total income in 2007.

Wescorp Balance Sheet (000)
September 2008

Assets	$	%	Liabilities and Equity	$	%
Cash and Due From Banks	344,727	1.4	Borrowed Funds and Other Liabilities	8.878,655	35.2
			Member Shares (i.e., savings accounts)	16,154,996	64.0
Investment Portfolio			Member Capital Accounts (see Exhibit 1)	1,006,298	4.0
Available for Sale (AFS)	12,228,358	48.4	Total Liabilities and Shares	26,039,949	103.2
Held To Maturity (HTM)	9,356,346	37.1			
Total AFS and HTM	21,584,704	85.5	Permanent Capital	213,074	0.8
US Central & Other Investments	1,116,898	4.4	Retained Earnings	787,407	3.1
Total Investment Portfolio	22,701,602	**89.9**	Total Permanent Capital & Retained Earnings	1,000,481	3.9
Loans and Other Assets	2,190,050	8.7	Unrealized Gain (Loss)	1,804,051	7.1
Total Assets	25,236,379	100.0	Total Liabilities and Equity	25,236,379	100.0

Wescorp's Investment Portfolio

	Investment Portfolio		***Unrealized Loss***	
HTM Portfolio	$	%	$	%
Alt A	9,115,944	40.2	560,285	36.4
CDOs	240,402	1.1	115,935	7.5
Total HTM	9,356,346	41.2	676,220	43.9
AFS Portfolio				
CDOs	56,054	0.2	138,940	9.0
CMBS	4,807,960	21.2	132,720	8.6
Sub-Prime	3,722,462	16.4	512,866	33.3
Prime	1,664,619	7.3	45,998	3.0
Agency & Other	1,977,263	8.7	32,283	2.1
Total AFS	12,228,358	53.9	862,808	56.1
US Central	336,348	1.5		
Other Investments	780,550	3.4		
Investment Portfolio	22,701,602	100.0	1,539,028	100.0

[1] Total "Unrealized Loss" does not include FAS 133 or Defined Benefit Losses

The only changes to Wescorp's Sub-prime, Alt A, and CDO balances since December 2007 are from principal payments and "Unrealized Loss" adjustments (see Wescorp's monthly financial summaries).

The chart above shows Wescorp's Investment Portfolio at September 2008. These figures were derived from Wescorp's most recent NCUA report, September 2008 Financial Statement, September 2008 Investment Portfolio Update (Update), August 2008 web cast, and 2007 Audited Financial Statement. The sub-prime Alt A, and CMBS amounts are net of their "Unrealized Loss" (see "Unrealized Loss" column).

The securities Wescorp purchased, including its sub-prime, Alt A, and CDO securities, were AAA rated (many still are today, see Ratings and Rating Agency section). These are the same type of securities that continue to produce huge losses for financial institutions, hedge funds, and other Investors.

Wescorp, like other Investors, purchased AAA rated sub-prime, Alt A, and CDO securities assuming they were high quality, low risk investments with better than average yields. As everyone has learned, the AAA ratings did not reflect the securities real risk—however, the higher yields, *a basic component in evaluating risk, did* (*see Investment Policy, Yield Drives Process*).

Secondary Markets, Production and Loans

Wescorp's sub-prime and Alt A securities make up over half of its Investment Portfolio and much of its income; familiarity with these securities, their underlying loans, and the secondary market they traded in is important to understand how they will ultimately impact Wescorp.

<u>Sub-prime and Alt A Markets</u>

Today's failed sub-prime and Alt A markets have some uncanny similarities to the overheated sub-prime and Alt A markets that collapsed in 1998. Their failure, which was triggered by a global monetary crisis, resulted from the need to produce more volume (regardless of credit), an unrelenting Investor demand for higher yields, a constant need for cash flow, lax underwriting, and minimal regulatory oversight (absent from the crisis: soaring home prices, unreliable credit ratings, exotic loans, and complex investment products).

The collapse of these markets produced (then) record sub-prime delinquencies, the failure of over 70 mortgage companies, the takeover of several Banks and Thrifts (who were funding sub-prime loans), and the bankruptcy of ContiFinancial Corporation, an Investment Bank securitizing sub-prime loans.

It took three years (1999 to 2001) for these markets to recover but once they did they rebounded with vigor, producing three years of record loan volume (2004 to 2006, see Exhibit 8)—before failing, again!

Fueling the remarkable growth:

- escalating home prices, including record increases in several states (mostly coastal and western)
  - a " buy before prices go higher and you are left behind" mentality
  - homes became uncapped lines of credit—the higher prices went, the more one could borrow
- "new" (or exotic) loan products, including Interest Only, Pay Option and stated income loans, that let borrowers *easily* over come soaring home prices
- mortgage companies who had a constant need for cash to fund operations
- an insatiable Investor demand for *safe* but high yields (an incongruity sustained by the Rating Agencies)
- weak regulations and a laissez-faire approach to supervision
- Lenders, Investment Banks, and Rating Agencies who were apathetic to risk and overlooked, ignored or permitted lax underwriting, poor management, and nominal quality control.

The first collapse of these markets, which took almost everyone by surprise, was triggered by global events (i.e., the devaluation of the Russian ruble and the Asian monetary crisis); problems at home initiated the failure of the sub-prime and Alt A markets in 2007. While many say claimed they were surprised about the collapse of these market, plenty of alarms were sounding before the markets failed. These distress signals, which were generally disregarded, included:

- sub-prime delinquencies started rising in mid-2005 and reached record levels in mid-2006—they continue to setting record highs each quarter, see Exhibit 5
- home price escalation slowed in early 2006 while home prices peaked in mid-2006 and began falling—they continue falling today, see Exhibit 9
- sub-prime and Alt A lenders allowed W-2 borrowers to use stated income loans starting in early 2005 (which increased volume)—few asked why W-2 borrowers needed stated income loans or why lenders would allow such loans (see Stated Income loans in Sub-prime and Alt A section)
- sub-prime and stated income loans began defaulting in 2005
- lenders started buying back defaulting sub-prime and Alt A loans in mid-2005 while the number of loans defaulting and lenders required to buy back loans surged in early to mid 2006
- regulatory agencies began public discussions about issuing restrictive sub-prime and Alt A loan guidelines in early 2006—such guidelines were issued in late 2006 (see Interagency Guidelines below)
- Investors began fleeing the secondary market in mid-2006 as delinquencies and buy backs soared

The sub-prime collapsed in early 2007; it was followed a few months later by the Alt A market. Wescorp said that it recognized problems in the sub-prime market in 2005 and stopped buying these securities in early 2006 (see Sub-prime Missed, Experience and Expertise section; it did not have the same foresight with Alt A securities (see Alt A Missed, Experience and Expertise section).

<u>Sub-prime and Alt A Loans</u>

The following describes the types of sub-prime and Alt A loans produced from 2004 to 2006 (i.e., the same type of loans that underlie the securities purchased by Wescorp).

Stated Income loans

Stated Income loans were collateral for both sub-prime and Alt A securities (see Exhibit 8). Often referred to these loans as "liar" loans by mortgage industry professionals, borrowers only need to "state" their income on an application; most lenders did not validate a borrower's stated income (even if it appeared unreasonable).

The Mortgage Asset Research Institute (an information services provider) found in a 2006 study that 60% of "stated" income borrowers inflated their income by over 50% (see Exhibit 12). Borrowers did this (usually with the assistance of a mortgage broker) to get a loan they needed or wanted. The result, some borrowers could not make their first payment, defaulting immediately after their loan funded; other borrowers will not be able to make the monthly payment required when their loan resets or recasts (see Exhibits 9 and 10).

Sub-prime loans (see Exhibit 11)

Sub-prime loans were made to borrowers with low credit scores (i.e., usually 640 or less), credit problems (e.g., late payments, collections, charge-offs, etc.), and employment and/or income issues. Most sub-prime loans were 30-year adjustable rate mortgages (ARMs) with initial fixed payment periods of two or three years. By 2004, over half of these loans were stated income loans (see Exhibit 8).

Sub-prime's worst performing loans were funded and securitized in 2006, 2007 and 2005 respectively, (most of Wescorp's current sub-prime securities were purchased in 2005). The loans underlying these securities continue producing record delinquency and default rates (see Delinquencies section). Many borrowers cannot afford the payment required when their loan resets (see Exhibit 11) and most cannot refinance since lenders are not offering sub-prime loans.

Interest Only (I/O) loans (see Exhibit 10)
In 2003, Alt A lenders made I/O loans, a Bank and Thrift portfolio product, into a popular consumer product (see Exhibit 8)—especially since borrowers could obtain these as a stated income loans—which significantly increased the loans popularity and use.

I/O loans let borrowers make interest only payments; the payments are for a fixed amount during loan's first two to five years. No principal payment is required during this time. I/O loan payments are several hundred dollars less than comparable fully amortizing loan payments (see chart below).

At the end of the I/O period, the loan resets, becoming a fully amortizing loan with monthly *principal and interest* payments. *Principal* payments are based on a loan's remaining term (i.e., for a 5/1 I/O loan, the remaining term when the loan resets is 25 years).

Many I/O borrowers have great difficulty making the monthly payment when their loan resets; the new payment typically produces "payment shock" since it can go up 25% to 80% more than the previous payment (see Exhibit 10); additionally, most I/O borrowers have a stated income loan but lenders are no longer making stated income loans.

Comparison: Monthly Payments

Loan Terms		Payment : 5/1 ARM Loan				Loan Terms		Payment : 5/1 ARM Loan		
Loan Amount	Interest Rate	Interest Only	Fully Amortizing	Payment Difference		Loan Amount	Interest Rate	Interest Only	Fully Amortizing	Payment Difference
$300,000	5.75%	$1,438	$1,750	$313		$400,000	5.75%	$1,917	$2,334	$417

Finally, most I/O borrowers have a stated income loan (see Exhibit 8) but lenders are no longer making stated income loans and most do not expect this type of loan to return (note: some expect this loans will be available in the future for a very small, well qualified, asset rich group of borrower—it will not be for those currently struggling with this loan).

Pay Option loans (see Exhibit 10)
Pay Option loans were initially a Thrift portfolio loan; these loans did not become a consumer product until 2003 when Alt A lenders began offering them. Lenders marketed Pay Option loans as an easy way to overcome rising home prices; they also offered them as stated income loans (which increased the number of borrowers who could obtain them).

Borrowers typically qualify for a Pay Option loan based on an interest rate of 3% or 4%; this "lower" qualification rate allows borrowers to obtain larger loan amounts than they can with an I/O loan. The qualification rate is set by the Lender; it is different than the loan's actual interest or the borrower's initial low monthly payment rate.

Pay Option loans allow borrowers to select the payment they make monthly until their loan recasts (see below). The borrower can choose from an initial low monthly payment, an I/O payment based on the loan's actual interest rate, or one of two fully amortizing payment options. The low initial monthly payment is based on a discounted interest rate of 1% - 2%; the loan's actual interest rate is typically 7.00% or more. The loan's initial low payment increases annually but not by more than 7.5% (i.e., a payment cap) during the loan's first five years or until the loan recasts (see below).

Pay Option loans require that interest be paid or added to the loan balance monthly until the loan recasts based on the loan's actual interest rate (i.e., usually 7.00% or more); loan amounts are allowed to grow, or negatively amortize ("neg am"), by up to 125% (i.e., "neg am" cap) of a loan's original amount.

Pay Option loans recast and become fully amortizing when their loan balance reaches its "neg am" cap (e.g., 125%) or at the end of five years, whichever occurs first. After the loan recasts, its new monthly payment is based on the loan's actual interest rate (i.e., 7.00% or more), remaining term, and "neg am" balance. As a result, new monthly payments often result in *payment shock* to the borrower since the payment can be 100% to 200% more than the loan's previous monthly payment (see Exhibit 10).

Pay Option lenders (e.g., WAMU, Wachovia, etc.) report that 80% of borrowers are currently making only their loan's initial low monthly payment—these loans are negatively amortizing while home values continue falling.

Most Pay Option borrowers will have great difficulty refinancing when their loan recasts since:

- lenders are not making Pay Option or stated income loans (i.e., 80% these loans were stated income, see Exhibit 8)
- many Pay Option borrowers have loan balances that exceed the value of their home (i.e., as a result of negative amortization and falling home values).

> Note: Two recent analyses, one from Fitch (the Rating Agency) and one from the Mortgage Bankers Association (MBA), show that borrowers often stop paying their mortgage when it exceeds the value of their home (see Exhibits 9, 10, and 12).

Interagency Guidance
The agencies who regulate federally chartered Banks, Thrifts, and Credit Unions, began to recognize the risks posed by some of these loan products in 2005; after several months of discussions with industry groups and various financial institutions they issued "Interagency Guidance on Nontraditional Mortgage Product Risks" in September 2006. The "Guidance" requires:

- lenders to "diligently verify and document a borrower's income…stated income should be accepted only if…mitigating factors…minimize the need for direct verification of repayment capacity"
- I/O borrowers to qualify based on their loan's fully indexed, fully amortizing payment
- Pay Option borrowers to qualify based on the loan's fully indexed rate, fully amortizing payment and the loan's maximum "neg am" amount (i.e., up to 125% of the original balance).

While the Guidance was intended to improve loan standards and curb the use of stated income, I/O, Pay Option loans, the collapse of the sub-prime and Alt A markets, which occurred just after the Guidance was published, actually eliminated these types of loans and ended many bad loan practices—the Guidance came a little too late, it may prove useful in the future if these loan products and markets return.

Wescorp's Securities and Underlying Collateral
Wescorp provides few details about the loans underlying its sub-prime and Alt A securities. However, Investment Banks that issued sub-prime and Alt A securities and Rating Agencies (i.e., Standard and Poors or S&P, Moody's, and Fitch) that rated these securities (i.e., the same type of securities Wescorp purchased) regularly publish information about the securities and underlying loans. The following charts display this information for sub-prime and Alt A loans securitized from 2000 to 2007 (see Exhibit 8).

Sub-Prime Loan Characteristics													
Year	Loan Amt	Credit Score	LTV	CLTV	Stated Income	Purchase Loan %	Cash out	NOO	% Calif	Pre-pay	Fixed	Hybrid ARM	Start Rate
2000	103	590	77	77	20%	35%	48	4	**	**	30	70	10.3
2001	111	598	77	77	25%	30%	54	4	**	**	34	66	9.8
2002	135	612	80	81	32%	29%	57	5	31	77	27	73	8.5
2003	155	621	80	84	39%	29%	57	5	34	75	33	67	7.5
2004	174	623	80	85	49%	36%	56	5	35	73	24	76	7.2
2005	193	627	80	87	53%	41%	52	5	32	72	15	85	7.5
2006	208	624	80	88	60%	43%	52	5	29	70	17	83	8.4

2007: not applicable—the sub-prime collapsed

Alt A Loan Characteristics														
Year	Loan Amt	Credit Score	LTV	CLTV	Stated Income	Purchase Loan %	Cash out	NOO	% Calif	Pre-pay	Fixed	Hybrid ARM	Option Arm	I/O
2000	185	696	70	70	59	68	21	16	35	21	92	7	0	1
2001	255	705	70	70	58	50	31	11	42	21	79	17	0	4
2002	244	757	70	74	56	47	30	15	42	30	73	19	0	8
2003	229	711	74	78	58	40	34	22	43	29	62	14	2	22
2004	244	710	74	83	59	54	30	20	43	35	28	14	11	47
2005	288	714	74	83	68	49	37	19	43	43	23	7	34	36
2006	312	708	79	86	80	45	38	17	43	52	16	5	38	41
2007	387	709	80	88	80	38	38	12	48	51	16	6	36	42

LTVs and CLTVs for Pay Option loans average 72% and 74% respectively; LTVs and CLTVs for I/O loans average 78% and 86% for 2002 to 2007.

ARM: adjustable rate mortgage   LTV: Loan to value ratio   CLTV: combined LTV   Cash-out: cash out refinance   NOO: Investor property loan   % Calif: % of loans in Cal.

S&P and Fitch (Rating Agencies), Bear Stearns (Investment Bank acquired by JP Morgan Chase), Loan Performance (a risk assessment company), and UBS (Swiss based financial services firm)

Based on the descriptions of securities listed in Wescorp's monthly financial summaries, 2007 Audited Financial Statement, delinquency information (see various Portfolio Updates), and web casts, the loans underlying its sub-prime and Alt A securities *have the same characteristics as those in the above charts*.

When these loans were securitized and purchased nearly everyone, including Wescorp, assumed:

- traditional delinquency for sub-prime loans and low delinquency for Alt A loans
- most borrowers would refinance when their loans reset or recast
- home values would continue rising as they had for years (i.e., which allowed borrowers to refinance)
- lenders would make or refinance sub-prime and stated income loans
- sub-prime and Alt A loans would continue to be securitized and the securities traded.

But these assumptions were overly optimistic and wrong:

- delinquencies, defaults, and buy backs soared to record levels for sub-prime and Alt A loans
- home prices collapsed (and continue going down today)
- lenders stopped making sub-prime, Alt A, stated income, and high LTV/CLTV loans
- Investors stopped buying sub-prime and Alt A securities—at any price.

As a result, most sub-prime and Alt A borrowers cannot refinance today. Lenders are not offering sub-prime, Pay Option, or stated income loans, falling home values continue to rob equity needed for a refinance, and most sub-prime and Alt A borrowers cannot make the monthly payment required when their loan resets or recasts (see Exhibit 10 and 11). Thus, delinquency rates, including the delinquency rates for loans underlying Wescorp's securities (see Delinquency section), continue soaring.

Wescorp's Operational and Accounting Changes

The collapse of the sub-prime and Alt A markets has overwhelmed the Balance Sheets of many, including Wescorp. The market value for sub-prime and Alt A securities continues falling as no one wants to buy these securities. By most estimates, AAA rated sub-prime and Alt A securities have lost over 50% of their original value; lower rated sub-prime and Alt A securities have lost 75% or more of their value.

To mitigate this problem and prevent it from causing its net worth to fall below regulatory requirements, Wescorp has made three operational decisions that affect the value and holding of its securities. For now, these decisions allow Wescorp to *report* losses directly on the Balance Sheet, avoid *recording* losses through the Income Statement (which would reduce Wescorp's net worth) and (perhaps) time for the securities to recover in value so Wescorp can be paid off when they mature (see Maturity Dates section).

The three operational decisions Wescorp has made include the adoption or use of:

1. Financial Accounting Standard (FAS) 115—1Q07

   FAS 115 (see Exhibit 3) allows Wescorp to *report* mark to market Investment securities losses directly on their Balance Sheet instead of *recording* such losses through the Income Statement, provided Wescorp meets the following requirements:

   - the securities decline in value is deemed to be temporary (see Exhibit 3)
   - Wescorp has the ability (i.e., cash for operations) *and* the intent to hold the securities to maturity
   - Wescorp expects to receive all principal and interest payments due from the securities.

   Wescorp began *reporting* mark to market losses on its Balance Sheet in early 2007. Wescorp stated then and has reiterated ever since in its web casts and presentations that it:

   - deems the loss in value of its sub-prime, Alt A, and CDO securities to be a temporary impairment only (see Exhibit 3)
   - has the ability and intends to hold these securities to maturity
   - has received all principal and interest required *and* expects such payments to continue to be made.

   Wescorp's statements (i.e., its securities are only temporarily impaired) and actions (it has not sold any AFS securities since it began *reporting* losses on the Balance Sheet) meet the requirements of FAS 115. Thus, Wescorp can *report* mark to market losses for its sub-prime, Alt A, and CDO securities directly on the Balance Sheet—it does not have to *record* the losses through its Income Statement (see Exhibit 7) or reduce its Net Worth.

2. "Hold to Maturity" (HTM) for selected securities—March 08

   Wescorp transferred its Alt A and most of its CDO securities from its Available For Sale (AFS) Portfolio to a new Hold to Maturity (HTM) Portfolio. Wescorp's 2007 Audited Financial Statement (note 16) said it transferred the securities to the HTM portfolio "…because currently there is not an active market in these sectors, therefore, a recovery in fair value may be prolonged. Wescorp has both the ability and intent to hold such securities until maturity. These securities are not considered to be other than temporarily impaired..."

   Accounting rules provide that when Wescorp transfers securities to its HTM portfolio, it no longer has to mark them to market *and* it can reverse any mark to market losses already taken. As of March 2008, Wescorp had recorded an "Unrealized Loss" of $814,452,000 for these securities. Wescorp said in its April 2008 web cast that it will reverse this loss over the securities average remaining life (i.e., three years). Ironically, as Wescorp reverses it's "Unrealized Loss" for these securities, the "book" value (or amount reported on the Balance Sheet) for these securities increases while the "market" value for these securities continues falling.

While the transfer of these securities to the HTM Portfolio eliminates the requirement to mark them to market, it does not ensure that Wescorp will be paid when it's Alt A securities mature. If Wescorp is not paid in full when the securities mature, it will have to *record* any (mark to market) losses through the Income Statement, which could cause its net worth to fall below regulatory requirements.

NOTE: Wescorp's sub-prime securities remain in the AFS portfolio (it *reports* losses for these securities directly on the Balance Sheet as an "Unrealized Loss"); as with its Alt A securities, Wescorp could move these securities to the HTM portfolio and reverse the losses it has already *reported.*

3. Level 3 pricing (and Fair Value)—March 08

Wescorp moved to Level 3 pricing in March 2008 for its sub-prime and CMBS securities. Level 3 pricing uses *fair value* pricing (see below) for securities when markets do not provide objective prices (i.e., when there is minimal or no trading of similar type securities). Accounting rules allow those who employ Level 3 pricing to use their own assumptions (i.e., provided the assumptions reflect a rational market) to determine the *fair value* of securities under review.

Wescorp's 2007 Audited Financial Statement (note 16) says that: "During the first quarter of 2008, obtaining valid *fair values*…(for) sub-prime and CMBS securities…became more difficult and challenging…(the) majority of transactions…appeared to be the result of forced liquidations…since *fair value* measurements assume that pricing levels reflect exchanges made in orderly transactions and are not the result of forced liquidations, Wescorp has moved to Level 3 inputs to measure *fair value* for (its sub-prime and CMBS securities) as of March 31, 2008…"

Wescorp said in its June 2008 Portfolio Update that "…on-going turmoil in the market has caused external pricing services…to become unreliable…there is no functioning market for (sub-prime securities)…Any sales that do take place are as a result of forced liquidation. The prices…are clearly distressed prices... (the) only active (sub-prime securities) markets are… (the) ABX index and …observable inputs for credit spreads (from) Bloomberg Loss Coverage Ratios." Wescorp said that it based its Level 3 pricing for sub-prime securities on the ABX and Loss Coverage Ratios.

The BIA or Bank for International Settlements (i.e., the Bank for central banks) said in June 2008 that the ABX showed the value of "AAA" rated sub-prime securities (to be) trading at a loss of 41% to original value. The BIA said that this loss should be higher (i.e., 50% or more) given the ABX framework (see skepticism and concerns in the next section about Wescorp's "Unrealized Loss" for sub-prime securities—it shows a loss of just 9.5% of the sub-prime securities original value).

Fair Value

Accounting rules allow Investors, when no objective market price for a security can be determined, to estimate a security's market value or what accounting rules call *fair value*. A security's *fair value* (is supposed to) represent a rational market's pricing; it is not a fire sale or forced liquidation value.

FAS 157 ("Fair Value Measurements") defines *fair value* as "the price that would be received to sell (a security)…in an orderly transaction between (willing and knowledgeable) market participants at (a) measurement date (e.g., when financial statements are published)."

To ensure uniformity and comparability when using *fair value* pricing, FAS 157 established a hierarchical process that prioritizes inputs (i.e., assumptions) used to determine a security's *fair value* and ranks input reliability. This hierarchical process has three levels:

- Level 1 Pricing: *the highest and most objective level*

  Uses observable, unadjusted quoted prices for identical assets in active markets with immediate access to determine values.

- Level 2 Pricing: *second highest level*

  Uses quoted prices for similar assets in active markets and inputs other than observable quoted prices for similar assets. Objective price adjustments can be made to quoted prices; however, if adjustments are not objective or there are no similar measurements, Level 3 pricing must be used.

- Level 3 Pricing: *lowest and least objective level—estimates require significant internal judgments*

  Uses inputs (or assumptions) not observable but should be external and market based (e.g., the ABX); if such inputs (or assumptions) are not readily available, a company may rely on its own inputs (or assumptions).

  While companies are required to outline their use of Level 3 pricing in published financial statements, they are not required to disclose assumptions. Thus, much skepticism abounds about the objectivity and suitability of assumptions used by those who employ Level 3 pricing for their sub-prime and Alt A securities (e.g., CitiBank, Merrill Lynch, etc.) along with concern about the adequacy of the write downs taken (i.e., despite the huge losses many have already posted)**.**

  This same skepticism and concern applies to Wescorp's *fair value* of (and "Unrealized Loss" for) its sub-prime and CMBS securities (it also applied to Wescorp's Alt A securities until they were moved to the HTM portfolio):

  - does Wescorp's Level 3 assumptions accurately reflect a "rational" market
  - does Wescorp's "Unrealized Loss" for its sub-prime securities (i.e., a loss of 9.5%) accurately reflect the *fair value* of these securities when market estimates (e.g., the ABX) for these securities ("AAA" rated) show they have lost 40% or more of their original value
  - if Wescorp must *record* its "Unrealized Loss" through the Income Statement how will such a loss affect it regulatory net worth (see Exhibit 7).

  Wescorp said it discussed "Level 3 pricing" with the NCUA (its Regulator) and KMPG (its auditor). Notably, KMPG states in Wescorp's 2007 Audited Financial Statement (note 17) that "…*fair values* are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by assumptions used…the derived values cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument..."

  Level 3 allows Wescorp to use its own assumptions; however, Wescorp's staff (see Experience and Expertise section) does not have experience or expertise with sub-prime loans, Alt A loans, commercial loans, or other types of loans—its experience is in securities and securities management. This raises significant questions about the assumptions Wescorp uses to determine the expected performance of loans underlying its securities (including assumptions about prepayment speeds, delinquency rates, defaults and foreclosures rates, etc). Without knowledge about the loans underlying its securities, the assumptions Wescorp uses may be inadequate and/or inappropriate and its Unrealized Loss may be under estimated.

Wescorp's Strategy Needs Help

The success of Wescorp's strategy to *report* losses directly on the Balance Sheet (i.e., for securities in its AFS portfolio), to hold securities in the HTM portfolio (i.e., not recognize mark to market losses), and to use Level 3 pricing when valuing its AFS securities requires no sale any AFS or HTM securities for any reason before they mature (see Liquidity Risk section) and for AFS or HTM securities to paid off by their maturity dates or before (see Maturity Dates section)

For Wescorp's AFS or HTM securities to be paid off on time, housing prices have to stabilize, delinquency has to improve, sub-prime lending has to resume, programs for borrowers who can not document income need to be instituted, and the secondary market has to revive. Without most of these occurring simultaneously, there will be insufficient proceeds to pay off Wescorp's maturing AFS and HTM securities. If these securities are not paid off at maturity, Wescorp will have to *record* any losses, including mark to market losses, through its Income Statement (see Exhibit 14)—which could cause its net worth to fall below regulatory requirements (the NCUA would have to determine what to do if such losses reduce Wescorp's net worth below regulatory requirements, see Contingency Planning section).

Liquidity Risk

Wescorp said in its 2008 web casts and monthly financial summaries that it has ample liquidity and that "(w)ith ongoing support from our members and more than $24 billion of collateralized funds available for borrowing purposes, we are well-positioned to weather the current storm."

Member Generated Liquidity

Wescorp stated in response to a question from its August 2008 web cast: "Our primary source of liquidity is…member credit unions. As long as (they) continue to support us, we will have no liquidity issues…." (see Cautionary Note). While such support is important, the new Corporate Credit Union Loan Guarantee Program (see below) removes many problems that liquidity risk might have posed and virtually eliminates the need for Wescorp to use securities to borrow funds in the event of a liquidity crisis.

Corporate Credit Union Loan Guarantee Program

The Corporate Credit Loan Guarantee Program, effective October 16, 2008 (and similar to the "Temporary Liquidity Guarantee Program" approved by the Federal Deposit Insurance Corporation), removes liquidity concerns for most Corporate Credit Unions. Under the program, the National Credit Union Share Insurance Fund (NCUSIF) provides "federally insured corporate credit unions with a 100% guarantee on new unsecured debt obligations…issued…on or before June 30, 2009, and maturing on or before June 30, 2012."

If Wescorp has a liquidity problem it can issue an unsecured promissory note guaranteed by the NCUSIF to obtain the funds it needs. Wescorp does not have to pledge securities to borrow the funds (see Liquidity, Collateral and FAS 115 next). The program lets Wescorp borrow any amount it needs since "(t)he amount of debt obligations covered by the guarantee…(is)…determined by the NCUA Board." While there are restrictions, this provision effectively removes limits on the amount Wescorp can borrow.

Liquidity, Collateral and FAS 115

Wescorp said in its June 2008 financial statement and 2008 Financial Analysis Report that it can borrow from US Central, the Federal Home Loan Bank (FHLB), and global financial institutions; it said that it has "…more than $24 billion of collateralized funds available for borrowing."

If Wescorp has to pledge any AFS or HTM securities as collateral to borrow funds, Wescorp would breach FAS 115's requirement that "(it) has the *ability* to hold the security to maturity." As a result, Wescorp would have to mark the securities pledged to market and record any losses through its Income Statement. The new Corporate Credit Union Loan Guarantee Program eliminates this problem.

Cautionary Note
Bear Stearns, the Investment Bank acquired by JP Mortgage Chase, did not have a solvency problem. Bear Stearns had a liquidity problem (the reason for its forced sale). Rumors about its liquidity persisted in the market for months. The Investment Bank announced numerous times over many weeks that it had sufficient liquidity despite recording on-going mark to market losses from its sub-prime and Alt A securities. After a while, Investors lost confidence and began withdrawing funds; before long there was a run on the institution (i.e., everyone wanted their funds). Once the run started, it overwhelmed Bear Stearns. The Federal Reserve stepped in, it said, to prevent potential (or perceived) global problems that a failure or bankruptcy might produce. Bear Sterns was solvent; however, it did not have the funds needed to meet the liquidity problem created by rumor and lack of Investor confidence—there were no federal programs available (e.g., Corporate Credit Union Loan Guarantee Program) to rescue the firm.

Maturity Dates
Based on Wescorp's January 2008 web cast and 2007 Audited Financial Statement, its sub-prime securities mature in late 2010 and it's Alt A securities mature in early 2011 (see Exhibit 8). Typically, refinance proceeds generate most of the funds to pay off maturing securities while excess spread and principal payments from subordinate tranches furnish any additional funds needed (see Exhibits 6 and 14).

As described in Wescorp's Securities and Underlying Collateral section, many of the loans underlying its sub-prime and Alt A securities are stated income, higher LTV loans. Most of these borrowers cannot refinance since they are unable to document their income and they do not have the equity or value needed for a new loan as a result of plunging home prices (see Exhibit 9)—additionally, most sub-prime borrowers still require a sub-prime loan, which lenders are not making today.

Exacerbating this problem is the delinquency Wescorp reported in its September 2008 Update for the loans underlying its sub-prime and Alt A securities (see Delinquencies section). Delinquency is increasing for both sub-prime loan and Alt A loans (which means less proceeds from principal payments, excess spread, and refinances).

If Wescorp's securities are not paid off when they mature, Wescorp will have to:

- *record* mark to market losses for matured securities through its Income Statement—which could cause its net worth to fall below regulatory requirements (the NCUA would have to determine what to do if such losses reduce Wescorp's net worth below regulatory requirements, see Contingency Planning section)
- determine if the securities not maturing are *still* temporarily impaired (see Exhibit 3) and if they will be paid when they mature (i.e., they may need to be marked to market).

Delinquencies

Delinquency and Maturing Securities
Securities typically rely on three sources of funds for Investor payments and payoff of maturing securities: principal payments from underlying loans, excess spread, and refinance proceeds. Delinquency jeopardizes these sources as it reduces both the amount of principal and interest payments received and the number of borrowers who can refinance (see Exhibit 14).

Sub-prime Delinquency

Wescorp reported that the delinquency rate for loans underlying its sub-prime securities was 24.3% at September 2008, up from 20.8% at June 2008 (see Exhibit 4). Comparatively, the Mortgage Bankers Association (MBA) reported that its sub-prime delinquency rate rose to 20.0% at September 2008, up from 18.7% at June 2008 (the MBA's September rate was a record high and ninth consecutive quarterly increase, see Exhibit 5).

While Wescorp said that it stopped buying sub-prime securities in early 2006 (see June 2008 Update) and that its "direct exposure to the 2006 and 2007 vintage sub-prime mortgages (i.e., sub-prime loans with the highest delinquency and default rates or sub-prime's worst performing loans)…is very modest" concerns about its exposure to sub-prime loans remain since:

- Wescorp's sub-prime delinquency rate (***which does not include*** sub-prime's worst performing loans) is higher than the MBA's sub-prime delinquency rate (***which includes*** sub-prime's worst performing loans).
- Wescorp's delinquency rate continues to increase faster than the MBA's delinquency rate.
- Based on the June 2008 Update, most of Wescorp's sub-prime securities were purchased in 2005 or before; borrowers in the underlying loans had an opportunity to refinance before the sub-prime market collapsed. Those who could refinance probably did; those who did not refinance are now making higher monthly payments or are delinquent. Additionally, most borrowers who did not refinance probably cannot refinance today since they:
  - do not have the value needed for a new loan
  - have credit problems and need a sub-prime loan but lenders are not making these loans
  - cannot document income and need a stated income loan but lenders are not making these loans.
- Low Libor rates in 2007 and 2008 produced only small monthly payment changes for most resetting sub-prime loans; however, based on Wescorp's rising delinquency rate even these modest changes have been too much for some borrowers.

If the loans underlying Wescorp's sub-prime securities continue to perform poorly, the proceeds needed to pay off Wescorp's maturing sub-prime securities may not materialize (see Exhibit 14). If this occurs, Wescorp will have to *record* mark to market losses for the securities through its Income Statement—which could result in its net worth falling below regulatory requirements (the NCUA would have to determine what to do if such losses reduce Wescorp's net worth below regulatory requirements, see Contingency Planning section).

Alt A Delinquency

Wescorp started buying Alt A securities in early 2006 (replacing its sub-prime security purchases with these securities).

Wescorp reported the loans underlying its Alt A securities had a 22.6% delinquency rate at September 2008 (see Exhibit 4). While the MBA does not report Alt A loan delinquencies separately, the Rating Agencies report delinquencies for Alt A loans in securitizations they rated (i.e., S & P and Moody's rated almost all Alt A securitizations from 2003 – 2007). At September 2008, the Rating Agencies reported that the delinquency rate for the Alt A loans they rated was 20.4%.

S&P said that "(Alt A loans) issued in 2006 continue to perform more poorly than prior vintages…(and Alt A loans issued) in 2007 have the highest amount of cumulative losses…compared with other vintages...the poor delinquency performance observed in the 2006 and 2007 vintages will likely get worse, considering…the majority of loans…have yet to…reset.” Moody’s added that 2006 and 2007 “Alt A (loans) have… higher levels of delinquencies and losses…relative to prior years.”

Factors driving Alt A loan delinquency (including Wescorp’s delinquency):

- borrowers cannot make the monthly payments required when their loans reset or recast—payments increase by 25% or more for I/O loans and 100% or more for Pay Options loans (see Exhibit 10)
- borrowers cannot obtain stated income loans, making it impossible for most Alt A borrowers to refinance (i.e., since they cannot document income needed for a new loan)
- falling home prices strip the equity borrowers need for a new loan.

S& P said that Alt A borrowers “will not be able to refinance…out of ballooning (i.e., resetting or recasting) mortgage payments. Lenders have…tightened underwriting guidelines and declining real estate values have eroded home equity…only a fraction of…Alt A borrowers qualify for (a new loan)...”

Alt A delinquency is expected to continue rising as Alt A loans reset or recast and borrowers find they cannot make their loan’s higher monthly payments; additionally, most Alt A borrowers will not be able to refinance since lenders are not making stated income loans or Pay Option loans and falling home values prevent many from refinancing. For Wescorp this means that the funds needed to pay off their maturing Alt A securities may not materialize (see Exhibit 14). If Wescorp’s Alt A securities are not paid off by the time they mature, Wescorp will have to *record* mark to market losses (assuming a decline in value) for the securities through its Income Statement—which could result in its net worth falling below regulatory requirements (the NCUA would have to determine what to do if such losses reduce Wescorp’s net worth below regulatory requirements, see Contingency Planning section).

Credit Support

Credit Support allows proceeds from the underlying loans of lower tranches in a security to be used to support Investor payments in the higher tranches of a security and to pay off maturing tranches of a security. Investors in higher tranches receive lower yields for this benefit while Investors in lower tranches obtain higher yields for providing this benefit. Wescorp only purchased the higher tranches of a security.

<u>Sub-Prime</u>

Wescorp said in its recent Portfolio Updates and web casts that Credit Support for its sub-prime securities will prevent any losses even in a catastrophic environment. An analysis prepared for this review suggests Wescorp’s conclusion may be valid but would be challenged if home prices continue falling, delinquency continues increasing and Libor rates rise.

Wescorp did not say that its Credit Support will ensure the timely pay off of its sub-rime securities when they mature (the analysis prepared for this report shows that Wescorp’s Credit Support will no be enough to pay off maturing securities). If Wescorp’s sub-prime securities mature and are not paid off, Wescorp will have to hold these securities until paid. If this occurs, Wescorp will have to *record* mark to market losses (assuming a decline in value) for the securities through its Income Statement, which could reduce its net worth below regulatory requirements (the NCUA would have to determine what to do if such losses reduce Wescorp’s net worth below regulatory requirements, see Contingency Planning section).

<u>Alt A</u>

Wescorp said in its Portfolio Updates and web casts that Credit Support for its Alt A securities is adequate in any circumstance. An analysis prepared for this report suggests that if home prices fall, peak to trough, over 40% (which they have already done in some areas, see Exhibit 9) and Alt A delinquencies (now at

23%) rise to 30% or more (which may happen when I/O loans reset and Pay Option loans recast) Wescorp's loss severity could reach 40% or more, exceeding the help its 19% Credit Support provides.

Assuming home prices and Wescorp's Alt A delinquency rate stabilize before reaching the levels used in the analysis, Wescorp's Credit Support may provide sufficient proceeds to eventually payoff its Alt A securities. However, such Credit Support does not ensure that sufficient proceeds will be available when the securities mature. If this occurs (i.e., securities are not paid off at maturity), Wescorp will have to *record* mark to market losses (assuming a decline in value) for maturing securities through its Income Statement, which could reduce its net worth below regulatory requirements (the NCUA would have to determine what to do if such losses reduce Wescorp's net worth below regulatory requirements, see Contingency Planning section).

Risk Models

Investment Banks, Rating Agencies, and Investors (e.g., Wescorp) use Risk Models to analyze and evaluate securities they issue, rate, and buy (respectively). The Risk Models used for mortgage securities are constructed using various economic conditions (e.g., inflation, unemployment, home price appreciation, etc.), a variety of foreclosure rates, loan default frequencies, loan delinquencies, prepayment speeds, credit scores, loan to value ratios, and other information that may be provided by Lenders.

Once considered the most efficient and reliable way to evaluate securities, the sub-prime and Alt A debacle has prompted a re-evaluation about the adequacy of Risk Models. While Risk Models incorporate numerous variables, historical performance, and various economic scenarios, they are only as good as their assumptions. If events such as rapidly falling home prices, overstated incomes, inability to refinance (whether from falling home values, lack of documentation, or elimination of loan programs), borrowers walking away from their mortgages, poor underwriting, weak appraisals, inadequate regulation, or the collapse of the Secondary Market are not included, Risk Models cannot anticipate or consider the effect they may have on securities reviewed (i.e., Wescorp and other Risk Models did not consider these events).

Wescorp said that a third party vendor has evaluated and confirmed its risk model results. However, Wescorp did not disclose if the assumptions the Vendor used differed from its own or if it (Wescorp) provided the assumptions used; given that Wescorp's results were confirmed, it is doubtful if any of the events listed above were used.

Risk Models will improve; however, it will take time (see S&P and Risk Models: Missed Opportunity, Exhibit 13). Until this happens (i.e., Risk Models can better assess risk and warn of impending problems), Investment Banks and Rating Agencies are adding or returning to independent third party loan file reviews and "hands-on" analysis to provide an early warning that something may be amiss (e.g., little or no regulatory supervision, accelerated home price changes, more exceptions to guidelines, use of compensating factors in place of actual requirements, etc.) and to ensure that Lenders are following prudent underwriting, documentation, and appraisal requirements.

<u>*Lenders Responsible for Quality Control—**the fox guarding the hen house***</u>

When Risk Models were introduced in the late 1990s, loan file quality (i.e., validating underwriting, documentation, and appraisals) was the responsibility of third party quality control firms who worked for Investment Banks (i.e., those securitizing the loans and selling the securities) or Investment Bank employees. With the introduction of Risk Models that responsibility was shifted to Lenders.

Investment Banks and Rating Agencies said that Lenders who did not meet loan "quality" responsibilities would be subject to buy back demands and other contractual remedies; they said this would be more than enough to ensure that Lenders would do their job (i.e., correctly and timely).

As the sub-prime and Alt A debacle has shown, many Lenders ignored their loan "quality" responsibilities as they pursued volume and profits—most of these lenders are now out of business, drowned by their own buy back demands (i.e., lack of quality control). Notably, when this transfer of responsibilities occurred few objected or raised any concerns.

Ratings and Rating Agencies

As defined by Standard & Poor, Moody's and Fitch (i.e., Rating Agencies), credit ratings are:

- an assessment and evaluation of a security (e.g., a mortgage backed security which consists of 1,000 - 25,000 mortgage loans) to meet its financial commitment (i.e., timely payments and pay offs)
- an informed opinion of how a security will perform
- an indication of credit risk, not a predictor of loss.

Credit ratings range from "AAA" to "D" with "AAA" to "BBB-" ratings being investment grade and indicating low to moderate credit risk while ratings below "BBB-" are non-investment grade and indicate high credit risk. The Rating Agencies assign credit ratings to each tranche in a security (see Exhibit 6) based on "stress" scenarios, seniority of the tranche, priority of cash flows, and other structural mechanisms.

The Rating Agencies performed their assessment and evaluation of sub-prime and Alt A securities based on data supplied by the Lenders and Investment Banks responsible for the securitization. The data helped determine enhancement levels and the amount of "AAA" and other rated bonds issued for a security. The information provided included expected default probabilities for each loan and the loss that would occur in the event of a default. The Rating Agencies did not validate the data they received; they relied on representations and warranties from the Lenders and Investment Banks who supplied it (accordingly, did the Lenders and Investment Banks involved have any reason to be economical with the truth).

<u>Rating Agencies Reduce Standards</u>

Based on statements from Rating Agency staffers involved in rating sub-prime and Alt A securities, the Rating Agencies repeatedly reduced credit rating standards to gain business (or market share) in 2004, 2005, and 2006. As a former S&P Managing Director said, it was "market-share war…criteria (used) was relaxed." Another S&P employee said in a 2006 e-mail, obtained by House of Representatives Committee on Oversight and Government Reform while investigating the role of the Rating Agencies in the sub-prime and Alt debacle, "let's hope we are all wealthy and retired by the time this house of cards falters."

The role of the Rating Agencies is to act as an independent, knowledgeable authority. By relaxing standards and not informing anyone they did this, the Rating Agencies:

- breached their fiduciary responsibility
- betrayed the trust Investors had in them
- put Investors (e.g., Wescorp) at substantial risk.

The Rating Agency's did this for their own financial gain.

As sub-prime and Alt A production reached record levels, S& P and Moody's produced more "AAA" ratings than any other type of rating. The Securities and Exchange Commission said that S&P and Moody's did this by violating internal procedures and improperly managing conflicts of interest when providing ratings to the Issuers that paid them—they allowed profits to replace integrity (see Investor responsibility below).

Rating Agencies Change

Despite damaging disclosures about their internal wrong doings, censure from Congress, and the dismal performance of “AAA” and “AA” rated sub-prime and Alt A securities, the Rating Agencies remain slow to adjust their ratings. Most of their adjustments have been to lower rated tranches (i.e., “A”, “BBB” etc.). They continue to promise more adjustments will be forthcoming.

The Rating Agencies recently announced (as a result of Congressional pressure) that they will change the sub-prime and Alt A securities rating process. Assuming these markets re-emerge, the new process will include an examination of lenders, a review of selected loan files *(something the Rating Agencies repeatedly said was unnecessary)*, and periodic discussions with Lender employees to determine if guidelines are being followed. These moves will help future Investors but they are far too late for Investors who have lost billions of dollars from badly rated sub-prime and Alt A securities.

(Shirking) Investor Responsibility

While much blame for the huge losses Investors have suffered can (and should) be placed at the doorstep of the Rating Agencies, Investors (e.g., Wescorp) also share some responsibility since:

- high yields and AAA ratings generally do not go together—high yields have always meant more risk
- Investors are responsible for their own security evaluations and decisions; ratings should only be used to corroborate evaluations and they should not be used as proxies for evaluations or decisions
- Investors should know at loan level what they are buying (i.e., appraisal and underwriting quality) and the quality of Lenders supplying the loans (when Investment Banks or Lenders do not allow loan level evaluation or Lender discussions, Investors should take such denials as a warning and avoid the securities—yields do supplant safety)
- credit ratings are paid for by the Issuers—that is the Investment Banks or those selling the securities, not by Investors or those buying the securities
- the Rating Agencies compete for business with just one product: credit ratings (thus, ***caveat emptor***).

Wescorp, like many other Investors:

- ignored these responsibilities, relying instead on credit ratings for due diligence
- ignored warnings in 2005 and 2006 that the Rating Agencies were producing too much “AAA” rated product (see Experience and Expertise, Alt A Missed section)
- overlooked the concerns many had about Alt A loans and securities: Alt A loans had no history for the Rating Agencies to base, compare, and/or determine future performance—this in turn meant the performance of the securities was strictly speculative since they had never been issued before
- did not review loan files or the Lenders providing the loans and did have others review loan files or the lenders supplying the loans
- disregarded the conflict of interest caused by Issuers paying the Rating Agencies for a rating.

Bond Insured Securities

Wescorp said that it purchased a nominal amount of sub-prime and Alt A securities with bond insurance as a credit enhancement. For securities it purchased with bond insurance, Wescorp said that:

- it purchased the securities following its credit enhancement protocol
- bond insurance was in addition to the credit support enhancement it required
- it did not rely on Bond insurance.

Most consider bond insurance of little or no value today; the claims already submitted from sub-prime and Alt A Investors overwhelm most Bond insurers' reserves and capital. Wescorp reports that "Bond Insurer problems should not (have) any impact on (it) given other enhancements are okay."

Ownership of Underlying Collateral
Wescorp said in its June 2008 Update that it does not own the loans underlying its sub-prime or Alt A securities, it did not select those servicing the loans, and the servicers make all loan servicing decisions without consultation with Wescorp.

As a result, Wescorp may find that the actions and decisions of servicers are at odds with its needs and requirements. Fitch, the Rating Agency, notes that more servicers are doing bulk liquidations, resulting in higher loss severities for security owners (e.g., Wescorp); such liquidations are typically done without the approval of security owners (i.e., since their permission is not required). Also, servicers typically make decisions about modifications and foreclosures based on *their* income and/or cash flow requirements not the security owners.

CDOs, CMBS and Prime Securities
<u>CDOs</u>
CDOs or Collateralized Debt Obligations are a creation of Wall Street's Investment Bankers; they are a repackaged and multi-layered version of other securities (see Exhibit 2) that are supposed to provide Investors with higher yields (*and generate fees for Investment Banks using recycled securities*).

Because the underlying collateral for a CDO is so far removed from the security, valuing CDOs is almost impossible. Most analysts currently value highly rated CDOs (e.g., the type that Wescorp owns) at 40% or less of their original value.

Wescorp reports that its CDOs are backed by sub-prime, Alt A, Prime, and other asset backed securities. Wescorp said that it owns "ten CDOs for a total of $561,700,000…(these) investments are comprised of the highest-rated tranches in each deal…(the) CDO portfolio possesses more than 30% credit enhancement (i.e., *less than its sub-prime credit enhancement*)...(our) analyses…shows that every CDO returns 100% of principal and interest."

Wescorp's assessment may be exceedingly optimistic; Wescorp could incur substantial CDO losses if these securities are not paid off at maturity:

- CDOs are the most toxic of securities—no one wants them except "vulture" Investors who only buy at rock bottom or "scavenger" prices (i.e., ten cents or less on the dollar)
- CDO values are currently 60% or more below their original value or purchase price (for Wescorp, this means a loss of over $330 million

  Note: CDOs are producing huge losses for those who own them unless, like Wescorp, the CDOs are put in a HTM portfolio where securities do not have to be marked to market unless they mature and are not paid.

<u>CMBS</u>
Wescorp provides little information about its Commercial Mortgage Backed Securities (CMBS); these securities make up almost 21% of its Investment Portfolio, which is more than its sub-prime portfolio. Because so little information has been provided, the following are concerns being raised about Wescorp's Commercial Mortgage Backed Securities:

- will the delinquency rate of the underlying loans in these securities continue climbing (i.e., what impact is the faltering economy having on borrowers and tenants in the properties)
- with no institutional requirements for underwriting commercial loans:
  - what types of property collateralize the loans that underlie Wescorp's CMBS (i.e., office buildings, warehouses, hotels, strip centers, etc.)
  - are the underlying loans of similar quality or are there significant differences in the quality of the loans (see Experience and Expertise section)
  - with no standard tenant rating process for commercial mortgage loans, what is the tenant quality supporting the loans underlying Wescorp's CMBS (see Experience and Expertise section)

Additional general concerns about Commercial Mortgage Backed Securities include:

- were underwriting standards relaxed as Lenders and Issuers ramped up CMBS production in 2006 and 2007 (i.e., similar to what Lenders and Issuers did with sub-prime and Alt A loans and securities)
- are the credit ratings issued reliable or are they like the credit ratings issued for sub-prime and Alt A securities (i.e., Issuer paid and market share driven).

<u>Prime</u>

Wescorp purchased most of its Prime securities in 2006 and 2007. Wescorp said in its June and September 2008 Portfolio Updates that these securities "continue to show excellent performance." However, delinquencies for the (jumbo) loans underlying Wescorp's Prime securities jumped to 7.7% at September 2008 from 5.5% at June 2008 and 2.8% at December 2007. S & P and Moody's are warning that delinquencies for 2006 and 2007 Prime securities will be the worst on record for Prime loans.

Wescorp's increasing delinquency rate is a concern since:

- over 50% of its Prime loans are stated income and Interest Only (see Sub-prime and Alt A loans section and Alt A Delinquency section)
- these loans have an average LTV of 75%—property values have fallen over 20% in most of the areas where Prime loans were offered/used

If Wescorp's Prime delinquency continues rising (as most expect):

- is Wescorp's "Unrealized Loss" adequate or will it need to be increased
- will Wescorp be paid off at the maturity of its Prime securities
  - with over half of the borrowers in the underlying loans having stated income loans, will there be sufficient proceeds from refinances if lenders are not making stated income loans
  - can borrowers refinance if property values have fallen by 20% or more—this means that the average LTV for these loans is 95% or more (i.e., significantly higher than the maximum LTV allowed for a Prime or jumbo loan refinance).

Wescorp's Credit Support for these securities is 11.55%. Wescorp considers this more than adequate in the event of any problems (including rising delinquency and falling home values).

<u>Experience and Expertise</u>

Wescorp said that the "expertise of our portfolio managers and investment professionals (staff)…bring added value…They foresaw the turbulent waters in advance, altered the portfolio strategy and curtailed activity in the sub-prime mortgage sector at the end of 2005…shifting purchases to only AAA-rated investments and focusing on higher-quality Prime, Alt-A and CMBS investment sectors."

Sub-Prime Missed

While Wescorp's staff recognized problems in the sub-prime market near the end of 2005, it appears there recognition was limited to only prospective purchases; the sub-prime securities they owned they kept instead of selling.

Wescorp's staff "foresaw" that sub-prime securities were taking on more risk, however, the staff did not recognize that the sub-prime securities they owned had the same "real" risk as the securities they did not want to buy (or, perhaps, they kept their sub-prime securities for their yield assuming any losses would be within an acceptable ban).

Alt A Missed

While Wescorp's staff recognized problems with sub-prime loans and securities near the end of 2005, they missed the same type or similar problems in the Alt A market (and, remarkably, with the CDO portfolio which contained sub-prime securities).

Unless Wescorp's staff was directed to buy Alt A securities because "not much Prime (was) available…(and Alt A) was the only game in town" (Wescorp's August 2008 web cast), it is difficult to understand how Wescorp's staff missed the many problems (which were well known) with Alt A loans and securities:

- most Alt A securities were rated "AAA" despite having no historical information to gauge how the underlying loans would perform—prior to 2003, Alt A loans were principally a financial institution portfolio product (i.e., the few Alt A loans securitized were included in sub-prime securitizations)
- most Alt A loans were stated income loans (see Exhibit 8)—there were constant warnings about borrowers (with the help of mortgage brokers) exaggerating incomes to get the loan they wanted
- payments for I/O and Pay Option loans could go up 25% to 200% when the loans reset or recast (see Exhibit 10)—while everyone knew about this problem, nothing was done until Regulatory Guidance was issued in late 2006 (just before the Alt A market collapsed)
- Pay Option borrowers made very low payments for very large loan amounts—however, most Pay Option borrowers (i.e., 80%) required a stated income loan since they could not or would not document their income (see Exhibits 8 and 10 and Markets and Loans section)
- most Pay Option loans were originated at 80% of their property value (see Exhibit 8)—neg am caps allowed most of these loans to grow to 125% of the loan's original amount (i.e., to grow to more than their property's original value)
- Pay Option Lenders reported in 2005 *and again in* 2006 that over 75% of Pay Option borrowers were only making minimum monthly loan payments—adding unpaid interest to their loan balance (i.e., just as home prices and values were beginning to fall).

Accounting Changes to Bolster Balance Sheet

Wescorp said in its September 2008 Financial Statement Summary that "...our rigorous investment process has helped us avoid many of the issues that have plagued other portfolios by focusing on high-quality securities…(and) we...continue to draw on our extensive (portfolio managers and investment professionals) experience and expertise…"

This assessment completely disregards or simply overlooks the changes Wescorp made in order to hold and account for its securities with no losses reported through the Income Statement:

- Wescorp moved its Alt A and most of its CDO securities into in its HTM portfolio, eliminating the need to mark to market these securities—in fact, based on GAAP, Wescorp is now reversing the "Unrealized Loss" they have recorded (the securities will be marked to market if they are not paid off at maturity—see Delinquencies and Maturity Date sections)
- adoption of FAS 115 which allows mark to market losses to be *reported* directly on the Balance Sheet—avoiding the need to *record* such losses through the Income Statement (which could result in Wescorp's net worth falling below regulatory requirements)
- use of Level 3 pricing (i.e., Wescorp's own assumptions) to price securities in its AFS portfolio.

Thus, accounting maneuvers, not a "rigorous investment process or extensive (portfolio managers and investment professionals) experience and expertise," has helped Wescorp temporarily "avoid many of the issues (*or losses*) that have plagued other portfolios…"

Expand the Staff and Broaden the Experience
Wescorp's portfolio managers and investment professionals are securities specialists; they do not have the same expertise in evaluating loans, including making a determination if stated income borrowers can or will pay their mortgages, assessing underwriting (along with the risk that loan exceptions present to the repayment of a loan), reviewing appraisals, or validating loan data—information Lenders use to make informed decisions and determine loan performance.

Given that a significant portion of its securities are mortgage related, it is recommended that Wescorp add one or more lending experts to its staff (i.e., Credit Officers familiar with mortgage loans, commercial loans, student loans, auto loans, and credit cards along with the risks each has). This would broaden Wescorp's knowledge and understanding of how borrowers behave in sub-prime, Alt A, Agency, Prime, commercial and other loans and how character, collateral, and credit affect loan performance (and, ultimately the performance of the securities they purchase).

These new staff members should be part of the "team" that evaluates and decides if a security should be purchased. These new staff members should have the same standing as Wescorp's portfolio managers and investment professionals; they should be able to reject any security deemed too risky (as a result of the underlying collateral) without having their decision overridden by a Wescorp portfolio manager and investment professional (including senior Wescorp management).

Contingency Planning
Wescorp's operational and accounting changes (i.e., the adoption of FAS 115, Level 3 pricing, and moving securities to the HTM portfolio) allow its sub-prime and Alt A securities time to collect the proceeds needed to payoff the securities when they mature. However, for this is to happen timely, more borrowers in the underlying loans will need to start making their monthly payments (i.e., delinquency deprives the securities of principal payments, excess spread, and refinance proceeds) and more borrowers will need to (be able to) refinance (see Exhibit 14).

Unfortunately, with the economy in recession, delinquencies are expected to continue rising as loans reset or recast, stated income or sub-prime loans are not expected to be available at any time in the next few years, and home values are expected to continue falling for at least another year. Thus, there almost certainly will not be sufficient proceeds available when Wescorp's sub-prime and Alt A securities mature.

If Wescorp's sub-prime and Alt A securities are not paid off at maturity, Wescorp will have to *record* mark to market losses for these securities through its Income Statement. If the losses result in Wescorp's net worth falling below regulatory requirements (see Exhibit 15), the NCUA will have to determine:

- how Wescorp will operate, including providing vital services to member credit unions,
- who will manage Wescorp (i.e., current management, new management, the NCUA, or someone or some other organization) if its net worth falls below regulatory requirements
- how to restore Wescorp's net worth and ability to operate without significant operational changes
- how withdrawals will be handled (i.e., preventing a "run") if member Credit Unions begin withdrawing shares from Wescorp (i.e., seeking safer venues)
- how to maintain confidence of credit union members if attention is focused on Wescorp's problems.

Investment Policy

Securities Selection Process

Wescorp said that it "has always been diligent in managing the credit quality of the portfolio and its exposure to risk…(t)he selection of individual securities for purchase adheres to stringent criteria with respect to the characteristics of the bond, the underlying collateral pool, and the integrity of the bond's structure…Wescorp's portfolio managers subject all securities to an in-depth analysis…focused on credit quality, collateral characteristics, cash flow, and the integrity of the bond's credit support and structure… the potential investment is then reviewed and analyzed by Wescorp's Investment Credit Services (ICS) department for underlying credit quality…ICS will either approve or reject the bond for purchase..."

Wescorp's securities selection process is similar to the process typically used other Investors:

- review the security's credit quality or credit rating (see Rating Agencies section)
- review the security's attributes (e.g., tranche support, excess spread, over-collateralization, etc.)
- review underlying loan attributes (e.g., LTV / CLTV, credit score, loan type, documentation—i.e., full or stated, and more) provided by the security's Issuer or Lenders
- review how the security pays (who is paid first and when payments are made) and how cash flows are directed to support customary Investor payments and maturing securities
- review loans and security performance based on various assumptions (see Risk Model section).

This process focuses on the *security*, not on the underlying loans that actually determine the performance of the security. Wescorp did not look at the loans underlying the securities it purchased; had Wescorp incorporated a loan file review requirement in the selection process, it may have reached a different decision regarding the sub-prime and Alt A securities it did purchase (see Policy Change section below).

Notably, loan file reviews of current delinquent and defaulting sub-prime and Alt A loans reveal a persistent pattern of exaggerated and/or misstated incomes, inflated appraisals, no employment verification, and sloppy underwriting—things that would been discovered if loan files had been reviewed during the security's selection process

Yield Drives Process

Wescorp said that the yields its "AAA" rated sub-prime and Alt A securities produce are the reason it can provide member credit unions with very competitive interest rates (i.e., "value-added investment products"). However, as Wescorp obtained "AAA" rated higher yields, it seems to have disregarded:

- the risk that sub-prime and Alt A loans have
  - sub-prime loans have always had high delinquency rates (i.e., annually 11% or more from 1992 and thereafter)—that is why they have higher yields
  - many of the loans did not require income documentation—that is why they have higher yields

- monthly payments for I/O and Pay Option loans can jump 25% to 200% when they reset or recast—most borrowers cannot afford resetting or recasting payments but this was not a consideration when the loans were underwritten or the securities purchased
- Pay Option loans let loan balances grow while borrowers make very low monthly payments—negative amortization means that loan balances can exceed property values even when home values are rising (falling home values exacerbate the problem of rising loan balances).

- the rule making discussion, problems, and risks the Regulatory Agencies, including the NCUA, were having throughout 2006 regarding stated income, I/O, and Pay Option loans
- most credit unions did not make sub-prime or Alt A loans—***they avoided these loans because of their risk and the harm they presented to members and the credit union*** (i.e., natural person credit unions did not make sub-prime or Alt A because they lacked "experience and expertise").

Wescorp's drive for higher yields (i.e., "provide member credit unions with very competitive interest rates") has resulted in it having to protect its Balance Sheet through accounting maneuvers and operational changes, and, to depend on the NCUA to provide ready access to liquidity if needed (see Liquidity Risk section—Liquidity, Collateral, and FAS 115).

<u>Policy Change</u>
Wescorp's Board of Directors, Supervisory Committee, senior management and member credit unions should restructure Wescorp's Investment Policy so that it allows Wescorp to serve its member credit unions without unwarranted risk. Safety, security, stability, and protection of member credit unions (and, ultimately, members of member credit unions) should be the core values of a revised Wescorp Investment Policy (and the principal focus of those involved in reforming it).

To prevent the problems Wescorp currently has and to return Wescorp to a safe and sound Corporate Credit Union, Wescorp's Investment Policy should include the following:

- define clearly what constitutes low investment risk, medium investment risk, and high investment risk; credit ratings can be incorporated but only if they are a "part" of comprehensive definition, not the sole determinant of the definition
- place investment concentration limits on the types of securities (and amount of risk) that Wescorp can purchase—higher concentration limits should favor low risk (or safe) investments (e.g., Treasuries and Agencies) while high risk investments should not be allowed at all (regardless of Wescorp's "experience and expertise" and desire or need for yield)
- focus Wescorp's security purchases on low risk investments (e.g., Treasuries and Agencies)
  - any securities deemed to have other than a low risk (as defined by the new Investment policy) should require a vote by the Board of Directors prior to their purchase
  - required a clear explanation of why any securities other than low risk investment securities are being purchased and how Wescorp will be protected in the event the securities do not perform as expected (unforeseen risks are not acceptable)
- require a "hands on" analysis and evaluation of the underlying collateral for any security purchased (i.e., this can be done through independent third parties and loan file random sampling, if necessary)
- ensure that safety and soundness is foremost to the Investment operation—there should never be an emphasis placed on or need to "provide member credit unions with very competitive interest rates."

As the NCUA said in a letter dated January 16, 2003 (i.e., before Wescorp purchased its sub-prime, Alt A, CDO, Prime and Commercial Mortgage Backed securities:

“Corporate credit union boards and management should be clearly aware of…serious risks presented by credit quality…Investments involve increasingly sophisticated structures…it is imperative that boards of corporate credit unions…examine their credit risk management policies…(and) corporate management …review their credit risk practices…to ensure the continued safety and soundness of their institutions.”

Apparently, Wescorp missed the letter!

Board Composition

Wescorp’s Board of Directors is composed of eleven professional Credit Union managers. These Directors come from Credit Unions as small as $30 million to Credit Unions over several billion dollars in size. However, these Directors are Credit Union professionals who have devoted their lives to serving members and helping their Credit Unions grow and prosper; most are not experts in investment instruments, investment analysis, or investment management.

Given the complexity of Wescorp’s balance sheet and its operations (i.e., a substantial amount of its assets will always be investments) and the lack of investment expertise most Credit Union professionals have, it is recommended that Wescorp’s Board have at least two “at large” Board members with expertise and experience in investment and risk analysis and managing a large portfolio of collateralized investments.

These new members, including their companies, should not be allowed to perform any services for Wescorp or any other Corporate Credit Union (or have any affiliation with any Investment service providers to Wescorp). Additionally, if these “at large” Board members are from an Investment Bank, the Bank should be prohibited from selling any Investments to any Credit Union (this avoids any conflict of interest which may be real or perceived).

Finally, Credit Union Board members should be required to have a minimum number of formal training hours in Investment securities management and loan underwriting. Such training should include complex securities analysis, security trading operations, risk assessment, and residential, commercial, auto, student and credit card lending. This training should be an on-going and annual requirement.

Conclusion

By number of member credit unions it serves, Wescorp is biggest Corporate Credit Union in the country (US Central is the largest Corporate Credit Union by asset size). Wescorp is a cooperative that provides its member credit unions with financial and investment services. Wescorp’s “principal activity is to serve its member credit unions by providing investment, credit settlement, and funds-transfer services” (Wescorp’s 2007 Audited Financial Statement, Note 1).

Wescorp’s role as an institutional service provider places it in a very special position with its member credit unions. If Wescorp is unable to supply vital liquidity and financial settlement services (e.g.., check clearing, ACH, funds transfer, ATM services, etc), or if it encounters difficulty or distress from its operating activities (i.e., its Investment Portfolio), the consequences could be damaging to and demanding on it’s member credit unions, other corporate credit unions, and the NCUA.

Wescorp’s member credit unions should not have to worry about delinquencies, fair value, or unrealized losses; they should be able to trust in Wescorp’s safety and soundness. Wescorp’s operations and Investment activity should be unexciting and risk adverse. Wescorp should provide member credit unions quality financial services, minimal risk, and the highest level safety and soundness—core elements of all credit unions.

Exhibit 1

Wescorp Balance Sheet
September 2008
($000)

Assets:	
Cash and Due From Banks	$ 344,727
Investments	
Trading Securities	$ 4,886
Securities Available for Sale	$12,228,358
Securities Held to Maturity	$ 9,356,346
US Central	$ 336,348
Other Investments	$ 775,664
Total Investments	$22,701,602
Loans	$ 2,061,511
Other Assets	$ 128,539
Total Assets	$25,236,379
Liabilities:	
Borrowed Funds	
FHLB Borrowing	$ 5,000,000
Medium – Term Notes	$ 249,843
Other Borrower Funds	$ 2.740,703
Total Borrowed Funds	8,490,546
Other Liabilities	$ 388,109
Total Liabilities	$ 8,878,655
Shares	
Market Shares	$ 4,241,451
Daily Shares	$ 273,873
Share Certificates	$11,613,857
Member Capital Accounts	$ 1,006,298
Total Member Shares	$17,135,479
Public Unit Shares	$ 25,815
Total Shares	$17,161,294
Permanent Capital	
Wescorp Permanent Capital	$ 211,427
Idaho Permanent Capital	$ 1,647
Total Permanent Capital	$ 213,074
Retained Earnings	
Corporate Reserve	$ 98,390
Market Flux Contingency & Undivided Earnings	$ 689,017
Total Retained Earnings	$ 787,407
Unrealized Gain / (Loss)	
Unrealized Gain (Loss) on Securities	($ 1,539,048)
Unrealized Gain (Loss) FAS 133	($ 252,997)
Unrealized Gain (Loss) Defined Benefit	($ 12,006)
Total Unrealized Gain (Loss)	($ 1,804,051)
Total Liabilities and Equity	$2,5,236,379

Wescorp Equity

Wescorp's September 2008 Financial Statement shows the following Equity position (i.e., without the Unrealized Loss):

Retained Earnings	$ 787,407,000
Paid-In Capital	213,074,000
Member Capital Account	1,006,298,000
Total Capital	$ 2,017,448,000

Pursuant to Part 704 of NCUA Rules and Regulations, Wescorp can count Member Capital Accounts (MCAs) as part of its Equity. Wescorp member credit unions are required to maintain a certain amount of funds in MCAs; these are three-year notice accounts based on the member credit unions assets and deposits held at Wescorp. These accounts are not subject to share insurance and are subordinate to all liabilities, member shares, and uninsured shareholders.

Exhibit 2: Definitions

- Alt A securities
  Security backed by loans where the borrowers typically have credit scores near Prime borrowers (i.e., the borrowers do not have late payments, collections, or other derogatory type of credit); most borrowers do not provide income documentation (i.e., these are mostly stated income loans). Borrowers may be self-employed or W-2 wage earners. Many borrowers have some reserves (some lenders verify the reserves and provide the borrower with a slightly better interest rate). Interest rates for the loans are higher Prime rates but below sub-prime rates (allowing the securities to pay a higher rate to Investors than Agencies or Treasuries).

  Alt A Loans are for borrowers with good to excellent credit, good to excellent credit scores, verifiable employment, and (for some) verifiable assets or reserves. Most borrowers (because they have difficulty documenting income or they are unwilling to disclose their income) do not document income; income is either stated on the application or not shown at all. Many Alt A borrowers live in high priced housing states (see Exhibit 10), are first time or move- up buyers who lack the down payment and/or income needed for a fully documented prime loan or are borrowers who want to refinance but cannot meet the requirement of a fully documented prime loan. Alt A lenders provided financing to 100% for many borrowers (even those with credit scores down to 580). Alt A loans include Interest Only and Pay Option loans (both can be stated income).

- Sub-prime securities
  Security backed by loans where the borrowers typically have credit, income, and/or property issues. Sub-prime borrowers usually have late payments (i.e., 30, 60, 90 or more days) on their mortgage, installment loans, or credit cards in the past 12 months. They may have (recent) collections, judgments, charge-offs, a bankruptcy and / or a foreclosure. Credit Scores range from 500 to 640. Some borrowers can document income but stated income loans are common. Reserves are not required. Interest rates for these loans are higher than Alt A and Prime rates (allowing the securities to pay a higher rate to Investors than Alt A securities, Agencies or Treasuries).

  Sub-prime loans are often considered a “band aid” loan (i.e., if payments are made timely, a borrower may be able to obtain a prime loan at a later date).

- Collateral Debt Obligations (CDOs)
  A sophisticated financial instrument that packages various types of securities backed by sub-prime loans, Alt A loans, credit cards, auto loans, and /or student loans. Owners of a CDO own a right to cash flow; they do not own the underlying collateral. CDOs are considered highly complex instruments and very difficult to value (even when there was a market for them). CDOs interest rates are typically higher than sub-prime rates.

- CMBS securities
  Security backed by commercial properties. Commercial property includes multi-family or apartments, retail buildings, office buildings, warehouses, light industrial building, etc. A common issue with these securities is the difficulty in assessing comparative risk since there are no standardized requirements for commercial loans. Additionally, while borrowers are scrutinized, the tenants occupying the buildings are often passed over with a minimal review of their lease.

- Other securities
  Includes mortgage securities where the loans in the security are guaranteed by Fannie Mae or Freddie Mac (i.e., these are often referred to as Agency securities) and mortgage backed securities collateralized by FHA and VA guaranteed loans (i.e., the securities are know as Ginnie Maes).

- Declining Market
  Generally determined from the appraisal; it is an area where home prices are declining and sales times are typically running six months or more. A key resource in determining declining markets is the OFHEO House Price Index (see Office of Federal Housing Enterprise Oversight), S&P/Case-Schiller Index, and National Association of REALTORS®.

Exhibit 3: FAS 115 and Temporary Impairment

FAS 115

Financial Accounting Standard (FAS) 115 requires investment in securities to be classified as held-to-maturity, trading, or available-for-sale. The classification is based on the intended use of the security and it dictates the accounting treatment for the security.

FAS 115 also requires that a determination be made if a security's "fair value" has declined below its "amortized cost" and for securities available-for-sale or held-to-maturity if the decline is other than temporary. If the decline is other than temporary, the security must be written down to its "fair value".

GAAP defines "fair value" as an amount determined:

- between willing buyers and willing sellers
- who have no compulsion to act
- have reasonable knowledge of the relevant facts.

SFAS (Statement of Financial Accounting Standards) 157 clarifies "fair value" as an estimate intended to communicate to investors the value of an asset at date certain, not the potential value of the asset at some future date (e.g., when the asset matures). The "fair value" estimate is determined by the price expected to be received in an orderly transaction; it is not the price that would be received at a fire sale or forced liquidation. An orderly transaction involves market participants willing to transact business and have adequate exposure to the market before the measurement date. A fire sale or forced liquidation is a transaction that involves market participants compelled (e.g., under duress) to perform.

Quoted market prices in an active market (i.e., sufficient competition between buyers and sells to prevent mistreatment) are the best evidence of fair market value and must be used when available.

FAS 115 allows a decline (i.e., loss) in value for available-for-sale securities to be *reported* as an "Unrealized Loss" directly on the Balance Sheet (i.e., not through the income statement) provided:

- the decline in value of the security is deemed temporary (see temporary impairment), and,
- the company has the ability (i.e., cash for operations) and intent to hold the security to maturity, and,
- the company expects to receive all principal and interest payments due from the security.

Accounting literature is unclear as to the specificity of when an "Investment Grade" security is impaired. There has been and continues to be much discussion as to when a loss should be or needs to be recognized through the Income Statement (versus recorded directly on the Balance Sheet because the security is temporarily impaired).

Wescorp follows current literature when it *reports* losses on securities it owns as an "Unrealized Loss" on the Balance Sheet. As Wescorp states, its sub-prime and Alt A securities are only temporarily impaired, it has the ability and intent to hold these securities to maturity, and it has received principal and interest as scheduled; therefore, it does not have to *record* any losses through its income statement.

Temporary Impairment

An "impairment" of a security occurs when the fair value of the security is less than its amortized cost basis. FAS 115 requires that if a security's impairment is judged to be other than temporary, the cost basis of the individual security must be written down to its "fair value" and the amount of the write-down *recorded* through the Income Statement (i.e., for an other-than-temporary impairment or OTTI). FAS 115 also allows losses in value for securities deemed to be only temporarily impaired to be *reported* directly on the Balance Sheet (i.e., as an "Unrealized Loss").

FAS 115 provides only one explicit example of other-than-temporary impairment. The language in FAS 115 is similar to that in FAS 114, Accounting by Creditors for Impairment of a Loan; if it is probable that the security owner "will be unable to collect all amounts due according to the contractual terms of a…security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred (and the loss *recorded* through the Income Statement)." FAS 115 also states that after a write-down through the Income Statement, "the new cost basis shall not be changed for subsequent recoveries in fair value…and the recovery in fair value should not be recognized until the security is sold."

Because accounting literature for other-than-temporary impairment is ambiguous, the Financial Accounting Standard Board's (FASB) Emerging Issues Task Force (EITF) issued The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments *(EITF 03-1)* in an attempt to mitigate this problem. It wanted certain disclosures included in the footnotes to financial statements. Adopted by the FASB Board in November 2003, the disclosures were first required in annual financial statements as of year-end 2003.

The disclosures require:

- quantitative and qualitative information about securities
- a table that shows for each category security the aggregate amount of unrealized losses on securities with impairment and the aggregate fair value of these securities
- disclosures be shown separately for securities "that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer"
- sufficient information so that "users to understand the quantitative disclosures."

Other requirements were to be installed as a result of EITF 03-1 but FASB withdrew their implementation amid mounting concerns of ambiguity and confusion.

The Securities and Exchange Commission (SEC) has also weighed in on securities impairment but it has not issued definitive rules regarding what constitutes an Other-Than-Temporary Impairment. It has said that while EITF 03-1 distinguishes between securities with unrealized losses of more than or less than one year, the one-year period does not imply or mean that unrealized losses are other-than-temporary impairments, and, depending on facts and circumstances, a decline in fair value that continues for more than one year may only be temporary.

Based on Accounting guidelines, companies and financial institutions (e.g., Wescorp) determine whether a security is other than temporarily impaired (i.e., subject to FASB and SEC rules, regulations, and guidelines). And, as noted by PricewaterhouseCoopers (in its DataLine 2008-22: Accounting Considerations Related to Other-Than-Temporary Impairment of Certain Investments in Debt and Equity Securities, Updated November 12, 2008):

- the process for determining an other-than-temporary-impairment is inherently judgmental, involving the weighing of positive and negative factors and evidence that may be objective or subjective
  - the duration and extent of a decline in fair value is a negative factor in assessing if an investment is impaired
  - it is difficult for management to assert that recognition of an Other-Than-Temporary Impairment is not required when the amount of unrealized losses is significant or the decline in value continues beyond a period that is considered reasonable
- (however) if management believes that collectibility of all amounts due in accordance with contractual terms is probable, a decline in fair value need not result in an Other-Than-Temporary Impairment charge provided management has the ability and intent to hold that security until a recovery in value occurs (or until maturity if necessary).

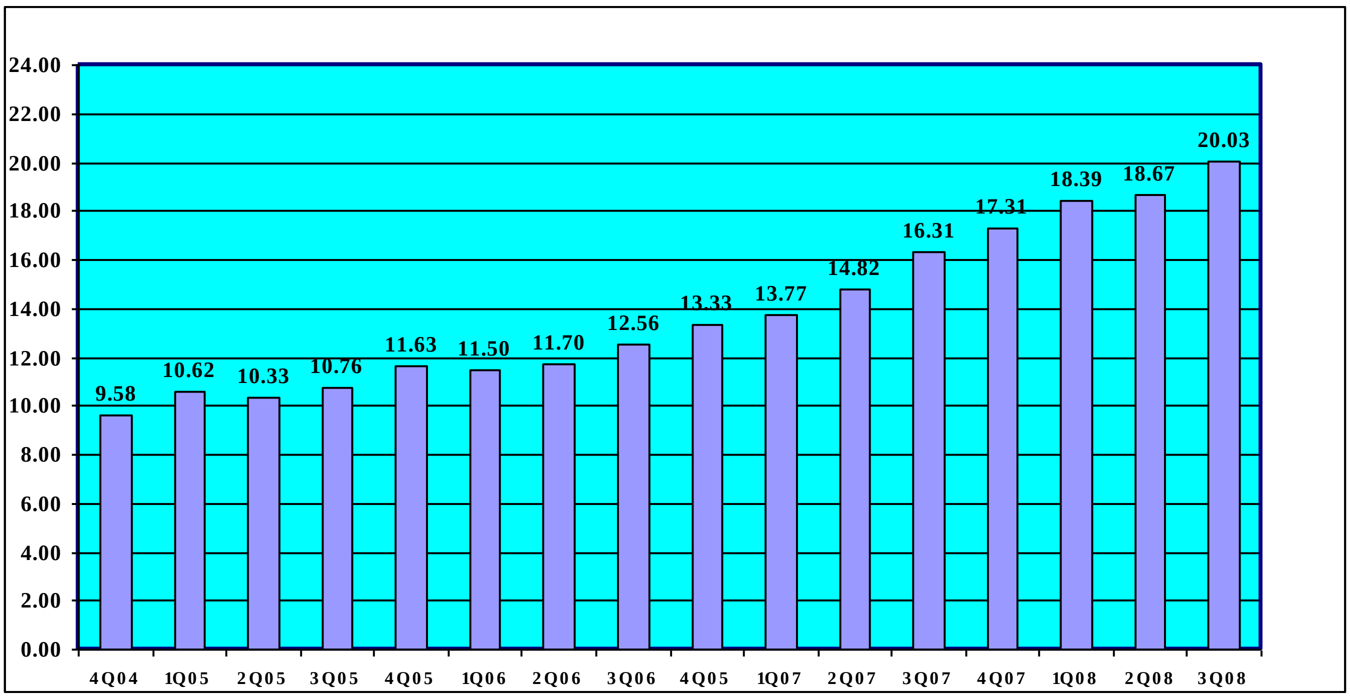
Wescorp's position continues to be that its securities are only temporarily impaired and that it will be fully paid when the securities mature.

Exhibit 4: Wescorp's Securities Delinquency Rates

Category	Date	Delinquency					MBA Delinquency
		60-89	90 +	FCL / BK	REO	Total	
Sub-Prime	12/31/07	2.43%	3.20%	7.11%	5.24%	17.98%	17.31%
	9/30/08	2.19%	3.99%	11.83%	6.31%	24.31%	20.03%
	Change	-0.24%	0.79%	4.72%	1.07%	6.33%	2.72%
Alt A	12/31/07	1.80%	1.36%	2.93%	1.08%	7.17%	
	9/30/08	3.00%	4.88%	10.53%	4.20%	22.61%	
	Difference	1.20%	3.52%	7.60%	3.12%	15.44%	
Prime	12/31/07	0.59%	0.56%	0.98%	0.46%	2.59%	
	9/30/08	1.21%	1.68%	3.48%	1.38%	7.73%	
	Difference	0.62%	1.12%	2.50%	0.92%	5.14%	

Wescorp's Investment Portfolio Update

Exhibit 5: MBA Sub-prime delinquencies



Mortgage Bankers Association

Exhibit 6: Typical Sub-prime or Alt A security

The sub-prime and Alt A securities that Wescorp owns are typically formed through an instrument known as a Real Estate Mortgage Investment Conduit or REMIC. While there are many varieties in these instruments, in its simplest form a REMIC is a multiple class (parts or tranches) mortgage cash flow security backed by a group of residential mortgage loans (i.e., collateral, which can include sub-prime and/or Alt A loans).

By directing cash flows from the underlying mortgage loans to a security's different parts or tranches, the security can establish interest rates, payment priority, and maturity dates for each part or tranche. This allows the security to meet the needs of various investors (e.g., investors who want lower risk, shorter term maturity, and priority over proceeds in exchange for a lower yield or investors who want a higher yield and are willing take on more risk, including letting cash flows go other parts or tranches of the securitization first).

REMICs are established through a Special Purpose Vehicle (SPV). SPVs are generally set up as bankruptcy remote Trusts; this is done to insulate investors from the credit risk of the originating financial institution or company (e.g., a mortgage company).

Investment Banks, Banks and mortgage companies sponsor SPVs but they do not own them; they use SPVs for loan securitizations (e.g., sub-prime or Alt A loans). The Investment Banks, Banks and mortgage companies sell loans they originate to a SPV. Investments Banks and Banks with Investment Bank operations (e.g., Bank of America or Citi Bank) underwrite the sale of the securities that the SPVs offer.

The Trusts issue interest bearing securities that obtain a credit rating. The credit rating is needed since the securitization relies on the cash flow created by the loans (which is what is rated), not the promise of the issuer.

The operations of mortgage related SPVs are generally limited to a single purpose: the acquisition and financing of specific assets (e.g. sub-prime or Alt A loans). Some Investors believe, contrary to legal and accounting restrictions, SPV sponsors will bail out them if there is the need—the Investment Banks, Banks, and mortgage companies have said SPVs they sponsor stand on their own.

Typical Sub-prime REMIC Structure

AAA **largest tranche makes up to 80% of the security** **Lowest Rate in the security**
AA **next largest tranche makes up 5% to 10% of the security** **Rate difference 50 to 100 basis points more than AAA**
A **next largest tranche makes up 2% to 5% of the security** **Rate difference 50 to 100 basis points more than AA**
BBB **next largest tranche makes up less than 5%** **Rate difference 50 to 100 basis points more than A**
BB **next largest tranche makes up less than 5%** **Rate difference 50 to 100 basis points more than BBB**
B **next largest tranche makes up less than 3%** **Rate difference 50 to 100 basis points more than BB**
Residual or Equity—smallest tranche **Usually retained by the Issuer**

These tranches generally make up a total of about 20% or the security. The number of sub-AAA tranches varies (i.e., from 3 or 4 sub-tranches to several sub-tranches) by security.

Residual or Equity tranche is created through over collateralization (i.e., from 1% to 5%)—this piece is the over collateralization (i.e., the tranches on top equal 100% of the security)

The Alt A REMIC structure is similar to the Sub-Prime REMIC structure except that the AAA tranche is usually up to 90% or more of the security while all other tranches are less than half of the percentages listed in the Sub-prime REMIC chart (it interesting and hard to understand that so many sub-prime loans or loans with credit, income and employment problems can rated AAA or that so many Stated Income mortgages with the potential of payment shock can be rated as AAA).

Exhibit 7: Unrealized Loss vs. Actual Loss

The following shows the difference between *reporting* a loss on the Balance Sheet and *recording* a loss through the Income Statement:

Recording Loss on the Balance Sheet		**Recording Loss through the Income Statement**	
Income Statement: No Affect		***Income Statement: Loss: $300,000***	
Assets		Assets	
Total Assets	$1,000,000	Total Assets	$1,000,000
Liabilities & Equity		Liabilities & Equity	
Liabilities	$1,100,000	Liabilities	$1,100,000
Net Equity:		Net Equity:	
Permanent Capital	$ 50,000	Permanent Capital	$ 50,000
Retained Earnings	$ 150,000	Retained Earnings	$ 150,000
Total Net Equity	$ 200,000	Loss: Current Period	$ 300,000
		Total Net Equity	$ 100,000
Unrealized Loss	$ 300,000		
Total Liabilities and Equity	$1,000,000	Total Liabilities and Equity	$1,000,000
This is an Operating company.		**This is an Insolvent company.**	

Recording vs. ***Reporting*** losses

American International Group (AIG) is the world's largest insurance company; it suffered a liquidity crisis after its credit ratings were downgraded below "AA" levels and had to obtain a Federal Reserve rescue package in late 2008.

Its Chief Executive Officer remarked on reporting its fourth quarter 2007 results: "AIG should have written off…$900 million…for unrealized losses versus $11.1 billion it (had to write) down to market (for a portfolio of $20.8 billion of "AAA" rated sub-prime securities). AIG, (is) in a position of financial strength (i.e., the largest insurance company in the world), (and) can hold those assets to maturity, so why (should we mark) them to market in an illiquid market?" Unlike Wescorp, AIG had to write the assets down even though the assets continue to pay.

AIG took a 56% write down in the value of its "AAA" rated sub-prime securities; Wescorp has taken a 10% write down of its "AAA" rated sub-prime securities. Questions abound about Wescorp's "Unrealized Loss":

- should the losses be *recorded* through the Income Statement
- is the loss amount *reported* adequate
- will Wescorp have to *record* losses that is has *reported* on the Balance Sheet at a later time

Wescorp's Operation

A review of Wescorp's Net Worth and Capital Adequacy shows the following when losses are *reported* on the Balance Sheet versus *recorded* through the Income Statement:

Total Member Capital Accounts, Permanent Capital & Retained Earnings without "Unrealized Loss" (see Exhibit 1)	$2,017,448,000
"Unrealized Loss" *reported* on the Balance Sheet (securities only)	$1,539,048,000
Net Equity if the "Unrealized Loss" is r*ecorded* through the Income Statement	$478,400,000
September 2008 Capital Adequacy based on September 2008 Balance Sheet (required 5/0%)	7.99%
Total Capital Ratio after "Unrealized Loss" is recorded through the Income Statement	*1.90%*

Exhibit 8: Sub-Prime and Alt A Loans

The following charts show the characteristics of sub-prime and Alt A loans and production for these loans from 2000 to 2007. The information is from Fitch (Rating Agency), Bear Stearns, Loan Performance (a risk assessment company owned), UBS (Investment Bank) and S&P (Wescorp's primary rating agency). Each firm publishes on-going reviews and reports about sub-prime and Alt A loans. It should be noted that this information was published quarterly and was available to anyone at no cost (i.e., it was available on the web sites of those listed above).

Definitions:

ARM: adjustable rate mortgage
LTV: Loan to value ratio
CLTV: combined loan to value ratio
NOO: Investor property loan (non-owner occupied
Cash-out: refinance with cash out
% Calif: % of loans located in California

Sub-Prime Loan Characteristics													
Year	Avg Loan Amt	Credit Score	LTV	CLTV	Stated Income	Pur	Cash out	NOO	% Calif	Prepay Penalty	Fixed	Hybrid ARM	Coupon at Closing
2000	103	590	77	77	20%	35%	48	4	**	**	30	70	10.3
2001	111	598	77	77	25%	30%	54	4	**	**	34	66	9.8
2002	135	612	80	81	32%	29%	57	5	31	77	27	73	8.5
2003	155	621	80	84	39%	29%	57	5	34	75	33	67	7.5
2004	174	623	80	85	49%	36%	56	5	35	73	24	76	7.2
2005	193	627	80	87	53%	41%	52	5	32	72	15	85	7.5
2006	208	624	80	88	60%	43%	52	5	29	70	17	83	8.4
Wescorp said that it did not purchase Sub-prime securities issued in 2006 or 2007.													

2007: not applicable—the sub-prime market collapsed

UBS/ Loan Performance /Fitch / Standard & Poors / Bear Stearns

Alt A Loan Characteristics													
Year	Avg Loan Amt	Credit Score	LTV	CLTV	Stated Income	Pur	Cash out	NOO	% Calif	Prepay Penalty	Fixed	Hybrid ARM	Option Arm	I/O
2000	185	696	**	**	59	68	21	16	35	21	92	7	0	1
2001	255	705	**	**	58	50	31	11	42	21	79	17	0	4
2002	244	757	**	74	56	47	30	15	42	30	73	19	0	8
2003	229	711	**	78	58	40	34	22	43	29	62	14	2	22
2004	244	710	74	83	59	54	30	20	43	35	28	14	11	47
2005	288	714	74	83	68	49	37	19	43	43	23	7	34	36
2006	312	708	79	86	80	45	38	17	43	52	16	5	38	41
2007	387	709	80	88	80	38	38	12	48	51	16	6	36	42

The LTVs and CLTVs average 72% and 74% respectively from 2002 to 2007 for Pay Option loans. The negative amortization feature of a Pay Option loan generally limits the use of second mortgage. The LTVs and CLTVs for I/O and Fixed Rate loans average 78% and 86% for 2002 to 2007. The LTVs and CLTVs shown include Pay Option loans, Interest Only loans, Hybrid Arm loans and Fixed Rate loans.

UBS/ Loan Performance /Fitch / Standard & Poors / Bear Stearns

Loan Production: 2001 - 2007								
Year	Production				As a % of Total			
	Sub-Prime	Alt A	Prime	Total	Sub-Prime	Alt A	Prime	Total
2001	173	53	1,994	2,220	8%	2%	90%	100%
2002	213	61	2,606	2,880	7%	2%	91%	100%
2003	332	80	3,538	3,950	8%	2%	90%	100%
2004	530	365	2,025	2,920	18%	13%	69%	100%
2005	665	866	1,589	3,120	21%	28%	51%	100%
2006	600	958	1,280	2,980	20%	32%	43%	100%
2007	193	732	1,505	2,430	8%	30%	62%	100%

Inside B&C Lending / MBA

Exhibit 9: Home Price Changes

As of September 30, 2008				
% Change from December 2006			% Change from December 2006	
Fresno (California)	-28%		Phoenix (Arizona)	-37%
Los Angeles (California)	-20%		Los Angeles (California)	-32%
Riverside (California)	-31%		San Diego (California)	-31%
Sacramento (California)	-28%		San Francisco (California)	-31%
San Diego (California)	-22%		Washington DC	-21%
San Francisco (California)	-7%		Miami (Florida)	-36%
Santa Ana (California)	-21%		Tampa (Florida)	-26%
Stockton (California)	-46%		Las Vegas (Nevada)	-37%
Cape Coral (Florida)	-35%		Composite-Average	-31%
Ft. Lauderdale (Florida)	-26%			
Miami (Florida)	-16%			
West Palm Beach (Florida)	-26%			
Las Vegas (Nevada)	-29%			
Reno (Nevada)	-19%			
Phoenix (Arizona)	-21%			
W/A/A (Virginia)	-13%			
B/F/G (Maryland)	-11%			
Composite- Average	-23%			
OFHEO			Case Schiller	

From Exhibit 8		Change in Value through September 2008		Adjusted LTV	Change in Value	Adjusted LTV
Year	LTV	2006 loans	2007 loans	Sept 2008	2009	2009
2006	79	-25%	●●●	> 100%	5% -10%	> 110%
2007	80	●●●	-21%	> 100%	5% -10%	≥ 110%

The LTVs shown do not factor in negative amortization percentage (i.e., from a Pay Option loan); if negative amortization were part in the calculation, the Adjusted LTVs would exceed the “neg am” caps for a Pay Option loan (i.e., the Adjusted LTV would be over 125%—which will happen to many Pay Option borrowers when their loans recast, this is a problem hiding in the wings).

Exhibit 10: Alt A Loans

Interest Only (I/O)

***Assumptions*:** Loan Type: 5/1 Interest Only Loan Amount: $350,000 Interest Rate: 5.75% Caps: 5 / 2 / 5
Index: 1 yr Libor Margin: 2.375% Rate at first adjustment: 5.125%

At the end of 5 yrs: Libor has	No Change	Is Up 1.00%	Is Up 2.00%
Index:			
1 yr Libor Rate	5.13%	6.13%	7.13%
Margin	2.38%	2.38%	2.38%
New Interest Rate	7.50%	8.50%	9.50%
New Monthly Pmt—			
Fully Amortized: 25 years	$2,587	$2,818	$3,058
Original I/O Payment:	$1,677	$1,677	$1,677
Payment Change	$910	$1,141	$1,381
Annualized % Change	11%	14%	17%
5 year Change	55%	68%	83%
New Monthly Pmt—			
I/O payment—year 6	$2,187	$2,479	$2,771
Original I/O Payment:	$1,677	$1,677	$1,677
Payment Change	$510	$802	$1,094
Annualized % Change	6%	10%	13%
5 year Change	31%	48%	65%

The Annualized % Change is how much a borrower's income must change annually to maintain the same debt ratio as when the loan was taken out (assumes all other payments remain the same).

Issues
Can incomes keep up: can borrower make the new payment?
Is there equity at the end of 5 years so the borrower can refinance?
Can borrower qualify for a new loan at reset (income, home value & credit)?

Pay Option Loans

Month	Monthly Payment		
	Min Amount	Interest Only	30 yr Payment
1 - 12	$1,608	$2,247	$2,806
13 - 24	$1,729	$3,804	$4,120
25 - 36	$1,858	$4,184	$4,523
37 - 48	$1,998	$4,468	$4,854
49 - 60	$2,148	$4,774	$5,215
61	**$5,548**	$5,048	$5,548

Loan: $500,000	1% Start Rate	125% max loan balance	9.95% Life Cap	Pmt Cap: 7.5%

The borrower's monthly payment changes $3,400 per month or 158% in year six over year five if only the minimum monthly payment is made during the first 5 years.

Issues at the end of 5 years:
--can the borrower afford to make the payment in year 6
--is there equity at end of year five if unpaid interest is added to the loan balance
--can the borrower refinance at the end of year 5
--can the borrower document income--see Exhibit 8 (stated income %)

Fitch Ratings

Based on data from First American's Loan Performance, over 80% of Pay Option borrowers in 2006 and 2007 vintages (i.e., the years Wescorp purchased most of its Alt A securities) are making only their minimum monthly payment. Combined with an initial average LTV of 79% (see Exhibit 8), a 125% payment cap, a home value decline of 25% or more from December 2006 to September 2008 (see Exhibit 9), and a 5% to 10% decline in 2009, most Pay Option borrowers will not be able to refinance when their loan recasts (i.e., the loan amount will exceed 100% of the value of the property). Also, over 80% of Pay Option loans in 2006 and 2007 were stated income loans (see Exhibit 8).

Exhibit 10: con’t

Top States with Pay Option and Alt A Loans (compare to Exhibit 9)

Pay Option Loans		Alt A Loans
Top States	% of loans	Top States
California	14	California
Florida	11	Florida
Nevada	11	Nevada
Idaho	9	Illinois
Washington	9	Arizona
Arizona	7	Georgia
New Jersey	7	New York
Virginia	6	Washington
Oregon	6	Virginia
41 other states	20	Maryland
Total	100	

Comparative Loan Amounts:
adjusted only for the mortgage payment (all other borrower payments remain the same)

Loan Type	**Loan Amount**	Interest Rate	Monthly Payment	Qualifying Requirement	Purchase Price w/10% down	***Loan Amt at Recast / Reset: 5yrs***
Conforming	**$350,000**	6.000%	$2,098	Full Payment	$388,900	***N/A***
I/O loan	**$419,600**	6.000%	$2,098	I/O Rate	$466,000	***$419,600***
Pay Option	**$467,250**	---	$2,098	3.50% rate	$519,000	***$584,000***
Conventional	**$500,000**	6.000%	$2,998	Full Payment	$555,500	***N/A***
I/O loan	**$599,600**	6.000%	$2,998	I/O Rate	$666,000	***$599,600***
Pay Option	**$667,750**	---	$2,998	3.50% rate	$742,000	***$844,000***

The lower qualifying requirement provided borrowers with larger loan amounts. This was a significant when home prices were soaring; it allowed borrowers to buy bigger homes and live in more desirable neighborhood—they were able to do this with low, affordable payments that I/O and Pay Options loans provided.

A major problem with I/O and Pay Option loans occurs when they reset or recast, payment can go up 25% to 200%, causing borrower delinquency, default, and foreclosure.

Exhibit 11: Sub-prime Loans

Loss at Foreclosure

(based on information in Exhibit 8 and 9)	2005		2006
Loan Amount	$193,000		$208,000
Average LTV: Sub-prime securities	80%		80%
Value of Property (based on LTV)	$241,250		$260,000
Estimated Property Value Decline through Sept 2008	28%		25%
Value of Property: June 2008	$173,700		$195,000
Foreclosure and Sales Cost			
Sale Commission: 5%	$8,685		$ 9,750
Costs (average)*	$50,000		$50,000
Net Proceeds from Sale	$115,015		$135,250
Balance Due (at June 2008)	$188,729		$205,542
assume amortization to	Dec-07		Dec-07
Loss on Sale	$73,714		$70,292
% Loss	**39%**		**34%**

*Costs include maintenance, fix up, interest accrued, legal, and other costs to foreclose and sell the home.

Payment Change at Reset - a reason why foreclosure occurs

	2005		2006
Average Coupon Rate or Initial Rate (see Exhibit 8)	7.50%		8.40%
Initial Principal & Interest Payment	$1,349		$1,585
RATE CHANGE			
Rate Cap over Initial Rate	3.00%		3.00%
Max Rate with Cap	10.50%		11.40%
Rate Change: 2005 Avg Libor (4.95) + 600 BPS	10.95%		
Rate Change: 2006 Avg Libor (3.52) + 600 BPS			9.52%
Reset Rate	10.50%		9.52%
First Reset P& I Payment [1]	$1,750		$1,741
Difference in Monthly Payment	$401		$156
% change in Monthly Payment	30%		10%

[1] Payment assumes borrower made Principal and Interest payments for 24 months

Most Sub-prime loans had a life (or max) cap of 6% over their Index (usually the 6 month Libor); some sub-prime loans had a periodic cap of 300 basis points over their start rate while other sub-prime loans had no periodic cap.

The nation's top sub-prime and foreclosure states are:

California, Florida, Nevada, Arizona, Michigan, Ohio, Illinois, Georgia.

***Other major sub-prime states but not in the top foreclosure states: New York and Pennsylvania*.**

Exhibit 12: Stated Income

The Mortgage Asset Research Institute (MARI) reports 60% of all Stated Income loans have incomes inflated by more than 50%.

Assumptions:

Loan Amount: $200,000	Interest Rate: 8.00%	LTV: 80%	Loan Type: 2/28
Index: 6 month Libor	Margin: 6.00%	Caps: 3.00% / 6.00%	Doc Type: Stated
Debt to Income (DTI) Ratio: 50%		Income Type: Salaried	Credit Card Pmts: $700/mn

Stated Income:	$4,716	Monthly Real Income	$3,159
Mortgage Payment:	$ 1,468	Mortgage Payment:	$1,468
Taxes & Insurance:	$ 200	Taxes & Insurance:	$ 200
Credit Card Pmts:	$ 700	Credit Card Pmts:	$ 700
Total Payments:	$ 2,368	Total Payments:	$2,368
DTI	50%	DTI	75%

If the borrower is a salaried borrower and the borrower's withholding (i.e., for Federal and State taxes and health benefits) is 20% or $631, the borrowers real cash flow (or residual) after Total Payments is $160. Residual pays for food, utilities, gas, and other monthly expenses. Thus, this borrower is already in trouble.

If the borrower cannot refinance when loan resets, it is expected that the new Total Payments will exceed borrower's monthly cash flow (i.e., the borrower/s new rate will be more than 8.00%). Result: Delinquency, Foreclosure or Bankruptcy.

Exhibit 13: Rating Agencies, Risk Models, and a Missed Opportunity

The following is an assessment from former S&P staff members regarding S&P's development and use of Risk Models and the focal point of S&P as the sub-prime and Alt A markets blossomed, peaked, and tumbled.

- Pre 1995: S & P uses *rules-based* model for determining the loss expected on any given bond
- 1995: S & P develops *statistical-based* model to estimate default and loss of each loan and the pools
- 1996: S & P implements *statistical-based* model using 500,000 loans and 5 years of performance data
- 1998 / 1999: S & P releases second version of *statistical-based* model using 900,000 loans and 8 years of performance data
- 2001: S & P develops third version of *statistical-based* model using 2.5 million loans and significant performance data—*this is the best version yet but it is not implemented due to budget constraints*
  - strain on analytical staff and work quality from huge transaction volumes requiring ratings
  - requests for more staff not granted as McGraw Hill (S & P's parent) worried about profits
- 2003 / 2004: S & P develops fourth version of *statistical-based* model developed based on 9.5 million loans and significant performance data—*not implemented, it was better than previous model and it covered new mortgage products, including Alt-A*

Each version was better than the prior one in determining default probabilities. Each was built with more data. If the third and fourth versions of the model been implemented warnings may have been sounded about the performance of some products and that may have lead to their removal as too expensive to put into bonds (i.e., loss estimates too high). The obsolete versions of the rating models did not capture or correctly measure the performance of the new sub-prime and Alt A loan products.

S&P chose not implement the third and fourth versions of the model because their focus was on profits for the parent company, McGraw-Hill. Complimenting this action was the RMBS group who had the largest share of the ratings market among the three major rating agencies—improving the model would not add to S & P's revenues.

Exhibit 14: Payoff of Securities at Maturity (need for refinances)

The following chart looks at the potential pay off of Wescorp's sub-prime securities when they mature. The chart assumes principal pay downs over five years (i.e., 2006 to 2010), excess spread at 0.50%, and no refinancing from 2007 to 2010 (i.e., since the collapse of the sub-prime market no lenders are making sub-prime or stated income loans—see Exhibit 8). The same analysis applies to Wescorp's Alt A securities (note: the amount of Alt A owned by Wescorp is over twice the amount of sub-prime securities it owns).

AAA rated sub-prime securities amount	$4,000,000
Collateral Loan Amount (103%)	$4,120,000
Interest Rate for underlying loans	7.50%
Pay down at end of year 5	$3,902,654
Proceeds from Loans ($4,120,000)	
Principal Pay down without Refinances (five years)	$217,346
Excess Spread @ 0.5%	$103,000
Total Proceeds	$320,346
Additional Proceeds needed from Refinances and subordinate tranches to pay off securities at maturity	$ 3,679,654

If the subordinate tranches total the same amount as the securities amount or $4,000,000 (*typically, subordinate tranches equal 25% or less of the AAA rated tranche*), the total proceeds available from principal pay downs and excess spread will be equal to $640,692 (i.e., twice the Total Proceeds shown in the chart). As a result, the proceeds needed from Refinances would be reduced to $3,359,308; this amount can come from loans in the lower tranches that are refinanced. However, loans in lower tranches would be expected to have a more difficult time refinancing (i.e., than loans underlying the AAA tranche) since they have more credit and/or income issues.

With out refinances, the probability of a timely payoff at the maturity of Wescorp's sub-prime and Alt A securities is highly unlikely. Until housing values rebound, lenders begin lending, and borrowers find products they qualify for (which many will not be able to do without a stated income or sub-prime loan product), refinances will remain very difficult to obtain and proceeds required to pay off the securities will not be available.

Exhibit 15: Wescorp Equity and Losses

Wescorp's September 2008 Financial Statement Equity position (i.e., without the Unrealized Loss):

Equity or Capital Position:	
Retained Earnings	$ 787,407,000
Paid-In Capital	213,074,000
Member Capital Account	1,006,298,000
Total Capital	$ 2,017,448,000
Minimum Expected Losses from Sub-prime, Alt A, and CDOs	
Sub-prime losses	$ 847,100,000
Alt A Losses	2,904,700,000
CDO Losses	357.800,000
Total Losses	$4,109,600,000
Net Equity after Losses (Sub-prime, Alt A and CD0s only)	**($2,002,152,000)**