

CONSUMER PORTFOLIO SERVICES INC

Form 10-Q

November 12, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the quarterly period ended September 30, 2010

Commission file number: 1-11416

CONSUMER PORTFOLIO SERVICES, INC.  
(Exact name of registrant as specified in its charter)

|   |   |
|---|---|
| California  | 33-0459135                              |
| (State or other jurisdiction of<br>incorporation or organization) | (IRS Employer<br>Identification<br>No.) |

|   |            |
|---|------------|
| 19500 Jamboree Road, Irvine,<br>California  | 92612      |
| (Address of principal executive<br>offices) | (Zip Code) |

Registrant's telephone number, including Area Code: (949) 753-6800

Former name, former address and former fiscal year, if changed since last report: N/A

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [ ] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer", "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer [ ] Accelerated Filer [ ]  
Non-Accelerated Filer [ ] Smaller Reporting Company [ X ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of November 8, 2010 the registrant had 17,246,207 common shares outstanding.

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## Item 1. Financial Statements

CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES  
 UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS  
 (In thousands, except share and per share data)

|  | September<br>30,<br>2010 | December<br>31,<br>2009 |
|--|--------------------------|-------------------------|
| <b>ASSETS</b>  |                          |                         |
| Cash and cash equivalents  | \$11,293                 | \$12,433                |
| Restricted cash and equivalents  | 120,105                  | 128,511                 |
| Finance receivables  | 629,508                  | 878,366                 |
| Less: Allowance for finance credit losses  | (21,198 )                | (38,274 )               |
| Finance receivables, net   | 608,310                  | 840,092                 |
| Residual interest in securitizations   | 3,696                    | 4,316                   |
| Furniture and equipment, net   | 1,313                    | 1,509                   |
| Deferred financing costs   | 5,780                    | 5,717                   |
| Deferred tax assets, net   | 28,850                   | 33,450                  |
| Accrued interest receivable  | 6,508                    | 8,573                   |
| Other assets   | 16,123                   | 33,660                  |
|  | \$801,978                | \$1,068,261             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                          |                         |
| <b>Liabilities</b>   |                          |                         |
| Accounts payable and accrued expenses  | \$20,932                 | \$17,906                |
| Warehouse lines of credit  | 39,692                   | 4,932                   |
| Residual interest financing  | 44,252                   | 56,930                  |
| Securitization trust debt  | 632,783                  | 904,833                 |
| Senior secured debt, related party   | 26,950                   | 26,118                  |
| Subordinated renewable notes   | 21,300                   | 21,965                  |
|  | 785,909                  | 1,032,684               |
| <b>COMMITMENTS AND CONTINGENCIES</b>   |                          |                         |
| <b>Shareholders' Equity</b>  |                          |                         |
| Preferred stock, \$1 par value;<br>authorized 5,000,000 shares; none issued  | -                        | -                       |
| Series A preferred stock, \$1 par value;<br>authorized 5,000,000 shares; none issued   | -                        | -                       |
| Common stock, no par value; authorized<br>75,000,000 shares; 17,250,647 and 18,034,909<br>shares issued and outstanding at September 30, 2010 and<br>December 31, 2009, respectively | 54,352                   | 55,346                  |
| Additional paid in capital, warrants   | 9,141                    | 8,371                   |
| Retained earnings/(Accumulated deficit)  | (41,788 )                | (22,504 )               |
| Accumulated other comprehensive loss   | (5,636 )                 | (5,636 )                |
|  | 16,069                   | 35,577                  |
|  | \$801,978                | \$1,068,261             |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.



CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (In thousands, except per share data)

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|---|-------------------------------------|------------|------------------------------------|-------------|
|   | 2010                                | 2009       | 2010                               | 2009        |
| Revenues:   |                                     |            |                                    |             |
| Interest income   | \$32,925                            | \$49,320   | \$107,072                          | \$165,459   |
| Servicing fees  | 1,768                               | 839        | 6,119                              | 2,811       |
| Other income  | 2,105                               | 2,662      | 6,724                              | 8,922       |
|   | 36,798                              | 52,821     | 119,915                            | 177,192     |
| Expenses:   |                                     |            |                                    |             |
| Employee costs  | 7,599                               | 8,224      | 25,075                             | 26,466      |
| General and administrative                                    | 3,593                               | 5,569      | 15,048                             | 18,021      |
| Interest  | 20,056                              | 26,175     | 63,380                             | 87,278      |
| Provision for credit losses                                   | 7,036                               | 15,258     | 25,742                             | 49,836      |
| Marketing   | 1,068                               | 895        | 2,573                              | 2,975       |
| Occupancy   | 763                                 | 825        | 2,303                              | 2,859       |
| Depreciation and amortization                                 | 180                                 | 182        | 478                                | 526         |
|   | 40,295                              | 57,128     | 134,599                            | 187,961     |
| Income (loss) before income tax expense (benefit)             | (3,497 )                            | (4,307 )   | (14,684 )                          | (10,769 )   |
| Income tax expense (benefit)                                  | 1,000                               | -          | 4,600                              | -           |
| Net income (loss)   | \$(4,497 )                          | \$(4,307 ) | \$(19,284 )                        | \$(10,769 ) |
| Earnings (loss) per share:                                    |                                     |            |                                    |             |
| Basic   | \$(0.26 )                           | \$(0.23 )  | \$(1.10 )                          | \$(0.57 )   |
| Diluted   | (0.26 )                             | (0.23 )    | (1.10 )                            | (0.57 )     |
| Number of shares used in computing earnings (loss) per share: |                                     |            |                                    |             |
| Basic   | 17,309                              | 18,583     | 17,530                             | 18,776      |
| Diluted   | 17,309                              | 18,583     | 17,530                             | 18,776      |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands)

|  | Nine Months Ended<br>September 30, |             |
|--|------------------------------------|-------------|
|  | 2010                               | 2009        |
| Cash flows from operating activities:  |                                    |             |
| Net income (loss)  | \$(19,284 )                        | \$(10,769 ) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                    |             |
| Amortization of deferred acquisition fees  | (4,206 )                           | (5,825 )    |
| Amortization of discount on securitization notes   | 4,534                              | 9,327       |
| Amortization of discount on senior secured debt, related party                           | 832                                | 737         |
| Depreciation and amortization  | 478                                | 526         |
| Amortization of deferred financing costs   | 3,489                              | 2,199       |
| Provision for credit losses  | 25,742                             | 49,836      |
| Stock-based compensation expense   | 1,200                              | 1,027       |
| Interest income on residual assets   | (727 )                             | (1,211 )    |
| Changes in assets and liabilities:   |                                    |             |
| Accrued interest receivable  | 2,065                              | 4,711       |
| Tax assets   | 4,600                              | -           |
| Other assets   | 18,885                             | 24,746      |
| Accounts payable and accrued expenses  | 3,026                              | 2,694       |
| Net cash provided by operating activities  | 40,634                             | 77,998      |
| Cash flows from investing activities:  |                                    |             |
| Purchases of finance receivables held for investment                                     | (79,390 )                          | (2,539 )    |
| Proceeds received on finance receivables held for investment                             | 289,636                            | 321,821     |
| Decreases in restricted cash and equivalents   | 8,406                              | 21,243      |
| Purchase of furniture and equipment  | (283 )                             | (532 )      |
| Net cash provided by investing activities  | 218,369                            | 339,993     |
| Cash flows from financing activities:  |                                    |             |
| Proceeds from issuance of securitization trust debt                                      | 31,739                             | --          |
| Proceeds from issuance of subordinated renewable notes                                   | 2,331                              | 527         |
| Payments on subordinated renewable notes   | (2,996 )                           | (5,016 )    |
| Net proceeds from (repayments to) warehouse lines of credit                              | 34,760                             | (4,748 )    |
| Proceeds from (repayments of) residual interest financing debt                           | (12,678 )                          | (7,450 )    |
| Repayment of securitization trust debt   | (308,323 )                         | (400,751 )  |
| Payment of financing costs   | (2,782 )                           | (1,722 )    |
| Repurchase of common stock   | (2,194 )                           | (519 )      |
| Net cash used in financing activities  | (260,143 )                         | (419,679 )  |
| Increase (decrease) in cash and cash equivalents   | (1,140 )                           | (1,688 )    |
| Cash and cash equivalents at beginning of period   | 12,433                             | 22,084      |
| Cash and cash equivalents at end of period   | \$11,293                           | \$20,396    |
| Supplemental disclosure of cash flow information:  |                                    |             |

|  |            |             |
|--|------------|-------------|
| Cash paid (received) during the period for:                  |            |             |
| Interest   | \$56,867   | \$76,840    |
| Income taxes   | \$(7,691 ) | \$(12,374 ) |
| Non-cash financing activities:                               |            |             |
| Warrants issued in connection with new term funding facility | \$770      | \$822       |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.



CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

Description of Business

We were formed in California on March 8, 1991. We specialize in purchasing and servicing retail automobile installment sale contracts ("automobile contracts" or "finance receivables") originated by licensed motor vehicle dealers located throughout the United States ("dealers") in the sale of new and used automobiles, light trucks and passenger vans. Through our purchases, we provide indirect financing to dealer customers for borrowers with limited credit histories, low incomes or past credit problems ("sub-prime customers"). We serve as an alternative source of financing for dealers, allowing sales to customers who otherwise might not be able to obtain financing. In addition to purchasing installment purchase contracts directly from dealers, we have also (i) acquired installment purchase contracts in three merger and acquisition transactions, (ii) purchased immaterial amounts of vehicle purchase money loans from non-affiliated lenders, and (iii) lent money directly to consumers for an immaterial amount of vehicle purchase money loans. In this report, we refer to all of such contracts and loans as "automobile contracts."

Basis of Presentation

Our Unaudited Condensed Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States of America, with the instructions to Form 10-Q and with Article 8 of Regulation S-X of the Securities and Exchange Commission, and include all adjustments that are, in our opinion, necessary for a fair presentation of the results for the interim periods presented. All such adjustments are, in the opinion of management, of a normal recurring nature. In addition, certain items in prior period financial statements may have been reclassified for comparability to current period presentation. Results for the nine-month period ended September 30, 2010 are not necessarily indicative of the operating results to be expected for the full year.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted from these Unaudited Condensed Consolidated Financial Statements. These Unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2009.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of income and expenses during the reported periods. Specifically, a number of estimates were made in connection with determining an appropriate allowance for finance credit losses, valuing residual interest in securitizations, accreting net acquisition fees, amortizing deferred costs, the recording of deferred tax assets and reserves for uncertain tax positions. These are material estimates that could be susceptible to changes in the near term and, accordingly, actual results could differ from those estimates.

Other Income

Other income consists primarily of sales tax refunds, recoveries on previously charged off contracts from previously unconsolidated trusts, convenience fees charged to obligors for certain types of payment transaction methods and fees paid to us by dealers for certain direct mail services we provide. We received \$1.6 million in sales tax refunds for the

period ended September 30, 2010. We did not receive any sales tax refunds in the

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

comparable period in 2009. Recoveries on the charged-off contracts relate to contracts from previously unconsolidated trusts and were \$1.0 million and \$1.2 million for the nine months ended September 30, 2010 and 2009, respectively. Convenience fees charged to obligors, which can be expected to increase or decrease in rough proportion to increases or decreases in our managed portfolio, were \$2.4 million and \$3.5 million for the same periods, respectively. Direct mail revenues were \$1.1 million and \$2.1 million for the nine months ended September 30, 2010 and 2009, respectively.

#### Stock-based Compensation

We recognize compensation costs in the financial statements for all share-based payments granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of FASB ASC 718 “Accounting for Stock Based Compensation”.

For the nine months ended September 30, 2010 and 2009, we recorded stock-based compensation costs in the amount of \$1.2 million and \$1.0 million, respectively. As of September 30, 2010, unrecognized stock-based compensation costs to be recognized over future periods equaled \$3.2 million. This amount will be recognized as expense over a weighted-average period of 3.0 years.

The following represents stock option activity for the nine months ended September 30, 2010:

|  | Number of<br>Shares<br>(in thousands) | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual Term |
|--|---------------------------------------|---------------------------------------|--|
| Options outstanding at the beginning of period | 6,874                                 | \$ 1.62                               | N/A  |
| Granted  | 520                                   | 1.81                                  | N/A  |
| Exercised                                      | -                                     | -                                     | N/A  |
| Forfeited                                      | (524)                                 | 1.78                                  | N/A  |
| Options outstanding at the end of period       | 6,870                                 | \$ 1.62                               | 5.8 years  |
| Options exercisable at the end of period       | 4,607                                 | \$ 1.79                               | 4.6 years  |

At September 30, 2010, the aggregate intrinsic value of options outstanding and exercisable was \$155,000 and \$48,000, respectively. There were no options exercised for the nine months ended September 30, 2010 and 2009. There were 1.0 million shares available for future stock option grants under existing plans as of September 30, 2010.

#### Purchases of Company Stock

During the nine-month periods ended September 30, 2010 and 2009, we purchased 784,262 and 695,350 shares, respectively, of our common stock, at average prices of \$1.55 and \$0.75, respectively.

#### New Accounting Pronouncements

In July 2010, the FASB issued FASB ASU 2010-20, Receivables (Topic 310) – Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which will require more information about credit quality. The ASU introduces the term “financing receivables”, which includes loans, trade accounts receivable, notes receivable,

credit cards, leveraged leases, direct financing leases, and sales-type leases. The term does not include receivables measured at fair value or the lower of cost of fair value and debt securities among others. It also defines two levels of disaggregation for disclosure: portfolio segment and class of financing receivables. A portfolio segment is defined as the level at which an entity determines its allowance for credit losses. A class of financing receivable is defined as a group of finance receivables determined on the basis of their initial measurement attribute (i.e., amortized cost of purchased credit impaired), risk characteristics, and an entity's method for monitoring and assessing credit risk. The ASU

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

requires an entity to provide additional disclosures including, but not limited to, a rollforward schedule of the allowance for credit losses (with the ending allowance balance further disaggregated based on impairment methodology) and the related ending balance of the finance receivable presented by portfolio segment, and the aging of past due financing receivables at the end of the period, the nature and extent of troubled debt restructurings that occurred during the period and their impact on the allowance for credit losses, the nature and extend of troubled debt restructurings that occurred within the last year, that have defaulted in the current reporting period, and their impact on the allowance for credit losses, the nonaccrual status of financing receivables, and impaired financing receivables, presented by class. The extensive new disclosures of information as of the end of a reporting period will become effective for both interim and annual reporting periods ending after December 15, 2010 for public companies. Specific items regarding activity that occurred before the issuance of the ASU, such as the allowance rollforward and modification disclosures will be required for periods beginning after December 15, 2010 for public companies. The Company is currently in the process of assessing the impact of this pronouncement on the consolidated financial statements.

#### Recent Developments

#### Uncertainty of Capital Markets and General Economic Conditions

Historically, we have depended upon the availability of warehouse credit facilities and access to long-term financing through the issuance of asset-backed securities collateralized by our automobile contracts. Since 1994, we have completed 50 term securitizations of approximately \$6.7 billion in contracts. We conducted four term securitizations in 2006, four in 2007, two 2008 and one in 2010. From July 2003 through April 2008 all of our securitizations were structured as secured financings. The second of our two securitization transactions in 2008 (completed in September 2008) and our most recent securitization in September 2010 were in substance a sale of the related contracts, and are treated as sales for financial accounting purposes.

Since the fourth quarter of 2007 through the end of 2009, we observed unprecedented adverse changes in the market for securitized pools of automobile contracts. These changes included reduced liquidity, and reduced demand for asset-backed securities, particularly for securities carrying a financial guaranty and for securities backed by sub-prime automobile receivables. Moreover, many of the firms that previously provided financial guarantees, which were an integral part of our securitizations, are no longer offering such guarantees. The adverse changes that took place in the market from the fourth quarter of 2007 through the end of 2009 caused us to conserve liquidity by significantly reducing our purchases of automobile contracts. Since October 2009, we have gradually increased our contract purchases by utilizing one \$50 million credit facility and another \$50 million term funding facility but we have no immediate plans to complete a term securitization with our recently purchased contracts. In September 2010, however, we took advantage of the more recent improvement in the market for asset-backed securities by re-securitizing the underlying contracts from our unrated September 2008 securitization. By doing so we were able to pay off the bonds associated with the September 2008 transaction and issue rated bonds with a significantly lower weighted average coupon. The September 2010 transaction was our first rated term securitization since 1993 that did not utilize a financial guaranty. Nevertheless, if the trend of improvement in the markets for asset-backed securities should reverse, or if we are unable to obtain additional contract financing facilities or complete a term securitization of our recently originated receivables, we may curtail further or cease our purchases of new automobile contracts, which could lead to a material adverse effect on our operations.

The downturn in economic conditions and the capital markets that began in the fourth quarter of 2007 have negatively affected many aspects of our industry. First, throughout 2008 and 2009 there was reduced demand for asset-backed securities secured by consumer finance receivables, including sub-prime automobile receivables, as compared to 2007

and earlier. During 2010, however, we have observed that yield requirements for investors that purchase securities backed by consumer finance receivables, including sub-prime automobile receivables, are approaching pre-2008 levels, albeit with significantly fewer transactions in the market. Second, there are fewer lenders who provide short-term warehouse financing for sub-prime automobile finance companies due to more uncertainty regarding the prospects of obtaining long-term

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

financing through the issuance of asset-backed securities than before 2008. In addition, many capital market participants such as investment banks, financial guaranty providers and institutional investors who previously played a role in the sub-prime auto finance industry have withdrawn from the industry, or in some cases, have ceased to do business. Finally, broad economic weakness and increasing unemployment in 2008 and 2009 made many of our customers less willing or able to pay, resulting in higher delinquency, charge-offs and losses. Each of these factors has adversely affected our results of operations. Should existing economic conditions worsen, both our ability to purchase new contracts and the performance of our existing managed portfolio may be impaired, which, in turn, could have a further material adverse effect on our results of operations.

**We May Have Rescission Liability in Connection with Offers and Sales of Our Renewable Unsecured Subordinated Notes to Certain Purchasers**

We filed a registration statement on Form S-2 with respect to our renewable unsecured subordinated notes on January 7, 2005 and subsequently filed amendments to such registration statement on April 13, May 2, and May 20, 2005 and April 11, 2006 (such registration statement, as so amended, the "Former Registration Statement"). We recently discovered that, under a rule of the SEC, we are no longer permitted to offer and sell our renewable unsecured subordinated notes in reliance on the Former Registration Statement. Consequently, purchasers who acquired such notes during the year ending September 30, 2010 may have a statutory right to rescind their purchases. As a result, we could be required to repurchase some or all of such notes at the original sale price plus statutory interest, less the amount of any income received by the purchasers. From October 1, 2009 to September 30, 2010, we sold a total of \$4.3 million of notes, including renewals of previously sold notes, but excluding notes that we have repaid.

**Financial Covenants**

Certain of our securitization transactions and our warehouse credit facility contain various financial covenants requiring certain minimum financial ratios and results. Such covenants include maintaining minimum levels of liquidity and net worth and not exceeding maximum leverage levels and maximum financial losses. In addition, certain securitization and non-securitization related debt contain cross-default provisions that would allow certain creditors to declare a default if a default occurred under a different facility.

The agreements under which we receive periodic fees for servicing automobile contracts in securitizations are terminable by the respective financial guaranty insurance companies (also referred to as note insurers) upon defined events of default, and, in some cases, at the will of the insurance company. In August 2010, we agreed with the note insurer for eight of our twelve currently outstanding securitizations to amend the applicable agreements to remove the financial covenants that were contained in three of the related agreements. In return for such amendments, we agreed to increase the required credit enhancement amounts in those three deals through increased spread account requirements. The remaining four transactions insured by this particular note insurer do not contain financial covenants.

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For the remaining four securitizations insured by different parties we have been receiving waivers for certain financial and operating covenants on a monthly and/or quarterly basis as summarized below:

| Financial covenant           | Applicable Standard                 | Status Requiring Waiver(as of or for the quarter ended September 30, 2010) |
|------------------------------|-------------------------------------|--|
| Warehouse financing capacity | \$200 million of warehouse capacity | \$50 million of warehouse capacity   |
| Adjusted net worth (I)       | \$87.6 million                      | \$16.1 million   |
| Leverage                     | Not greater than 4.5:1              | 7.1:1  |
| Adjusted net worth (II)      | \$95.3 million                      | \$16.1 million   |

The covenant regarding warehouse financing capacity is a covenant to maintain one or more credit facilities that allow us to finance acquisition of automobile contracts on a revolving basis, with a minimum aggregate capacity of \$200 million. The adjusted net worth covenants are covenants to maintain minimum levels of adjusted net worth, defined as our consolidated book value under GAAP with the exclusion of intangible assets such as goodwill. There are two separate adjusted net worth covenants because there are two separate note insurers that have this covenant in their related securitizations agreements. The leverage covenant requires that we not exceed the specified ratio of debt over the defined adjusted net worth. Debt is defined in this covenant to mean consolidated liabilities less warehouse lines of credit and securitization trust debt; using this definition at September 30, 2010, we had debt of \$113.4 million.

Without the waivers we have received from the related note insurers, we would have been in violation of covenants relating to minimum net worth, maximum financial losses, maximum leverage levels and maintenance of active warehouse facilities with respect to four of our 12 currently outstanding securitization transactions. Upon such an event of default, and subject to the right of the related note insurers to waive such terms, the agreements governing the securitizations call for payment of a default insurance premium, ranging from 25 to 100 basis points per annum on the aggregate outstanding balance of the related insured senior notes, and for the diversion of all excess cash generated by the assets of the respective securitization pools into the related spread accounts to increase the credit enhancement associated with those transactions. The cash so diverted into the spread accounts would otherwise be used to make principal payments on the subordinated notes in each related securitization or would be released to us. To the extent that principal payments on the subordinated notes are delayed, we will incur greater interest expense on the subordinated notes than we would have without the required increase to the related spread accounts. As of the date of this report, cash is being diverted to the related spread accounts in seven transactions. In addition, upon an event of default, the note insurers have the right to terminate us as servicer. Although our termination as servicer has been waived, we are paying default premiums, or their equivalent, with respect to insured notes representing \$402.5 million of the \$632.8 million of securitization trust debt outstanding at September 30, 2010. It should be noted that the principal amount of such securitization trust debt is not increased, but that the increased insurance premium is reflected as increased interest expense. Furthermore, such waivers are temporary, and there can be no assurance as to their future extension. We do, however, believe that we will obtain such future extensions of our servicing agreements because it is generally not in the interest of any party to the securitization transaction to transfer servicing. Nevertheless, there can be no assurance as to our belief being correct. Were an insurance company in the future to exercise its option to terminate such agreements or to pursue other remedies, such remedies could have a material adverse effect on our liquidity and results of operations, depending on the number and value of the affected transactions. Our note insurers continue to extend our term as servicer on a monthly and/or quarterly basis, pursuant to the servicing agreements.





CONSUMER PORTFOLIO SERVICES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## (2) Finance Receivables

The following table presents the components of Finance Receivables, net of unearned interest and deferred acquisition fees and originations costs:

|  | September 30,<br>2010 | December 31,<br>2009 |
|--|-----------------------|----------------------|
|  | (In thousands)        |                      |
| Finance Receivables                                      |                       |                      |
| Automobile finance receivables, net of unearned interest | \$ 638,934            | \$ 884,819           |
| Less: Unearned acquisition fees and originations costs   | (9,426 )              | (6,453 )             |
| Finance Receivables                                      | \$ 629,508            | \$ 878,366           |

The following table presents a summary of the activity for the allowance for credit losses for the nine-month periods ended September 30, 2010 and 2009:

|  | September 30,<br>2010 | September 30,<br>2009 |
|--|-----------------------|-----------------------|
|  | (In thousands)        |                       |
| Balance at beginning of period                     | \$ 38,274             | \$ 78,036             |
| Provision for credit losses on finance receivables | 25,742                | 49,836                |
| Charge offs  | (62,652 )             | (116,949 )            |
| Recoveries   | 19,834                | 22,143                |
| Balance at end of period                           | \$ 21,198             | \$ 33,066             |

We have excluded from finance receivables those contracts that we previously classified as finance receivables, but which we reclassified as other assets because we have repossessed the vehicle securing the contract. The following table presents a summary of such repossessed inventory, together with the allowance for losses in repossessed inventory that is not included in the allowance for credit losses. This allowance results in the repossessed inventory being valued at the estimated fair value less selling costs.

|  | September 30,<br>2010 | December 31,<br>2009 |
|--|-----------------------|----------------------|
|  | (In thousands)        |                      |
| Gross balance of repossessions in inventory        | \$ 18,647             | \$ 37,821            |
| Allowance for losses on repossessed inventory      | (13,800 )             | (28,084 )            |
| Net repossessed inventory included in other assets | \$ 4,847              | \$ 9,737             |

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## (3) Securitization Trust Debt

We have completed a number of securitization transactions that are structured as secured borrowings for financial accounting purposes. The debt issued in these transactions is shown on our Unaudited Condensed Consolidated Balance Sheets as “Securitization trust debt,” and the components of such debt are summarized in the following table:

| Series          | Final<br>Scheduled<br>Payment<br>Date (1) | Receivables<br>Pledged at<br>September 30,<br>2010 | Initial<br>Principal | Outstanding<br>Principal at<br>September 30,<br>2010 | Outstanding<br>Principal at<br>December 31,<br>2009 | Weighted<br>Average<br>Contractual<br>Interest Rate at |
|-----------------|---|--|----------------------|--|---|--|
|                 |   |  |                      |  |   | September 30,<br>2010                                  |
|                 |   |  |                      |  |   | (Dollars in thousands)                                 |
| CPS<br>2004-B   | February<br>2011                          | -  | 96,369               | -  | 1,254   | -  |
| CPS<br>2004-C   | April 2011                                | -  | 100,000              | -  | 1,989   | -  |
| CPS<br>2004-D   | December<br>2011                          | -  | 120,000              | -  | -   | -  |
| CPS<br>2005-A   | October<br>2011                           | -  | 137,500              | -  | 6,924   | -  |
| CPS<br>2005-B   | February<br>2012                          | 3,520  | 130,625              | 3,538  | 10,021  | 4.67%  |
| CPS<br>2005-C   | March<br>2012                             | 7,947  | 183,300              | 8,262  | 19,661  | 5.13%  |
| CPS<br>2005-TFC | July 2012                                 | -  | 72,525               | -  | 5,330   | -  |
| CPS<br>2005-D   | July 2012                                 | 8,894  | 145,000              | 9,279  | 19,295  | 5.69%  |
| CPS<br>2006-A   | November<br>2012                          | 21,516   | 245,000              | 22,104   | 41,546  | 5.33%  |
| CPS<br>2006-B   | January<br>2013                           | 30,282   | 257,500              | 34,641   | 56,664  | 6.75%  |
| CPS<br>2006-C   | June 2013                                 | 36,003   | 247,500              | 41,305   | 64,332  | 6.09%  |
| CPS<br>2006-D   | August<br>2013                            | 42,204   | 220,000              | 45,484   | 69,584  | 5.86%  |
| CPS<br>2007-A   | November<br>2013                          | 67,679   | 290,000              | 72,587   | 107,011   | 5.82%  |
| CPS<br>2007-TFC | December<br>2013                          | 17,993   | 113,293              | 19,680   | 31,087  | 5.94%  |
| CPS<br>2007-B   | January<br>2014                           | 87,934   | 314,999              | 96,573   | 135,602   | 6.39%  |
| CPS<br>2007-C   | May 2014                                  | 104,849  | 327,499              | 111,691  | 158,955   | 6.47%  |
|                 |   | 122,484  | 310,359              | 135,900  | 175,578   | 7.71%  |

|                       |                 |            |              |            |            |        |
|-----------------------|-----------------|------------|--------------|------------|------------|--------|
| CPS<br>2008-A         | October<br>2014 |            |              |            |            |        |
| Delayed<br>Draw Notes | July 2017       | 41,729     | 9,174        | 31,739     | -          | 11.00% |
|                       |                 | \$ 593,034 | \$ 3,320,643 | \$ 632,783 | \$ 904,833 |        |

- (1) The Final Scheduled Payment Date represents final legal maturity of the securitization trust debt. Securitization trust debt is expected to become due and to be paid prior to those dates, based on amortization of the finance receivables pledged to the Trusts. Expected payments, which will depend on the performance of such receivables, as to which there can be no assurance, are \$118.2 million in 2010, \$313.0 million in 2011, \$154.5 million in 2012, \$44.1 million in 2013 and \$3.0 million in 2014.

All of the securitization trust debt was sold in private placement transactions to qualified institutional buyers. The debt was issued through our wholly-owned bankruptcy remote subsidiaries and is secured by the assets of such subsidiaries, but not by our other assets. Principal of \$481.0 million, and the related interest payments, are guaranteed by financial guaranty insurance policies issued by third party financial institutions.

The terms of the various securitization agreements related to the issuance of the securitization trust debt and the warehouse credit facilities require that we meet certain delinquency and credit loss criteria with respect to the collateral pool, and require that we maintain minimum levels of liquidity and net worth and not exceed maximum leverage levels and maximum financial losses. In addition, certain securitization and non-securitization related debt contain cross-default provisions, which would allow certain creditors to declare a

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default if a default were declared under a different facility. We have received waivers regarding the potential breach of certain such covenants relating to minimum net worth, maximum financial losses, maximum leverage levels and maintenance of active warehouse credit facilities.

We are responsible for the administration and collection of the automobile contracts. The securitization agreements also require certain funds be held in restricted cash accounts to provide additional collateral for the borrowings or to be applied to make payments on the securitization trust debt. As of September 30, 2010, restricted cash under the various agreements totaled approximately \$120.1 million. Interest expense on the securitization trust debt consists of the stated rate of interest plus amortization of additional costs of borrowing. Additional costs of borrowing include facility fees, insurance and amortization of deferred financing costs and discounts on notes sold. Deferred financing costs and discounts on notes sold related to the securitization trust debt are amortized using a level yield method. Accordingly, the effective cost of the securitization trust debt is greater than the contractual rate of interest disclosed above.

Our wholly-owned bankruptcy remote subsidiaries were formed to facilitate the above asset-backed financing transactions. Similar bankruptcy remote subsidiaries issue the debt outstanding under our warehouse line of credit. Bankruptcy remote refers to a legal structure in which it is expected that the applicable entity would not be included in any bankruptcy filing by its parent or affiliates. All of the assets of these subsidiaries have been pledged as collateral for the related debt. All such transactions, treated as secured financings for accounting and tax purposes, are treated as sales for all other purposes, including legal and bankruptcy purposes. None of the assets of these subsidiaries are available to pay other creditors of ours.

In March 2010, we entered into a \$50 million delayed draw note facility with a syndicate of note purchasers including affiliates of Angelo, Gordon & Co., L.P. and an affiliate of Cohen & Company Securities. Under the delayed draw note facility, the note purchasers have agreed to purchase up to \$50 million in asset-backed notes, subject to collateral eligibility and other terms and conditions, up through the end of 2010. Amounts outstanding bear interest at a fixed rate of 11.00%, which may be decreased to 9.00% should the notes receive investment grade ratings from at least two of the following three credit rating agencies: Moody's; Standard & Poor's; or Fitch. Principal payments on the notes are due as the underlying receivables are paid or charged off, and the final maturity is in July 2017. As of September 30, 2010, there was \$31.7 million outstanding under the note purchase agreement.

#### (4) Interest Income

The following table presents the components of interest income:

|                                 | Three Months Ended |           | Nine Months Ended |            |
|---------------------------------|--------------------|-----------|-------------------|------------|
|                                 | September 30,      |           | September 30,     |            |
|                                 | 2010               | 2009      | 2010              | 2009       |
|                                 | (In thousands)     |           | (In thousands)    |            |
| Interest on Finance Receivables | \$ 32,458          | \$ 48,813 | \$ 105,410        | \$ 163,737 |
| Residual interest income        | 204                | 346       | 877               | 1,012      |
| Other interest income           | 263                | 161       | 785               | 710        |
| Interest income                 | \$ 32,925          | \$ 49,320 | \$ 107,072        | \$ 165,459 |

(5) Earnings (Loss) Per Share

Earnings (loss) per share for the three-month and nine-month periods ended September 30, 2010 and 2009 were calculated using the weighted average number of shares outstanding for the related period. The following

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table reconciles the number of shares used in the computations of basic and diluted earnings (loss) per share for the three-month and nine-month periods ended September 30, 2010 and 2009:

|  | Three Months Ended |        | Nine Months Ended |        |
|--|--------------------|--------|-------------------|--------|
|  | September 30,      |        | September 30,     |        |
|  | 2010               | 2009   | 2010              | 2009   |
|  | (In thousands)     |        | (In thousands)    |        |
| Weighted average number of common shares outstanding during                            |                    |        |                   |        |
| the period used to compute basic earnings (loss) per share                             | 17,309             | 18,583 | 17,530            | 18,776 |
|  |                    |        |                   |        |
| Incremental common shares attributable to exercise of outstanding options and warrants |                    |        |                   |        |
|  | -                  | -      | -                 | -      |
|  |                    |        |                   |        |
| Weighted average number of common shares used to compute                               |                    |        |                   |        |
| diluted earnings (loss) per share  | 17,309             | 18,583 | 17,530            | 18,776 |

If the anti-dilutive effects of common stock equivalents were considered, shares included in the diluted earnings (loss) per share calculation for the three-month and nine-month periods ended September 30, 2010 would have included an additional 2.8 million and 3.3 million shares, respectively, attributable to the exercise of outstanding options and warrants. For the three-month and nine-month periods ended September 30, 2009, there were 2.8 million shares attributable to the exercise of outstanding options and warrants.

#### (6) Income Taxes

We file numerous consolidated and separate income tax returns with the United States and with many states. With few exceptions, we are no longer subject to United States federal income tax examinations for years before 2005 and are no longer subject to state and local income tax examinations by tax authorities for years before 2003.

We have subsidiaries in various states that are currently under audit for years ranging from 1998 through 2005. To date, no material adjustments have been proposed as a result of these audits.

We do not anticipate that total unrecognized tax benefits will significantly change due to any settlements of audits or expirations of statutes of limitations over the next twelve months.

The Company and its subsidiaries file a consolidated federal income tax return and combined or stand-alone state franchise tax returns for certain states. We utilize the asset and liability method of accounting for income taxes, under which deferred income taxes are recognized for the future tax consequences attributable to the differences between the financial statement values of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. We have estimated a valuation allowance against that portion of the deferred tax asset whose utilization in future periods is not more than likely. Our net deferred tax asset of \$28.9 million as of September 30, 2010 is net of a valuation allowance of \$38.0 million.

On a quarterly basis, we determine whether a valuation allowance is necessary for our deferred tax asset. In performing this analysis, we consider all evidence currently available, both positive and negative, in determining whether, based on the weight of that evidence, the deferred tax asset will be realized. We establish a valuation allowance when it is more likely than not that a recorded tax benefit will not be realized. The expense to create the valuation allowance is recorded as additional income tax expense in the period the valuation allowance is established. During the first nine months of 2010, we increased our valuation allowance by \$9.4 million.



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In determining the possible future realization of deferred tax assets, we have considered the taxes paid in the current and prior years that may be available to recapture, as well as future taxable income from the following sources: (a) reversal of taxable temporary differences; (b) future operations exclusive of reversing temporary differences; and (c) tax planning strategies that, if necessary, would be implemented to accelerate taxable income into years in which net operating losses might otherwise expire. Tax planning strategies include the sale of certain assets, such as residual interests in securitizations, servicing rights and charged off receivables, that can produce significant taxable income within the relevant carryforward period. Such strategies could be implemented without significant impact on our core business or our ability to generate future growth. The costs related to the implementation of these tax strategies were considered in evaluating the amount of taxable income that could be generated in order to realize our deferred tax assets.

We received federal income tax refunds of \$7.9 million in the nine-month period ended September 30, 2010 resulting from a carryback of net operating losses incurred in 2008 to periods when we reported taxable income. The amount of the refunds was recorded as a receivable and included in Other Assets on our balance sheet at December 31, 2009.

(7) Legal Proceedings

**Stanwich Litigation.** We were for some time a defendant in a class action (the “Stanwich Case”) brought in the California Superior Court, Los Angeles County. The original plaintiffs in that case were persons entitled to receive regular payments (the “Settlement Payments”) under out-of-court settlements reached with third party defendants. Stanwich Financial Services Corp. (“Stanwich”), then an affiliate of our former chairman of the board of directors, is the entity that was obligated to pay the Settlement Payments. Stanwich had defaulted on its payment obligations to the plaintiffs and in September 2001 filed for reorganization under the Bankruptcy Code, in the federal Bankruptcy Court of Connecticut. By February 2005, we had settled all claims brought against us in the Stanwich Case.

In November 2001, one of the defendants in the Stanwich Case, Jonathan Pardee, asserted claims for indemnity against us in a separate action, which is now pending in federal district court in Rhode Island. We have filed counterclaims in the Rhode Island federal court against Mr. Pardee, and have filed a separate action against Mr. Pardee's Rhode Island attorneys, in the same court. Each of these actions in the court in Rhode Island is stayed, awaiting resolution of an adversary action brought against Mr. Pardee in the bankruptcy court, which is hearing the bankruptcy of Stanwich.

We had reached an agreement in principle with the representative of creditors in the Stanwich bankruptcy to resolve the adversary action. Under the agreement in principle, we were to pay the bankruptcy estate \$625,000 and abandon our claims against the estate, while the estate would abandon its adversary action against Mr. Pardee. The bankruptcy court has rejected that proposed settlement, the representative of creditors has appealed that rejection, and the appeal was denied on April 8, 2009 and there has been no significant activity in the case since that time. There can be no assurance as to the ultimate outcome of these matters.

The reader should consider that any adverse judgment against us in these cases for indemnification, in an amount materially in excess of any liability already recorded in respect thereof, could have a material adverse effect on our financial position.

**Other Litigation.**

We are routinely involved in various legal proceedings resulting from our consumer finance activities and practices, both continuing and discontinued. We believe that there are substantive legal defenses to such claims, and intend to

defend them vigorously. There can be no assurance, however, as to the outcome.

We have recorded a liability as of September 30, 2010 that we believe represents a sufficient allowance for legal contingencies, including those described above. Any adverse judgment against us, if in an amount materially in excess of the recorded liability, could have a material adverse effect on our financial position.

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## (8) Employee Benefits

On March 8, 2002 we acquired MFN Financial Corporation and its subsidiaries in a merger. We sponsor the MFN Financial Corporation Benefit Plan (the "Plan"). Plan benefits were frozen June 30, 2001. The table below sets forth the Plan's net periodic benefit cost for the nine-month periods ended September 30, 2010 and 2009.

|   | Three Months Ended |        | Nine Months Ended |        |
|---|--------------------|--------|-------------------|--------|
|   | September 30,      |        | September 30,     |        |
|   | 2010               | 2009   | 2010              | 2009   |
|   | (In thousands)     |        | (In thousands)    |        |
| Components of net periodic cost (benefit)     |                    |        |                   |        |
| Service cost                                  | \$ -               | \$ -   | \$ -              | \$ -   |
| Interest Cost                                 | 241                | 237    | 723               | 711    |
| Expected return on assets                     | (222 )             | (175 ) | (667 )            | (525 ) |
| Amortization of transition (asset)/obligation | -                  | -      | -                 | -      |
| Amortization of net (gain) / loss             | 127                | 169    | 382               | 507    |
| Net periodic cost (benefit)                   | \$ 146             | \$ 231 | \$ 438            | \$ 693 |

We contributed \$687,000 to the Plan during the nine-month period ended September 30, 2010 and we anticipate making contributions in the amount of \$112,000 for the remainder of 2010.

## (9) Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157") (ASC 820 10 65). SFAS No. 157 (ASC 820 10 65) clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy.

SFAS No. 157 (ASC 820 10 65) defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The three levels are defined as follows: level 1 - inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets; level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

In September 2008 we sold automobile contracts in a securitization that was structured as a sale for financial accounting purposes. In that sale, we retained both securities and a residual interest in the transaction that are measured at fair value. We describe below the valuation methodologies we use for the securities retained and the residual interest in the cash flows of the transaction, as well as the general classification of such instruments pursuant to the valuation hierarchy. The securities retained, which is included in Other Assets on our Unaudited Consolidated Balance Sheet as of December 31, 2009, were sold in September 2010 in the re-securitization transaction described in Note 1. In the same transaction, the residual interest was reduced by \$1.5 million. The residual interest in such securitization is \$3.7 million as of September 30, 2010 and is classified as level 3 in the three-level valuation hierarchy. We determine the value of that residual interest using a discounted cash flow model that includes estimates for prepayments and losses. We use a discount rate of 20% per annum and a cumulative net loss rate of 21.5%. The

assumptions we use are based on historical performance of automobile contracts we have originated and serviced in the past, adjusted for current market conditions. No gain or loss was recorded as a result of the re-securitization transaction described above.

Repossessed vehicle inventory, which is included in Other Assets on our balance sheet, is measured at fair value using Level 2 assumptions based on our actual loss experience on sale of repossessed vehicles. At

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September 30, 2010, the finance receivables related to the repossessed vehicles in inventory totaled \$18.6 million. We have applied a valuation adjustment of \$13.8 million, resulting in an estimated fair value and carrying amount of \$4.8 million.

We have no Level 3 assets that are measured at fair value on a nonrecurring basis. The table below presents a reconciliation for Level 3 assets measured at fair value on a recurring basis using significant unobservable inputs:

|  | Residual<br>Interest in<br>Securitizations<br>(in thousands) |
|--|--|
| Balance at January 1, 2010   | \$ 4,316   |
| Reduction of residual interest<br>as a result of re-securitization | (1,497 )   |
| Included in earnings   | 877  |
| Balance at September 30,<br>2010                                   | \$ 3,696   |

The following summary presents a description of the methodologies and assumptions used to estimate the fair value of our financial instruments. Much of the information used to determine fair value is highly subjective. When applicable, readily available market information has been utilized. However, for a significant portion of our financial instruments, active markets do not exist. Therefore, significant elements of judgment were required in estimating fair value for certain items. The subjective factors include, among other things, the estimated timing and amount of cash flows, risk characteristics, credit quality and interest rates, all of which are subject to change. Since the fair value is estimated as of September 30, 2010 and December 31, 2009, the amounts that will actually be realized or paid at settlement or maturity of the instruments could be significantly different. The estimated fair values of financial assets and liabilities at September 30, 2010 and December 31, 2009, were as follows:

|                                      | September 30, 2010 |               | December 31, 2009 |               |
|--------------------------------------|--------------------|---------------|-------------------|---------------|
|                                      | Carrying<br>Value  | Fair<br>Value | Carrying<br>Value | Fair<br>Value |
| Financial Instrument                 |                    |               |                   |               |
|                                      | (In thousands)     |               |                   |               |
| Cash and cash equivalents            | \$ 11,293          | \$ 11,293     | \$ 12,433         | \$ 12,433     |
| Restricted cash and equivalents      | 120,105            | 120,105       | 128,511           | 128,511       |
| Finance receivables, net             | 608,310            | 589,308       | 840,092           | 806,154       |
| Residual interest in securitizations | 3,696              | 3,696         | 4,316             | 4,316         |
| Accrued interest receivable          | 6,508              | 6,508         | 8,573             | 8,573         |
| Warehouse lines of credit            | 39,692             | 39,692        | 4,932             | 4,932         |
| Accrued interest payable             | 4,094              | 4,094         | 4,267             | 4,267         |
| Residual interest financing          | 44,252             | 44,252        | 56,930            | 56,930        |
| Securitization trust debt            | 632,783            | 648,088       | 904,833           | 942,075       |
| Senior secured debt                  | 26,950             | 26,950        | 26,118            | 26,118        |
| Subordinated renewable notes         | 21,300             | 21,300        | 21,965            | 21,965        |

Cash, Cash Equivalents and Restricted Cash

The carrying value equals fair value.

Finance Receivables, net

The fair value of finance receivables is estimated by discounting future cash flows expected to be collected using current rates at which similar receivables could be originated.

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Residual Interest in Securitizations

The fair value is estimated by discounting future cash flows using credit and discount rates that we believe reflect the estimated credit, interest rate and prepayment risks associated with similar types of instruments.

Accrued Interest Receivable and Payable

The carrying value approximates fair value because the related interest rates are estimated to reflect current market conditions for similar types of instruments.

Warehouse Lines of Credit, Residual Interest Financing, and Senior Secured Debt and Subordinated Renewable Notes

The carrying value approximates fair value because the related interest rates are estimated to reflect current market conditions for similar types of secured instruments.

Securitization Trust Debt

The fair value is estimated by discounting future cash flows using interest rates that we believe reflects the current market rates.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Overview

We are a specialty finance company focused on consumers who have limited credit histories, low incomes or past credit problems, whom we refer to as sub-prime customers. Our business is to purchase and service retail automobile contracts originated primarily by franchised automobile dealers and, to a lesser extent, by select independent dealers in the United States in the sale of new and used automobiles, light trucks and passenger vans. Through our automobile contract purchases, we provide indirect financing to sub-prime customers of dealers. We serve as an alternative source of financing for dealers, facilitating sales to customers who otherwise might not be able to obtain financing from traditional sources, such as commercial banks, credit unions and the captive finance companies affiliated with major automobile manufacturers. In addition to purchasing installment purchase contracts directly from dealers, we have also (i) acquired installment purchase contracts in three merger and acquisition transactions, (ii) purchased immaterial amounts of vehicle purchase money loans from non-affiliated lenders, and (iii) lent money directly to consumers for an immaterial amount of vehicle purchase money loans. In this report, we refer to all of such contracts and loans as "automobile contracts."

We were incorporated and began our operations in March 1991. From inception through September 30, 2010, we have purchased a total of approximately \$8.8 billion of automobile contracts from dealers. In addition, we obtained a total of approximately \$605.0 million of automobile contracts in mergers and acquisitions we made in 2002, 2003 and 2004. Since January 2008, our managed portfolio has been decreasing. From January 2008 through September 2009 our strategy was to reduce contract purchases to conserve our liquidity in response to adverse economic conditions as discussed further below. Since October 2009, we have been gradually increasing our new contract purchases with funding from two contract financing facilities established in September 2009 and March 2010 and as further described below. Our total managed portfolio was approximately \$843.0 million at September 30, 2010 compared to \$1,197.3 million at September 30, 2009.

We are headquartered in Irvine, California, where most operational and administrative functions are centralized. All credit and underwriting functions are performed in our California headquarters, and we service our automobile contracts from our California headquarters and from three servicing branches in Virginia, Florida and Illinois.

We purchase contracts in our own name ("CPS") and, until July 2008, also in the name of our wholly-owned subsidiary, TFC. Programs marketed under the CPS name are intended to serve a wide range of sub-prime customers, primarily through franchised new car dealers. Our TFC program served vehicle purchasers enlisted in the U.S. Armed Forces, primarily through independent used car dealers. In July 2008, we suspended contract purchases under our TFC program. We purchase automobile contracts with the intention of financing them on a long-term basis through securitizations. Securitizations are transactions in which we sell a specified pool of contracts to a special purpose entity of ours, which in turn issues asset-backed securities to fund the purchase of the pool of contracts from us.

### Securitization and Warehouse Credit Facilities

Throughout the period for which information is presented in this report, we have purchased automobile contracts with the intention of financing them on a long-term basis through securitizations, and on an interim basis through warehouse credit facilities. All such financings have involved identification of specific automobile contracts, sale of those automobile contracts (and associated rights) to one of our special-purpose subsidiaries, and issuance of asset-backed securities to fund the transactions. Depending on the structure, these transactions may properly be accounted for under generally accepted accounting principles as sales of the automobile contracts or as secured



financings.

When structured to be treated as a secured financing for accounting purposes, the subsidiary is consolidated with us. Accordingly, the sold automobile contracts and the related debt appear as assets and liabilities, respectively, on our consolidated balance sheet. We then periodically (i) recognize interest and fee income on the contracts, (ii) recognize interest expense on the securities issued in the transaction and (iii) record as expense a provision for credit losses on the contracts.

Since the third quarter of 2003, we have conducted 25 term securitizations. Of these 25, 19 were periodic (generally quarterly) securitizations of automobile contracts that we purchased from automobile dealers under our regular programs. Three of the 19 securitizations included contracts from either our acquired portfolios, our subsidiary TFC that served vehicle purchasers enlisted in the U.S. Armed Forces, or contracts that we repurchased from prior securitizations. In addition, in March 2004 and November 2005, we completed securitizations of our retained interests in other securitizations that we and our affiliates previously sponsored. The debt from the March 2004 transaction was repaid in August 2005, and the debt from the November 2005 transaction was repaid in May 2007. In September 2010, we completed a securitization (2010-A) where the underlying receivables were originally securitized in our September 2008 securitization. The 2010-A bonds were issued at a lower weighted average coupon than the original 2008 securitization and the proceeds were used to retire the bonds of the original September 2008 securitization. Since July 2003 all of our securitizations have been structured as secured financings, except our September 2008 and September 2010 securitizations. Each of those transactions were in substance a sale of the underlying receivables and are treated as sales for financial accounting purposes.

#### Uncertainty of Capital Markets and General Economic Conditions

Historically, we have depended upon the availability of warehouse credit facilities and access to long-term financing through the issuance of asset-backed securities collateralized by our automobile contracts. Since 1994, we have completed 50 term securitizations of approximately \$6.7 billion in contracts. We conducted four term securitizations in 2006, four in 2007, two 2008 and one in 2010. From July 2003 through April 2008 all of our securitizations were structured as secured financings. The second of our two securitization transactions in 2008 (completed in September 2008) and our most recent securitization in September 2010 were in substance a sale of the related contracts, and are treated as sales for financial accounting purposes.

Since the fourth quarter of 2007 through the end of 2009, we observed unprecedented adverse changes in the market for securitized pools of automobile contracts. These changes included reduced liquidity, and reduced demand for asset-backed securities, particularly for securities carrying a financial guaranty and for securities backed by sub-prime automobile receivables. Moreover, many of the firms that previously provided financial guarantees, which were an integral part of our securitizations, are no longer offering such guarantees. The adverse changes that took place in the market from the fourth quarter of 2007 through the end of 2009 caused us to conserve liquidity by significantly reducing our purchases of automobile contracts. Since October 2009, we have gradually increased our contract purchases by utilizing one \$50 million credit facility and another \$50 million term funding facility but we have no immediate plans to complete a term securitization with our recently purchased contracts. In September 2010, however, we took advantage of the more recent improvement in the market for asset-backed securities by re-securitizing the underlying receivables from our unrated September 2008 securitization. By doing so we were able to pay off the bonds associated with the September 2008 transaction and issue rated bonds with a significantly lower weighted average coupon. The September 2010 transaction was our first rated term securitization since 1993 that did not utilize a financial guaranty. Nevertheless, if the trend of improvement in the markets for asset-backed securities should reverse, or if we are unable to obtain additional contract financing facilities or complete a term securitization of our recently originated receivables, we may curtail further or cease our purchases of new automobile contracts, which could lead to a material adverse effect on our operations.

The downturn in economic conditions and the capital markets that began in the fourth quarter of 2007 have negatively affected many aspects of our industry. First, throughout 2008 and 2009 there was reduced demand for asset-backed securities secured by consumer finance receivables, including sub-prime automobile receivables, as compared to 2007 and earlier. During 2010, however, we have observed that yield requirements for investors that purchase securities backed by consumer finance receivables, including sub-prime automobile receivables, are approaching pre-2008 levels, albeit with significantly fewer transactions in the market. Second, there are fewer lenders who provide short term warehouse financing for sub-prime automobile finance companies due to more uncertainty regarding the

prospects of obtaining long-term financing through the issuance of asset-backed securities that before 2008. In addition, many capital market participants such as investment banks, financial guaranty providers and institutional investors who previously

played a role in the sub-prime auto finance industry have withdrawn from the industry, or in some cases, have ceased to do business. Finally, broad economic weakness and increasing unemployment in 2008 and 2009 made many of our customers less willing or able to pay, resulting in higher delinquency, charge-offs and losses. Each of these factors has adversely affected our results of operations. Should existing economic conditions worsen, both our ability to purchase new contracts and the performance of our existing managed portfolio may be impaired, which, in turn, could have a further material adverse effect on our results of operations.

#### Financial Covenants

Certain of our securitization transactions and our warehouse credit facility contain various financial covenants requiring certain minimum financial ratios and results. Such covenants include maintaining minimum levels of liquidity and net worth and not exceeding maximum leverage levels and maximum financial losses. In addition, certain securitization and non-securitization related debt contain cross-default provisions that would allow certain creditors to declare a default if a default occurred under a different facility.

The agreements under which we receive periodic fees for servicing automobile contracts in securitizations are terminable by the respective financial guaranty insurance companies (also referred to as note insurers) upon defined events of default, and, in some cases, at the will of the insurance company. In August 2010, we agreed with the note insurer for eight of our twelve currently outstanding securitizations to amend the applicable agreements to remove the financial covenants that were contained in three of the related agreements. In return for such amendments, we agreed to increase the required credit enhancement amounts in those three deals through increased spread account requirements. The remaining four transactions insured by this particular note insurer do not contain financial covenants.

For the remaining four securitizations insured by different parties we have been receiving waivers for certain financial and operating covenants on a monthly and/or quarterly basis as summarized below:

| Financial covenant           | Applicable Standard                 | Status Requiring Waiver(as of or for the quarter ended September 30, 2010) |
|------------------------------|-------------------------------------|--|
| Warehouse financing capacity | \$200 million of warehouse capacity | \$50 million of warehouse capacity   |
| Adjusted net worth (I)       | \$87.6 million                      | \$16.1 million   |
| Leverage                     | Not greater than 4.5:1              | 7.1:1  |
| Adjusted net worth (II)      | \$95.3 million                      | \$16.1 million   |

The covenant regarding warehouse financing capacity is a covenant to maintain one or more credit facilities that allow us to finance acquisition of automobile contracts on a revolving basis, with a minimum aggregate capacity of \$200 million. The adjusted net worth covenants are covenants to maintain minimum levels of adjusted net worth, defined as our consolidated book value under GAAP with the exclusion of intangible assets such as goodwill. There are two separate adjusted net worth covenants because there are two separate note insurers that have this covenant in their related securitizations agreements. The leverage covenant requires that we not exceed the specified ratio of debt over the defined adjusted net worth. Debt is defined in this covenant to mean consolidated liabilities less warehouse lines of credit and securitization trust debt; using this definition at September 30, 2010, we had debt of \$113.4 million.

Without the waivers we have received from the related note insurers, we would have been in violation of covenants relating to minimum net worth, maximum financial losses, maximum leverage levels and maintenance of active warehouse facilities with respect to four of our 12 currently outstanding securitization



transactions. Upon such an event of default, and subject to the right of the related note insurers to waive such terms, the agreements governing the securitizations call for payment of a default insurance premium, ranging from 25 to 100 basis points per annum on the aggregate outstanding balance of the related insured senior notes, and for the diversion of all excess cash generated by the assets of the respective securitization pools into the related spread accounts to increase the credit enhancement associated with those transactions. The cash so diverted into the spread accounts would otherwise be used to make principal payments on the subordinated notes in each related securitization or would be released to us. As of the date of this report, cash is being diverted to the related spread accounts in seven transactions. In addition, upon an event of default, the note insurers have the right to terminate us as servicer. Although our termination as servicer has been waived, we are paying default premiums, or their equivalent, with respect to insured notes representing \$402.5 million of the \$632.8 million of securitization trust debt outstanding at September 30, 2010. It should be noted that the principal amount of such securitization trust debt is not increased, but that the increased insurance premium is reflected as increased interest expense. Furthermore, such waivers are temporary, and there can be no assurance as to their future extension. We do, however, believe that we will obtain such future extensions of our servicing agreements because it is generally not in the interest of any party to the securitization transaction to transfer servicing. Nevertheless, there can be no assurance as to our belief being correct. Were an insurance company in the future to exercise its option to terminate such agreements or to pursue other remedies, such remedies could have a material adverse effect on our liquidity and results of operations, depending on the number and value of the affected transactions. Our note insurers continue to extend our term as servicer on a monthly and/or quarterly basis, pursuant to the servicing agreements.

## Results of Operations

### Comparison of Operating Results for the three months ended September 30, 2010 with the three months ended September 30, 2009

**Revenues.** During the three months ended September 30, 2010, revenues were \$36.8 million, a decrease of \$16.0 million, or 30.3%, from the prior year revenue of \$52.8 million. The primary reason for the decrease in revenues is a decrease in interest income. Interest income for the three months ended September 30, 2010 decreased \$16.4 million, or 33.2%, to \$32.9 million from \$49.3 million in the prior year. The primary reason for the decrease in interest income is the decrease in finance receivables held by consolidated subsidiaries. In September 2010 we took advantage of the more recent improvement in the market for asset-backed securities by re-securitizing the underlying receivables from our unrated September 2008 securitization. By doing so we were able to pay off the bonds associated with the September 2008 securitization including a senior bond that we owned since inception of that transaction. We recorded interest income on that senior bond of \$32,000 and \$84,000 during the three months ended September 30, 2010 and 2009, respectively. We hold a residual interest in the September 2010 securitization that is similar to the structure and economics of the original 2008 securitization.

**Servicing fees** totaling \$1.8 million in the three months ended September 30, 2010 increased \$929,000, or 110.7%, from \$839,000 in the prior year. The increase in servicing fees is the result of our appointment in November 2009 as a third-party servicer for a \$147 million portfolio of sub-prime automobile receivables owned by a bankruptcy remote subsidiary of CompuCredit Corporation. We also earned base servicing fees on our September 2008 term securitization transaction (which is treated as a sale for financial accounting purposes) and a portfolio which we have serviced for SeaWest Financial Corporation since April 2004, which has declined to an immaterial amount as of September 30, 2010. As of September 30, 2010 and 2009, our managed portfolio owned by consolidated vs. non-consolidated subsidiaries and other third parties was as follows:



|  | September 30, 2010 |       |   | September 30, 2009 |       |   |
|--|--------------------|-------|---|--------------------|-------|---|
|  | Amount             | %     |   | Amount             | %     |   |
|  | (\$ in millions)   |       |   |                    |       |   |
| Total Managed Portfolio                |                    |       |   |                    |       |   |
| Owned by Consolidated Subsidiaries     | \$ 657.6           | 78.0  | % | \$ 1,049.3         | 87.6  | % |
| Owned by Non-Consolidated Subsidiaries | 95.8               | 11.4  | % | 148.0              | 12.4  | % |
| Third Party Portfolio                  | 89.6               | 10.6  | % | -                  | 0.0   | % |
| Total                                  | \$ 843.0           | 100.0 | % | \$ 1,197.3         | 100.0 | % |

At September 30, 2010, we were generating income and fees on a managed portfolio with an outstanding principal balance of \$843.0 million (this amount includes \$95.8 million of automobile contracts on which we earn servicing fees and a residual interest and also includes another \$89.6 million of automobile contracts on which we earn servicing fees and own a note collateralized by such contracts), compared to a managed portfolio with an outstanding principal balance of \$1,197.3 million as of September 30, 2009. At September 30, 2010 and 2009, the managed portfolio composition was as follows:

|                       | September 30, 2010 |       |   | September 30, 2009 |       |   |
|-----------------------|--------------------|-------|---|--------------------|-------|---|
|                       | Amount             | %     |   | Amount             | %     |   |
|                       | (\$ in millions)   |       |   |                    |       |   |
| Originating Entity    |                    |       |   |                    |       |   |
| CPS                   | \$741.6            | 88.0  | % | \$1,169.4          | 97.7  | % |
| TFC                   | 11.8               | 1.4   | % | 27.9               | 2.3   | % |
| MFN                   | -                  | 0.0   | % | -                  | 0.0   | % |
| SeaWest               | -                  | 0.0   | % | -                  | 0.0   | % |
| Third Party Portfolio | 89.6               | 10.6  | % | -                  | 0.0   | % |
| Total                 | \$843.0            | 100.0 | % | \$1,197.3          | 100.0 | % |

Other income decreased by \$557,000, or 20.9%, to \$2.1 million in the three months ended September 30, 2010 from \$2.7 million during the prior year. Other income consists primarily of sales tax refunds, convenience fees charged to our borrowers for certain electronic payments, fees paid to us by dealers for lead generation and certain direct mail products that we offer, and recoveries on portfolios that we previously acquired through acquisitions. In the current period, each category of other income decreased somewhat from the prior year's period.

Expenses. Our operating expenses consist largely of provision for credit losses, interest expense, employee costs and general and administrative expenses. Provision for credit losses and interest expense are significantly affected by the volume of automobile contracts we purchased during a period and by the outstanding balance of finance receivables held by consolidated subsidiaries. Employee costs and general and administrative expenses are incurred as applications and automobile contracts are received, processed and serviced. Factors that affect margins and net income (loss) include changes in the automobile and automobile finance market environments, and macroeconomic factors such as interest rates and the unemployment level.

Employee costs include base salaries, commissions and bonuses paid to employees, and certain expenses related to the accounting treatment of outstanding stock options, and are one of our most significant operating expenses. These costs (other than those relating to stock options) generally fluctuate with the level of applications and automobile contracts processed and serviced.

Other operating expenses consist largely of facilities expenses, telephone and other communication services, credit services, computer services, marketing and advertising expenses, and depreciation and amortization.



Total operating expenses were \$40.3 million for the three months ended September 30, 2010, compared to \$57.1 million for the prior year, a decrease of \$16.8 million, or 29.5%. The decrease is primarily due to the continued decline in the balance of our outstanding managed portfolio and the related costs to service it.

Employee costs decreased by \$623,000, or 7.6%, to \$7.6 million during the three months ended September 30, 2010, representing 18.9% of total operating expenses, from \$8.2 million for the prior year, or 14.4% of total

operating expenses. Since January 2008, we have reduced staff through attrition and reductions in force as a result of the uncertainty in capital markets and the related limited access to financing for new contract purchases. At September 30, 2010 we had 435 employees compared to 489 employees at September 30, 2009.

General and administrative expenses include costs associated with purchasing and servicing our portfolio of finance receivables, including expenses for facilities, credit services, and telecommunications. General and administrative expenses were \$3.6 million, a decrease of 35.5%, compared to the previous year and represented 8.9% of total operating expenses.

Interest expense for the three months ended September 30, 2010 decreased \$6.1 million, or 23.4%, to \$20.1 million, compared to \$26.2 million in the previous year. The decrease is primarily the result of changes in the amount and composition of debt carried on our consolidated balance sheet. Interest on securitization trust debt decreased by \$7.8 million in the three months ended September 30, 2010 compared to the prior year. For the current period, interest on securitization trust debt includes \$723,000 in interest expense on our \$50 million term funding facility that was established in March 2010 and had an outstanding balance of \$31.7 million at September 30, 2010. Interest expense on senior secured and subordinated debt increased by \$406,000, and interest expense on residual interest financing decreased \$221,000 in the three months ended September 30, 2010 compared to the prior year. Interest expense on warehouse debt increased by \$1.5 million for the three months ended September 30, 2010 compared to the prior year as a result of our increased contract purchases in 2010. We have increased our borrowings on the \$50 million credit facility established in September 2009 to provide funding for these purchases. As of September 30, 2010, it had an outstanding balance of \$39.7 million. In the prior period, we had just established the \$50 million credit facility which had an outstanding balance equal to \$5.2 million as of September 30, 2009.

Provision for credit losses was \$7.0 million for the three months ended September 30, 2010, a decrease of \$8.2 million, or 53.9% compared to the prior year and represented 17.5% of total operating expenses. The provision for credit losses maintains the allowance for loan losses at levels that we feel are adequate for probable credit losses that can be reasonably estimated. The decrease in provision expense is the result of the decrease in the size and the increase in the average age of the portfolio owned by our consolidated subsidiaries. Although losses and provision expense have decreased in the current period compared to the prior year, the annualized net charge offs as a percentage of the average servicing portfolio have remained fairly constant due to the decreasing size of the portfolio.

Marketing expenses consist primarily of commission-based compensation paid to our employee marketing representatives. Our marketing representatives earn a salary plus commissions based on our volume of contract purchases and sales of training programs, lead sales, and direct mail products that we offer our dealers. Marketing expenses increased by \$172,000, or 19.2%, to \$1.1 million, compared to \$896,000 in the previous year, and represented 2.7% of total operating expenses. As a result of our \$50 million term funding facility and our \$50 million credit facility we were able to purchase 2,359 contracts representing \$35.2 million in principal balances in the current period compared to 37 contracts representing \$506,000 in principal balances in the prior year.

Occupancy expenses decreased by \$62,000 or 7.5%, to \$763,000 compared to \$825,000 in the previous year and represented 2.0% of total operating expenses.

Depreciation and amortization expenses decreased by \$2,000 or 1.1%, to \$180,000 compared to \$182,000 in the previous year and represented 1.3% of total operating expenses.

For the three months ended September 30, 2010, we recorded no net tax benefit and added \$1.0 million to the valuation allowance for our deferred tax assets. As of September 30, 2010, our net deferred tax asset of \$28.9 million is net of a valuation allowance of \$38.0 million. We have considered the circumstances that may affect the ultimate realization of our deferred tax assets and have concluded that the valuation allowance is appropriate at this

time. However, if future events change our expected realization of our deferred tax assets, we may be required to increase the valuation allowance against that asset in the future.

# Comparison of Operating Results for the nine months ended September 30, 2010 with the nine months ended September 30, 2009

**Revenues.** During the nine months ended September 30, 2010, revenues were \$119.9 million, a decrease of \$57.3 million, or 32.3%, from the prior year revenue of \$177.2 million. The primary reason for the decrease in revenues is a decrease in interest income. Interest income for the nine months ended September 30, 2010 decreased \$58.4 million, or 35.3%, to \$107.1 million from \$165.5 million in the prior year. The primary reason for the decrease in interest income is the decrease in finance receivables held by consolidated subsidiaries. In September 2010 we took advantage of the more recent improvement in the market for asset-backed securities by re-securitizing the underlying receivables from our unrated September 2008 securitization. By doing so we were able to pay off the bonds associated with the September 2008 securitization including a senior bond that we owned since inception of that transaction. We recorded interest income on that senior bond of \$149,000 and \$289,000 during the three months ended September 30, 2010 and 2009, respectively. We hold a residual interest in the September 2010 securitization that is similar to the structure and economics of the original 2008 securitization.

**Servicing fees** totaling \$6.1 million in the nine months ended September 30, 2010 increased \$3.3 million, or 117.6%, from \$2.8 million in the prior year. The increase in servicing fees is the result of our appointment in November 2009 as a third-party servicer for a \$147 million portfolio of sub-prime automobile receivables owned by a bankruptcy remote subsidiary of CompuCredit Corporation. We also earned base servicing fees on our September 2008 term securitization transaction (which is treated as a sale for financial accounting purposes) and a portfolio which we have serviced for SeaWest Financial Corporation since April 2004, which has declined to an immaterial amount as of September 30, 2010. As of September 30, 2010 and 2009, our managed portfolio owned by consolidated vs. non-consolidated subsidiaries and other third parties was as follows:

|  | September 30, 2010 |              |          | September 30, 2009 |              |          |
|--|--------------------|--------------|----------|--------------------|--------------|----------|
|  | Amount             | %            |          | Amount             | %            |          |
| <b>Total Managed Portfolio</b>         | (\$ in millions)   |              |          |                    |              |          |
| Owned by Consolidated Subsidiaries     | \$ 657.6           | 78.0         | %        | \$ 1,049.3         | 87.6         | %        |
| Owned by Non-Consolidated Subsidiaries | 95.8               | 11.4         | %        | 148.0              | 12.4         | %        |
| Third Party Portfolio                  | 89.6               | 10.6         | %        | -                  | 0.0          | %        |
| <b>Total</b>                           | <b>\$ 843.0</b>    | <b>100.0</b> | <b>%</b> | <b>\$ 1,197.3</b>  | <b>100.0</b> | <b>%</b> |

At September 30, 2010, we were generating income and fees on a managed portfolio with an outstanding principal balance of \$843.0 million (this amount includes \$95.8 million of automobile contracts on which we earn servicing fees and own a residual interest and another \$89.6 million of automobile contracts on which we earn servicing fees and own a note collateralized by such contracts), compared to a managed portfolio with an outstanding principal balance of \$1,197.3 million as of September 30, 2009. At September 30, 2010 and 2009, the managed portfolio composition was as follows:

|                           | September 30, 2010 |      |   | September 30, 2009 |      |   |
|---------------------------|--------------------|------|---|--------------------|------|---|
|                           | Amount             | %    |   | Amount             | %    |   |
| <b>Originating Entity</b> | (\$ in millions)   |      |   |                    |      |   |
| CPS                       | \$ 741.6           | 88.0 | % | \$ 1,169.4         | 97.7 | % |
| TFC                       | 11.8               | 1.4  | % | 27.9               | 2.3  | % |
| MFN                       | -                  | 0.0  | % | -                  | 0.0  | % |
| SeaWest                   | -                  | 0.0  | % | -                  | 0.0  | % |
| Third Party Portfolio     | 89.6               | 10.6 | % | -                  | 0.0  | % |

|       |    |       |       |   |    |         |       |   |
|-------|----|-------|-------|---|----|---------|-------|---|
| Total | \$ | 843.0 | 100.0 | % | \$ | 1,197.3 | 100.0 | % |
|-------|----|-------|-------|---|----|---------|-------|---|

Other income decreased by \$2.2 million, or 24.6%, to \$6.7 million in the nine months ended September 30, 2010 from \$8.9 million during the prior year. Other income consists primarily of sales tax refunds, convenience fees charged to our borrowers for certain electronic payments, fees paid to us by dealers for lead generation and certain direct mail products that we offer, and recoveries on portfolios that we previously acquired through acquisitions. In the current period, each category of other income decreased somewhat from the prior year's period, other than sales tax refunds, which were greater in the current period.

**Expenses.** Our operating expenses consist largely of provision for credit losses, interest expense, employee costs and general and administrative expenses. Provision for credit losses and interest expense are significantly affected by the volume of automobile contracts we purchased during a period and by the outstanding balance of finance receivables held by consolidated subsidiaries. Employee costs and general and administrative expenses are incurred as applications and automobile contracts are received, processed and serviced. Factors that affect margins and net income (loss) include changes in the automobile and automobile finance market environments, and macroeconomic factors such as interest rates and the unemployment level.

Employee costs include base salaries, commissions and bonuses paid to employees, and certain expenses related to the accounting treatment of outstanding stock options, and are one of our most significant operating expenses. These costs (other than those relating to stock options) generally fluctuate with the level of applications and automobile contracts processed and serviced.

Other operating expenses consist largely of facilities expenses, telephone and other communication services, credit services, computer services, marketing and advertising expenses, and depreciation and amortization.

Total operating expenses were \$134.6 million for the nine months ended September 30, 2010, compared to \$188.0 million for the prior year, a decrease of \$53.4 million, or 28.4%. The decrease is primarily due to the continued decline in the balance of our outstanding managed portfolio and the related costs to service it.

Employee costs decreased by \$1.4 million, or 5.3%, to \$25.1 million during the nine months ended September 30, 2010, representing 18.6% of total operating expenses, from \$26.5 million for the prior year, or 14.1% of total operating expenses. Since January 2008, we have reduced staff through attrition and reductions in force as a result of the uncertainty in capital markets and the related limited access to financing for new contract purchases. At September 30, 2010 we had 435 employees compared to 489 employees at September 30, 2009.

General and administrative expenses include costs associated with purchasing and servicing our portfolio of finance receivables, including expenses for facilities, credit services, and telecommunications. General and administrative expenses were \$15.0million, a decrease of 16.5%, compared to the previous year and represented 11.2% of total operating expenses.

Interest expense for the nine months ended September 30, 2010 decreased \$23.9 million, or 27.4%, to \$63.4 million, compared to \$87.3 million in the previous year. The decrease is primarily the result of changes in the amount and composition of debt carried on our consolidated balance sheet. Interest on securitization trust debt decreased by \$26.4 million in the nine months ended September 30, 2010 compared to the prior year. For the current period, interest on securitization trust debt includes \$1.1 million in interest expense on our \$50 million term funding facility that was established in March 2010 and had an outstanding balance of \$31.7 million at September 30, 2010. Interest expense on senior secured and subordinated debt increased by \$695,000, and interest expense on residual interest financing decreased \$1.0 million in the nine months ended September 30, 2010 compared to the prior year. Interest expense on warehouse debt increased by \$2.8 million for the nine months ended September 30, 2010 compared to the prior year as a result of our increased contract purchases in 2010. We have increased our borrowings on the \$50 million credit facility established in September 2009 to provide funding for these purchases. As of September 30, 2010, it had an outstanding balance of \$39.7 million. In the prior period, we had just established the \$50 million credit facility which

had an outstanding balance equal to \$5.2 million as of September 30, 2009.

Provision for credit losses was \$25.7 million for the nine months ended September 30, 2010, a decrease of \$24.1 million, or 48.3% compared to the prior year and represented 19.1% of total operating expenses. The provision for credit losses maintains the allowance for loan losses at levels that we feel are adequate for probable credit losses that can be reasonably estimated. The decrease in provision expense is the result of the

decrease in the size and the increase in the average age of the portfolio owned by our consolidated subsidiaries. Although losses and provision expense have decreased in the current period compared to the prior year, the annualized net charge offs as a percentage of the average servicing portfolio have remained fairly constant due to the decreasing size of the portfolio.

Marketing expenses consist primarily of commission-based compensation paid to our employee marketing representatives. Our marketing representatives earn a salary plus commissions based on our volume of contract purchases and sales of training programs, lead sales, and direct mail products that we offer our dealers. Marketing expenses decreased by \$402,000, or 13.5%, to \$2.6 million, compared to \$3.0 million in the previous year, and represented 1.9% of total operating expenses.

Occupancy expenses decreased by \$556,000 or 19.4%, to \$2.3 million compared to \$2.9 million in the previous year and represented 1.7% of total operating expenses.

Depreciation and amortization expenses decreased \$48,000, or 9.1%, to \$478,000 from \$526,000 in the previous year.

For the nine months ended September 30, 2010, we recorded no net tax benefit and added \$4.6 million to the valuation allowance for our deferred tax assets. As of September 30, 2010, our net deferred tax asset of \$28.9 million is net of a valuation allowance of \$38.0 million. We have considered the circumstances that may affect the ultimate realization of our deferred tax assets and have concluded that the valuation allowance is appropriate at this time. However, if future events change our expected realization of our deferred tax assets, we may be required to increase the valuation allowance against that asset in the future.

#### Credit Experience

Our financial results are dependent on the performance of the automobile contracts in which we retain an ownership interest. The table below documents the delinquency, repossession and net credit loss experience of all automobile contracts that we were servicing as of the respective dates shown. Credit experience for CPS and TFC program receivables and receivables acquired in acquisitions is shown on a combined basis in the table below. The table does not include the experience of third-party servicing portfolios. While the broad economic weakness and increasing unemployment over the last several years has resulted in higher delinquencies and net charge-offs, the increase in the percentage levels for 2010 and 2009 from previous years is also partially attributable to the decrease in the size and the increase in the average age of our managed portfolio.



Delinquency Experience (1)  
CPS, TFC and Acquired Portfolios

|   | September 30, 2010     |            | September 30, 2009 |              | December 31, 2009 |              |
|---|------------------------|------------|--------------------|--------------|-------------------|--------------|
|   | Number of              |            | Number of          |              | Number of         |              |
|   | Contracts              | Amount     | Contracts          | Amount       | Contracts         | Amount       |
|   | (Dollars in thousands) |            |                    |              |                   |              |
| Delinquency Experience  |                        |            |                    |              |                   |              |
| Gross servicing portfolio (1)   | 90,181                 | \$ 753,499 | 119,721            | \$ 1,197,706 | 111,105           | \$ 1,057,348 |
| Period of delinquency (2)   |                        |            |                    |              |                   |              |
| 31-60 days  | 3,113                  | 22,684     | 3,266              | 30,347       | 2,787             | 24,628       |
| 61-90 days  | 1,647                  | 12,788     | 2,102              | 20,860       | 1,824             | 16,840       |
| 91+ days  | 1,146                  | 8,988      | 1,754              | 18,301       | 1,205             | 10,358       |
| Total delinquencies (2)   | 5,906                  | 44,460     | 7,122              | 69,508       | 5,816             | 51,826       |
| Amount in repossession (3)  | 2,627                  | 20,626     | 4,062              | 36,204       | 4,305             | 40,815       |
| Total delinquencies and amount in repossession (2)  | 8,533                  | \$ 65,086  | 11,184             | \$ 105,712   | 10,121            | \$ 92,641    |
| Delinquencies as a percentage of gross servicing portfolio                                  | 6.5%                   | 5.9%       | 5.9%               | 5.8%         | 5.2%              | 4.9%         |
| Total delinquencies and amount in repossession as a percentage of gross servicing portfolio | 9.5%                   | 8.6%       | 9.3%               | 8.8%         | 9.1%              | 8.8%         |

(1) All amounts and percentages are based on the amount remaining to be repaid on each automobile contract, including, for pre-computed automobile contracts, any unearned interest. The information in the table represents the gross principal amount of all automobile contracts purchased by us, including automobile contracts subsequently sold by us in securitization transactions that we continue to service.

(2) We consider an automobile contract delinquent when an obligor fails to make at least 90% of a contractually due payment by the following due date, which date may have been extended within limits specified in the Servicing Agreements. The period of delinquency is based on the number of days payments are contractually past due. Automobile contracts less than 31 days delinquent are not included.

(3) Amount in repossession represents financed vehicles that have been repossessed but not yet liquidated.

Net Charge-Off Experience (1)  
CPS, TFC and SeaWest Combined

|  | September 30,<br>2010  | September 30,<br>2009 | December 31,<br>2009 |
|--|------------------------|-----------------------|----------------------|
|  | (Dollars in thousands) |                       |                      |
| Average servicing portfolio outstanding  | \$ 868,961             | 1,390,959             | \$ 1,319,106         |
| Annualized net charge-offs as a percentage of<br>average servicing portfolio (2) | 9.7%                   | 10.4%                 | 11.0%                |

(1) All amounts and percentages are based on the principal amount scheduled to be paid on each automobile contract, net of unearned income on pre-computed automobile contracts.

(2) Net charge-offs include the remaining principal balance, after the application of the net proceeds from the liquidation of the vehicle (excluding accrued and unpaid interest) and amounts collected subsequent to the date of charge-off, including some recoveries which have been classified as other income in the accompanying interim financial statements. September 30, 2010 and September 30, 2009 percentage represents nine months ended September 30, 2010 and September 30, 2009 annualized. December 31, 2009 represents 12 months ended December 31, 2009.

## Liquidity and Capital Resources

Our business requires substantial cash to support our purchases of automobile contracts and other operating activities. Our primary sources of cash have been cash flows from operating activities, including proceeds from term securitization transactions and other sales of automobile contracts, amounts borrowed under various revolving credit facilities (also sometimes known as warehouse credit facilities), servicing fees on portfolios of automobile contracts previously sold in securitization transactions or serviced for third parties, customer payments of principal and interest on finance receivables, fees for origination of automobile contracts, and releases of cash from securitized pools of automobile contracts in which we have retained a residual ownership interest and from the spread account associated with such pools. Our primary uses of cash have been the purchases of automobile contracts, repayment of amounts borrowed under lines of credit and otherwise, operating expenses such as employee, interest, occupancy expenses and other general and administrative expenses, the establishment of spread account and initial overcollateralization, if any, and the increase of credit enhancement to required levels in securitization transactions, and income taxes. There can be no assurance that internally generated cash will be sufficient to meet our cash demands. The sufficiency of internally generated cash will depend on the performance of securitized pools (which determines the level of releases from those pools and their related spread accounts), the rate of expansion or contraction in our managed portfolio, and the terms upon which we are able to acquire, sell, and borrow against automobile contracts.

Net cash provided by operating activities for the nine-month period ended September 30, 2010 was \$40.6 million compared to net cash provided by operating activities for the nine-month period ended September 30, 2009 of \$78.0 million.

Net cash provided by investing activities for the nine-month period ended September 30, 2010 was \$218.4 million compared to net cash provided by investing activities of \$340.0 million in the prior year period. Cash provided by investing activities primarily results from principal payments and other proceeds received on finance receivables held for investment. Cash used in investing activities generally relates to purchases of automobile contracts. Purchases of finance receivables held for investment were \$79.4 million and \$2.5 million during the first nine months of 2010 and 2009, respectively. The significant decrease in contract purchases in the 2010 and 2009 periods compared to prior periods, together with the receipt of significant proceeds from finance receivables held for investment resulted in net cash provided by investing activities. In prior years new contract purchases were significantly higher, which resulted in net cash being used by investing activities for those periods.

Net cash used by financing activities for the three months ended September 30, 2010 was \$260.1 million compared to net cash used by financing activities of \$419.7 million in the prior year period. Cash used by financing activities is generally related to the repayment of securitization trust debt, reduced by the amount of all new issuances of securitization trust debt. We repaid \$308.3 million in securitization trust debt in the nine months ended September 30, 2010 compared to \$400.8 million in the prior year period.

We purchase automobile contracts from dealers for a cash price approximately equal to the principal amount of the contract, reduced by an acquisition fee. Those automobile contracts generate cash flow, however, over a period of years. As a result, we have been dependent on warehouse credit facilities to purchase automobile contracts, and on the availability of cash from outside sources in order to finance our continuing operations, as well as to fund the portion of automobile contract purchase prices not financed under revolving warehouse credit facilities. From December 2008 until September 2009 we had no available funding facilities and reduced our volume of contract purchases to nominal levels. In September 2009, we entered into a \$50 million, two-year revolving credit agreement with Fortress Credit Corp. ("Fortress"). In March 2010, we entered into a \$50 million term funding facility with a syndicate of note purchasers including affiliates of Angelo, Gordon & Co., L.P. and an affiliate of Cohen & Company Securities.



The Fortress agreement allows advances to us of up to 75% of the principal balance of eligible collateral (automobile receivables) that we now hold or may purchase in the future from dealers. Advances bear interest at a floating rate equal to one-month LIBOR plus 12.00%, but in all events no less than 14.00% per year. As part of the consideration given to Fortress for committing to make loans under this facility, we issued a 10-year warrant to purchase up to 1,158,087 of our common shares, at an exercise price of \$0.879 per share (we refer to this as the Fortress Warrant). Issuance of the Fortress Warrant required an adjustment to the terms of an existing outstanding warrant regarding 1,564,324 shares, reducing the exercise price of that other warrant from \$1.44 per share to \$1.407 per share and increasing the number of shares available for purchase to 1,600,991. As of September 30, 2010 there was \$39.7 million outstanding under the Fortress facility.

Under the term funding facility, the note purchasers have agreed to purchase up to \$50 million in asset-backed notes, subject to collateral eligibility and other terms and conditions, through the end of 2010. Amounts outstanding bear interest at a fixed rate of 11.00%, which may be decreased to 9.00% should the notes receive investment grade ratings from at least two of the following three credit rating agencies: Moody's; Standard & Poor's; or Fitch. Principal payments on the notes are due as the underlying receivables are paid or charged off, and the final maturity is July 17, 2017. In connection with the establishment of this term funding facility, we paid a closing fee of \$750,000 and issued to certain of the note purchasers or their designees warrants to purchase 500,000 shares of our common stock at an exercise price of \$1.41 per share (we refer to this as the Page Five Warrant). Issuance of the Page Five Warrant required adjustments to the terms of two existing outstanding warrants. The first warrant related to 1,600,991 shares, on which the exercise price was decreased from \$1.407 per share to \$1.398 per share and the number of shares available for purchase were increased to 1,611,114. The second affected warrant related to 283,985 shares, which was increased to 285,781 shares. As of September 30, 2010, there was \$31.7 million outstanding under the note purchase agreement.

On July 10, 2008 we amended the terms of our then outstanding residual credit facility to establish an amortization schedule for principal reductions and providing for an extension, at our option if certain conditions were met, of the maturity from June 2009 to June 2010. In June 2009 we met all the conditions and extended the maturity of the term note. In May 2010, we extended the maturity date from June 2010 to May 2011. As of September 30, 2010 the aggregate indebtedness under this facility was \$44.3 million.

The acquisition of automobile contracts for subsequent sale in securitization transactions, and the need to fund spread accounts and initial overcollateralization, if any, and increase credit enhancement levels when those transactions take place, results in a continuing need for capital. The amount of capital required is most heavily dependent on the rate of our automobile contract purchases, the required level of initial credit enhancement in securitizations, and the extent to which the previously established trusts and their related spread accounts either release cash to us or capture cash from collections on securitized automobile contracts. Of those, the factor most subject to our control is the rate at which we purchase automobile contracts.

We are and may in the future be limited in our ability to purchase automobile contracts due to limits on our capital. As of September 30, 2010, we had unrestricted cash of \$11.3 million. We have \$10.3 million available under our Fortress facility, \$18.3 million available under the term funding facility (in both facilities subject to available eligible collateral) and no immediate plans to complete a securitization. Our plans to manage our liquidity include maintaining our rate of automobile contract purchases at a level that matches our available capital, and, wherever appropriate, reducing our operating costs. There can be no assurance that we will be able to obtain additional future funding facilities or to complete securitizations on favorable economic terms or that we will be able to complete securitizations at all. If we are unable to complete such securitizations, we may be unable to increase our rate of automobile contract purchases, in which case our interest income and other portfolio related income would continue to decrease.

Our liquidity will also be affected by releases of cash from the trusts established with our securitizations. While the specific terms and mechanics of each spread account vary among transactions, our securitization agreements generally provide that we will receive excess cash flows, if any, only if the amount of credit enhancement has reached specified levels and/or the delinquency, defaults or net losses related to the automobile contracts in the pool are below certain predetermined levels. In the event delinquencies, defaults or net losses on the automobile contracts exceed such levels, the terms of the securitization: (i) may require increased credit enhancement to be accumulated for the particular pool; (ii) may restrict the distribution to us

of excess cash flows associated with other pools; or (iii) in certain circumstances, may permit the insurers to require the transfer of servicing on some or all of the automobile contracts to another servicer. There can be no assurance that collections from the related trusts will continue to generate sufficient cash. Moreover, most of our spread account balances are pledged as collateral to our residual interest financing. As such, most of the current releases of cash from our securitization trusts are directed to pay the obligations of our residual interest financing.

Certain of our securitization transactions and our warehouse credit facility contain various financial covenants requiring certain minimum financial ratios and results. Such covenants include maintaining minimum levels of liquidity and net worth and not exceeding maximum leverage levels and maximum financial losses. In addition, certain securitization and non-securitization related debt contain cross-default provisions that would allow certain creditors to declare a default if a default occurred under a different facility.

The agreements under which we receive periodic fees for servicing automobile contracts in securitizations are terminable by the respective note insurers upon defined events of default, and, in some cases, at the will of the insurer. We have received waivers regarding the potential breach of certain such covenants relating to minimum net worth, maximum financial losses, maximum leverage levels and maintenance of active warehouse credit facilities. Without such waivers, certain credit enhancement providers would have had the right to terminate us as servicer with respect to certain of our outstanding securitization pools. Although such rights have been waived, such waivers are temporary, and there can be no assurance as to their future extension. We do, however, believe that we will obtain such future extensions because it is generally not in the interest of any party to the securitization transaction to transfer servicing. Nevertheless, there can be no assurance as to our belief being correct. Were a note insurer in the future to exercise its option to terminate such agreements, such a termination could have a material adverse effect on our liquidity and results of operations, depending on the number and value of the terminated agreements. Our note insurers continue to extend our term as servicer on a monthly and/or quarterly basis, pursuant to the servicing agreements.

The agreements for our residual interest financing, revolving credit facility and term funding facility include financial covenants which, if breached, would be an event of default. We have entered into an amendment that avoided the potential breach of a minimum net worth covenant on the revolving credit facility. Without such amendment, the lender could have, among other things, ceased providing funding to us for new contract purchases, terminated us as servicer of the pledged receivables and sold the pledged contracts to satisfy the debt.

Our plan for future operations and meeting the obligations of our financing arrangements includes returning to profitability by gradually increasing the amount of our contract purchases with the goal of increasing the balance of our outstanding managed portfolio. Our plans also include financing future contract purchases with credit facilities and term securitizations that offer a lower overall cost of funds compared to our current facilities. To illustrate, in the last six months of 2009 we purchased \$6.1 million in contracts and our sole credit facility had a minimum interest rate of 14.00% per annum. By comparison, in the first nine months of 2010, we purchased \$79.4 million in contracts and entered into the \$50 million term funding facility which has an interest rate of 11.00% per annum and the ability to decrease such rate to 9.00% per annum if certain conditions are met. Moreover, the weighted average effective coupon of our September 2010 securitization was 3.21% and did not include a financial guaranty policy. This transaction demonstrates our ability to access the lower cost of funds available in the current market environment without the financial guaranties we historically incorporated into our term securitization structures. In addition, less competition in the auto financing marketplace has resulted in better terms for our recent contract purchases compared to prior years. For the first nine months of 2010 and the years ended December 31, 2009, 2008 and 2007, the average acquisition fee we charged per automobile contract purchased under our CPS programs was \$1,405, \$1,508, \$592 and \$209, respectively, or 9.5%, 11.7%, 3.9% and 1.4%, respectively, of the amount financed. Similarly, the weighted average annual percentage rate of interest payable by our customers on newly purchased contracts has increased significantly to 20.06% for the first nine months of 2010 from 19.9%, 18.5%, and 18.1% in 2009, 2008 and 2007, respectively.

We have and will continue to have a substantial amount of indebtedness. At September 30, 2010, we had approximately \$765.0 million of debt outstanding. Such debt consisted primarily of \$632.8 million of



securitization trust debt, and also included \$39.7 million in a warehouse line of credit, \$44.3 million of residual interest financing, \$27.0 million of senior secured related party debt and \$21.3 million in subordinated notes. Such notes have maturities that range from three months to 10 years.

Our recent operating results include net losses of \$57.2 million and \$26.1 million in 2009 and 2008, respectively. We believe that our results have been materially and adversely affected by the disruption in the capital markets that began in the fourth quarter of 2007, by the recession that began in December 2007, and by related high levels of unemployment. Our ability to repay or refinance maturing debt may be adversely affected by prospective lenders' consideration of our recent operating losses.

We filed a registration statement on Form S-2 with respect to our renewable unsecured subordinated notes on January 7, 2005 and subsequently filed amendments to such registration statement on April 13, May 2, and May 20, 2005 and April 11, 2006 (such registration statement, as so amended, the "Former Registration Statement"). We recently discovered that, under a rule of the SEC, we are no longer permitted to offer and sell our renewable unsecured subordinated notes in reliance on the Former Registration Statement. Consequently, purchasers who acquired such notes during the year ending September 30, 2010 may have a statutory right to rescind their purchases. As a result, we could be required to repurchase some or all of such notes at the original sale price plus statutory interest, less the amount of any income received by the purchasers. From October 1, 2009 to September 30, 2010, we sold a total of \$4.3million of notes, including renewals of previously sold notes, but excluding notes that we have repaid.

Although we believe we are able to service and repay our debt, there is no assurance that we will be able to do so. If our plans for future operations do not generate sufficient cash flows and operating profits, our ability to make required payments on our debt would be impaired. Failure to pay our indebtedness when due could have a material adverse effect and may require us to issue additional debt or equity securities.

## Critical Accounting Policies

### (a) Allowance for Finance Credit Losses

In order to estimate an appropriate allowance for losses incurred on finance receivables held on our Unaudited Condensed Consolidated Balance Sheet, we use a loss allowance methodology commonly referred to as "static pooling," which stratifies our finance receivable portfolio into separately identified pools. Using analytical and formula-driven techniques, we estimate an allowance for finance credit losses, which management believes is adequate for probable credit losses that can be reasonably estimated in our portfolio of finance receivable automobile contracts. Provision for losses is charged to our Unaudited Consolidated Statement of Operations. Net losses incurred on finance receivables are charged to the allowance. Management evaluates the adequacy of the allowance by examining current delinquencies, the characteristics of the portfolio and the value of the underlying collateral. As conditions change, our level of provisioning and/or allowance may change as well.

### (b) Contract acquisition fees and originations costs

Upon purchase of a contract from a dealer, we generally charge or advance the dealer an acquisition fee. For contracts securitized in pools which were structured as sales for financial accounting purposes, the acquisition fees associated with contract purchases were deferred until the contracts were securitized, at which time the deferred acquisition fees were recognized as a component of the gain on sale.

For contracts purchased and securitized in pools which are structured as secured financings for financial accounting purposes, dealer acquisition fees and deferred originations costs are applied against the carrying value of finance receivables and are accreted into earnings as an adjustment to the yield over the estimated life of the contract using the interest method, in accordance with Statement of Financial Accounting Standard No.

91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.

(c) Income taxes

We and our subsidiaries file consolidated federal income and combined state franchise tax returns. We utilize the asset and liability method of accounting for income taxes, under which deferred income taxes are recognized for the future tax consequences attributable to the differences between the financial statement values of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recorded against that portion of the deferred tax asset whose utilization in future period is not more than likely.

In determining the possible future realization of deferred tax assets, we have considered the taxes paid in the current and prior years that may be available to recapture, as well as future taxable income from the following sources: (a) reversal of taxable temporary differences; (b) future operations exclusive of reversing temporary differences; and (c) tax planning strategies that, if necessary, would be implemented to accelerate taxable income into years in which net operating losses might otherwise expire. Tax planning strategies include the sale of certain assets, such as residual interests in securitizations, servicing rights and charged off receivables, that can produce significant taxable income within the relevant carryforward period. Such strategies could be implemented without significant impact on our core business or our ability to generate future growth. The costs related to the implementation of these tax strategies were considered in evaluating the amount of taxable income that could be generated in order to realize our deferred tax assets.

(d) Stock-based compensation

For the nine months ended September 30, 2010 and 2009, we recorded \$1.2 million and \$1.0 million respectively, in stock-based compensation costs, resulting from grants of options during the period and vesting of previously granted options. As of September 30, 2010, there were \$3.2 million in unrecognized stock-based compensation costs to be recognized over future periods.

Forward Looking Statements

This report on Form 10-Q includes certain “forward-looking statements.” Forward-looking statements may be identified by the use of words such as “anticipates,” “expects,” “plans,” “estimates,” or words of like meaning. Our provision for credit losses is a forward-looking statement, as it is dependent on our estimates as to future chargeoffs and recovery rates. Factors that could affect charge-offs and recovery rates include changes in the general economic climate, which could affect the willingness or ability of obligors to pay pursuant to the terms of automobile contracts, changes in laws respecting consumer finance, which could affect our ability to enforce rights under automobile contracts, and changes in the market for used vehicles, which could affect the levels of recoveries upon sale of repossessed vehicles. Factors that could affect our revenues in the current year include the levels of cash releases from existing pools of automobile contracts, which would affect our ability to purchase automobile contracts, the terms on which we are able to finance such purchases, the willingness of dealers to sell automobile contracts to us on the terms that we offer, and the terms on which and whether we are able to complete term securitizations once automobile contracts are acquired. Factors that could affect our expenses in the current year include competitive conditions in the market for qualified personnel and interest rates (which affect the rates that we pay on notes issued in our securitizations).



Item 4. Controls and Procedures

We maintain a system of internal controls and procedures designed to provide reasonable assurance as to the reliability of our published financial statements and other disclosures included in this report. As of the end of the period covered by this report, we evaluated the effectiveness of the design and operation of such disclosure controls and procedures. Based upon that evaluation, the principal executive officer (Charles E. Bradley, Jr.) and the principal financial officer (Jeffrey P. Fritz) concluded that the disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, material information relating to us that is required to be included in our reports filed under the Securities Exchange Act of 1934. There have been no changes in our internal controls over financial reporting during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II — OTHER INFORMATION

### Item 1. Legal Proceedings

The information provided under the caption “Legal Proceedings,” Note 7 to the Unaudited Condensed Consolidated Financial Statements, included in Part I of this report, is incorporated herein by reference.

### Item 1A. Risk Factors

We remind the reader that risk factors are set forth in Item 1A of our report on Form 10-K, filed with the U.S. Securities and Exchange Commission on April 1, 2010. Where we are aware of material changes to such risk factors as previously disclosed, we set forth below an updated discussion of such risks. The reader should note that the other risks identified in our report on Form 10-K remain applicable to us.

We require a substantial amount of cash to service our substantial debt.

To service our existing substantial indebtedness, we require a significant amount of cash. Our ability to generate cash depends on many factors, including our successful financial and operating performance. Our financial and operational performance depends upon a number of factors, many of which are beyond our control. These factors include, without limitation:

- the economic and competitive conditions in the asset-backed securities market;
- the performance of our current and future automobile contracts;
- the performance of our residual interests from our securitizations and warehouse credit facilities;
- any operating difficulties or pricing pressures we may experience;
- our ability to obtain credit enhancement for our securitizations;
- our ability to establish and maintain dealer relationships;
- the passage of laws or regulations that affect us adversely;
- our ability to compete with our competitors; and
- our ability to acquire and finance automobile contracts.

Depending upon the outcome of one or more of these factors, we may not be able to generate sufficient cash flow from operations or obtain sufficient funding to satisfy all of our obligations. We note in particular that the market for asset-backed securities is, as of the date of this report, severely adverse to issuers such as ourselves. We also note that credit enhancement in the form of financial guaranty insurance policies does not appear to be available. There can be

no assurance as to when, whether or on what terms we may be able to securitize pools of automobile contracts in the future. If the unavailability of securitization transactions were to cause us to be unable to pay our debts, we would be required to pursue one or more alternative strategies, such as selling assets, refinancing or restructuring our indebtedness or selling additional equity capital. These alternative strategies might not be feasible at the time, might prove inadequate or could require the prior consent of our lenders.

We need substantial liquidity to operate our business.

We have historically funded our operations principally through internally generated cash flows, sales of debt and equity securities, including through securitizations and warehouse credit facilities, borrowings

under senior secured debt agreements and sales of subordinated notes. However, we may not be able to obtain sufficient funding for our future operations from such sources. As of the date of this report, our access to the capital markets is impaired, with respect to both short-term and long-term debt. As a result, our results of operations, financial condition and cash flows have been and may continue to be materially and adversely affected. We require a substantial amount of cash liquidity to operate our business. Among other things, we have used such cash liquidity to:

- acquire automobile contracts;
- fund overcollateralization in warehouse credit facilities and securitizations;
- pay securitization fees and expenses;
- fund spread accounts in connection with securitizations;
- satisfy working capital requirements and pay operating expenses;
- pay taxes; and
- pay interest expense.

To mitigate the effects of our difficulties in obtaining financing on acceptable terms, we have materially reduced our acquisitions of automobile contracts, and have refrained from attempting to conduct securitization transactions on terms that we believe would be too burdensome to be prudent. We continue to pay our operating expenses, taxes and interest expense, and to satisfy our working capital requirements. However, there can be no assurance of our continued ability to do so.

We have substantial indebtedness.

We have and will continue to have a substantial amount of indebtedness. At September 30, 2010 and December 31, 2009, we had approximately \$765.0 million and \$1,014.8 million, respectively, of debt outstanding. Such debt consisted, as of December 31, 2009, primarily of \$904.8 million of securitization trust debt, and also included \$4.9 million of warehouse indebtedness, \$56.9 million of residual interest financing, \$26.1 million of senior secured debt and \$22.0 million owed under a subordinated notes program. At September 30, 2010, such debt consisted primarily of \$632.8 million of securitization trust debt, and also included \$39.7 million of warehouse indebtedness, \$44.3 million of residual interest financing, \$27.0 million of senior secured debt, and \$21.3 million owed under a subordinated notes program. We are currently offering the subordinated notes to the public on a continuous basis, and such notes have maturities that range from three months to 10 years.

Our substantial indebtedness could adversely affect our financial condition by, among other things:

- increasing our vulnerability to general adverse economic and industry conditions;
- requiring us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing amounts available for working capital, capital expenditures and other general corporate purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- placing us at a competitive disadvantage compared our competitors that have less debt; and



- limiting our ability to borrow additional funds.

Although we believe we are able to service and repay such debt, there is no assurance that we will be able to do so. If we do not generate sufficient operating profits, our ability to make required payments on our debt would be impaired. Failure to pay our indebtedness when due could have a material adverse effect.

If an increase in interest rates results in a decrease in our cash flow from excess spread, our results of operations may be impaired.

Our profitability is largely determined by the difference, or "spread," between (i) the interest rates payable under our warehouse credit facilities and on the asset-backed securities issued in our securitizations, or payable in any alternate permanent financing transactions, and (ii) the effective interest rate received by us on the automobile contracts that we acquire. Disruptions in the market for asset-backed securities observed over the past several years have resulted in an increase in the interest rates we paid on the asset-backed securities that we issued in our most recent securitization, as compared with prior transactions, and may result in any future transactions involving comparably high (or higher) interest rates payable by us. Although we have attempted to offset increases in our cost of funds by increasing fees we charge to dealers when purchasing contracts and by requiring higher interest rates on contracts we purchase, there can be no assurance that such price increases on our part will fully offset increases in interest we pay to finance our managed portfolio.

In addition to the interest rates payable in our financing transactions, there are other factors that affect our ability to manage interest rate risk. Specifically, we are subject to interest rate risk during the period between when automobile contracts are purchased from dealers and when such contracts are sold and financed in a securitization or any alternate permanent financing transaction. Interest rates on our warehouse credit facilities are adjustable while the interest rates on the automobile contracts are fixed. Therefore, if interest rates increase, the interest we must pay to the lenders under our warehouse credit facilities is likely to increase while the interest realized by us from those warehoused automobile contracts remains the same, and thus, during the warehousing period, the excess spread cash flow received by us would likely decrease. Additionally, contracts warehoused and then securitized during a rising interest rate environment may result in less excess spread cash flow realized by us under those securitizations as, historically, our securitization facilities pay interest to security holders on a fixed rate basis set at prevailing interest rates at the time of the closing of the securitization, which may be several months after the securitized contracts were originated and entered the warehouse, while our customers pay fixed rates of interest on the contracts, set at the time they purchase the underlying vehicles. A decrease in excess spread cash flow could adversely affect our earnings and cash flow.

To mitigate, but not eliminate, the short-term risk relating to interest rates payable by us under the warehouse facilities, we have generally held automobile contracts in the warehouse credit facilities for less than four months. The disruptions in the market for asset-backed securities issued in securitizations have caused us to lengthen that period, which has reduced the effectiveness of this mitigation strategy. To mitigate, but not eliminate, the long-term risk relating to interest rates payable by us in securitizations, we have in the past, and intend to continue to, structure some of our securitization transactions to include pre-funding structures, whereby the amount of securities issued exceeds the amount of contracts initially sold into the securitization. In pre-funding, the proceeds from the pre-funded portion are held in an escrow account until we sell the additional contracts into the securitization in amounts up to the balance of the pre-funded escrow account. In pre-funded securitizations, we effectively lock in our borrowing costs with respect to the contracts we subsequently sell into the securitization. However, we incur an expense in pre-funded securitizations equal to the difference between the money market yields earned on the proceeds held in escrow prior to subsequent delivery of contracts and the interest rate paid on the securities issued in the securitization. The amount of such expense may vary. Despite these mitigation strategies, an increase in prevailing interest rates would cause us to receive less excess spread cash flows on automobile contracts, and thus could adversely affect our earnings and cash flows.



## We May Have Rescission Liability in Connection with Offers and Sales of Our Renewable Unsecured Subordinated Notes to Certain Purchasers

We filed a registration statement on Form S-2 with respect to our renewable unsecured subordinated notes on January 7, 2005 and subsequently filed amendments to such registration statement on April 13, May 2, and May 20, 2005 and April 11, 2006 (such registration statement, as so amended, the "Former Registration Statement"). We recently discovered that, under a rule of the SEC, we are no longer permitted to offer and sell our renewable unsecured subordinated notes in reliance on the Former Registration Statement. Consequently, purchasers who acquired such notes during the twelve-month period ending September 30, 2010 may have a statutory right to rescind their purchases. As a result, we could be required to repurchase some or all of such notes at the original sale price plus statutory interest, less the amount of any income received by the purchasers. From October 1, 2009 to September 30, 2010, we sold a total of \$4.3 million of notes, including renewals of previously sold notes, but excluding notes that we have repaid.

## Forward-Looking Statements

Discussions of certain matters contained in this report may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Exchange Act, and as such, may involve risks and uncertainties. These forward-looking statements relate to, among other things, expectations of the business environment in which we operate, projections of future performance, perceived opportunities in the market and statements regarding our mission and vision. You can generally identify forward-looking statements as statements containing the words "will," "would," "believe," "may," "could," "expect," "anticipate," "intend," "estimate," "assume" or other similar expressions. Our actual results, performance and achievements may differ materially from the results, performance and achievements expressed or implied in such forward-looking statements. The discussion under "Risk Factors" identifies some of the factors that might cause such a difference, including the following:

- changes in general economic conditions;
- our ability or inability to obtain necessary financing
  - changes in interest rates;
- our ability to generate sufficient operating and financing cash flows;
  - competition;
- level of future provisioning for receivables losses; and
- regulatory requirements.

Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Actual results may differ from expectations due to many factors beyond our ability to control or predict, including those described herein, and in documents incorporated by reference in this report. For these statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

We undertake no obligation to publicly update any forward-looking information. You are advised to consult any additional disclosure we make in our periodic reports filed with the SEC. See "Where You Can Find More Information" and "Documents Incorporated by Reference."

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the three months ended September 30, 2010, we purchased a total of 114,133 shares of our common stock, as described in the following table:



# Issuer Purchases of Equity Securities

| Period(1)      | Total                            |                                    | Total Number<br>of<br>Shares<br>Purchased as          | Approximate<br>Dollar<br>Value of Shares<br>that<br>May Yet be<br>Purchased<br>Under the Plans<br>or<br>Programs(2) |
|----------------|----------------------------------|------------------------------------|---|---|
|                | Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Part of Publicly<br>Announced<br>Plans or<br>Programs |   |
|                |                                  |                                    |   |   |
|                |                                  |                                    |   |   |
| July 2010      | 27,900                           | \$ 0.94                            | 27,900  | \$ 2,151,438  |
| August 2010    | 67,421                           | 0.95                               | 67,421  | 2,087,141   |
| September 2010 | 18,812                           | 0.84                               | 18,812  | 2,071,381   |
| Total          | 114,133                          | \$ 0.93                            | 114,133   |   |

(1) Each monthly period is the calendar month.

(2) In July 2010, our board of directors authorized the purchase of an additional \$2 million of our outstanding securities.

## Item 6. Exhibits

The Exhibits listed below are filed with this report.

- 4.14 Instruments defining the rights of holders of long-term debt of certain consolidated subsidiaries of the registrant are omitted pursuant to the exclusion set forth in subdivisions (b)(iv)(iii)(A) and (b)(v) of Item 601 of Regulation S-K (17 CFR 229.601). The registrant agrees to provide copies of such instruments to the United States Securities and Exchange Commission upon request.
- 31.1 Rule 13a-14(a) Certification of the Chief Executive Officer of the registrant.
- 31.2 Rule 13a-14(a) Certification of the Chief Financial Officer of the registrant.
- 32 Section 1350 Certifications.\*

\* These Certifications shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liability of that section. These Certifications shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the registration statement specifically states that such Certifications are incorporated therein.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CONSUMER PORTFOLIO SERVICES, INC.  
(Registrant)

Date: November12, 2010

By: /s/ CHARLES E. BRADLEY, JR.

Charles E. Bradley, Jr.

President and Chief Executive Officer

(Principal Executive Officer)

Date: November12, 2010

By: /s/ JEFFREY P. FRITZ

Jeffrey P. Fritz

Senior Vice President and Chief Financial Officer

(Principal Financial Officer)

