

Consolidated Financial Statements of

PACIFIC & WESTERN CREDIT CORP.

Years ended October 31, 2009



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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Pacific & Western Credit Corp. as at October 31, 2009 and 2008 and the consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at October 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Saskatoon, Canada

December 8, 2009, except for note 24 which is as of January 27, 2010

PACIFIC & WESTERN CREDIT CORP.

Consolidated Balance Sheet

October 31, 2009, and 2008

(thousands of dollars)

	2009	2008
Assets		
Cash and cash equivalents	\$ 172,297	\$ 207,831
Securities (note 3)	275,847	163,162
Loans, net of allowance for credit losses (note 4)	929,831	1,110,807
Other assets (note 5)	33,750	30,667
	<u>\$ 1,411,725</u>	<u>\$ 1,512,467</u>
Liabilities and Shareholders' Equity		
Deposits (note 6)	\$ 1,217,136	\$ 1,389,455
Notes payable (note 7)	77,933	70,405
Other liabilities (note 8)	71,293	28,476
	<u>1,366,362</u>	<u>1,488,336</u>
Preferred share liabilities (note 9)	27,892	–
Shareholders' equity:		
Share capital (note 10)	40,226	39,387
Retained earnings (deficit)	(6,454)	3,796
Accumulated other comprehensive income (loss)	(16,301)	(19,052)
	<u>17,471</u>	<u>24,131</u>
Commitments and contingencies (note 20)		
	<u>\$ 1,411,725</u>	<u>\$ 1,512,467</u>

See accompanying notes to consolidated financial statements.

On behalf of the Board:

David R. Taylor
President and Chief Executive Officer

C. Scott Ritchie
Chairman of the Board

PACIFIC & WESTERN CREDIT CORP.

Consolidated Statements of Operations

Years ended October 31, 2009 and 2008

(thousands of dollars, except per share amounts)

	2009	2008
Interest income:		
Loans	\$ 56,083	\$ 53,490
Securities	21,255	15,285
Loan fees	1,660	3,431
	<u>78,998</u>	<u>72,206</u>
Interest expense:		
Deposits and other	64,708	59,005
Notes payable	8,892	4,646
Preferred share liabilities	548	—
	<u>74,148</u>	<u>63,651</u>
Net interest income	4,850	8,555
Provision for credit losses (note 4)	3,449	2,815
Net interest income after provision for credit losses	1,401	5,740
Other income (charges) (note 12)	1,449	(14,732)
Net interest and other income (charges)	2,850	(8,992)
Non-interest expenses:		
Salaries and benefits	6,942	7,598
General and administrative	5,936	4,475
Premises and equipment	2,089	1,952
	<u>14,967</u>	<u>14,025</u>
Loss before income taxes	(12,117)	(23,017)
Income taxes (note 13)	(2,222)	(2,928)
Net loss	<u>\$ (9,895)</u>	<u>\$ (20,089)</u>
Basic earnings (loss) per share (note 14)	\$ (0.74)	\$ (1.49)
Diluted earnings (loss) per share (note 14)	\$ (0.74)	\$ (1.49)

See accompanying notes to consolidated financial statements.

PACIFIC & WESTERN CREDIT CORP.

Consolidated Statements of Comprehensive Income (Loss)

Years ended October 31, 2009 and 2008

(thousands of dollars)

	2009	2008
Net loss	\$ (9,895)	\$ (20,089)
Other comprehensive income (loss), net of tax		
Net unrealized gains (losses) on assets held as available for sale ⁽¹⁾	1,767	(11,866)
Amount transferred to net loss for hedges ⁽²⁾	–	190
Amount transferred to net loss for available-for-sale assets ⁽³⁾	984	(38)
Amount transferred to net loss for impairment writedowns on available-for-sale assets ⁽⁴⁾	–	(797)
Other comprehensive income (loss)	2,751	(12,511)
Comprehensive loss	\$ (7,144)	\$ (32,600)

⁽¹⁾ Net of income tax benefit (expense) of (\$721) (2008-\$5,085).

⁽²⁾ Net of income tax benefit (expense) of \$nil (2008-\$104).

⁽³⁾ Net of income tax benefit (expense) of (\$413) (2008-\$26).

⁽⁴⁾ Net of income tax benefit (expense) of \$nil (2008-\$21).

See accompanying notes to consolidated financial statements.

PACIFIC & WESTERN CREDIT CORP.

Consolidated Statements of Changes in Shareholders' Equity

Years ended October 31, 2009 and 2008

(thousands of dollars)

	2009	2008
Common shares (note 10):		
Balance, beginning of year	\$ 35,663	\$ 35,743
Proceeds of shares issued	–	288
Issued on payment of Class B preferred share dividend	154	–
Repurchase of shares	–	(368)
Balance, end of year	\$ 35,817	\$ 35,663
Preferred shares (note 10):		
<i>Class A preferred shares:</i>		
Balance, beginning of year	\$ 3,545	\$ 3,545
Converted during the year	(2,484)	–
Balance, end of year	\$ 1,061	\$ 3,545
<i>Class B preferred shares (note 10):</i>		
Issued during the year, net of costs	\$ 3,022	\$ –
Balance, end of year	\$ 3,022	\$ –
Contributed surplus (notes 10 & 11):		
Balance, beginning of year	\$ 179	\$ 182
Fair value of stock options granted	147	622
Repurchase of shares	–	(625)
Balance, end of year	\$ 326	\$ 179
Retained earnings:		
Balance, beginning of year	\$ 3,796	\$ 24,125
Net loss	(9,895)	(20,089)
Dividends paid	(355)	(240)
Balance, end of year	\$ (6,454)	\$ 3,796
Accumulated other comprehensive income (loss) net of taxes (note 10):		
Balance, beginning of year	\$ (19,052)	\$ (6,541)
Other comprehensive income (loss)	2,751	(12,511)
Balance, end of year	\$ (16,301)	\$ (19,052)
Total shareholders' equity	\$ 17,471	\$ 24,131

See accompanying notes to consolidated financial statements.

PACIFIC & WESTERN CREDIT CORP.

Consolidated Statements of Cash Flows

Years ended October 31, 2009 and 2008

(thousands of dollars)

	2009	2008
Cash provided by (used in):		
Operations:		
Net loss	\$ (9,895)	\$ (20,089)
Items not involving cash:		
Provision for credit losses	3,449	2,815
Impairment writedown on other assets	-	11,341
Impairment writedown on securities	-	3,703
Change in derivative financial instruments	(296)	197
Future income tax provision (recovery)	(2,222)	(2,928)
Stock-based compensation	147	622
Gain on disposal of available-for-sale securities	(9,970)	(676)
Interest expense on preferred share liabilities	154	-
Gain on real estate held for sale	(626)	-
Change in other assets and liabilities	(5,565)	(30,467)
	(24,824)	(35,482)
Investing:		
Purchase of securities	(975,356)	(1,780,775)
Proceeds from sale and maturity of securities	876,806	1,935,703
Loans	178,043	(115,316)
	79,493	39,612
Financing:		
Deposits	(172,319)	106,699
Other financings	46,578	(49,917)
Proceeds of shares issued	-	288
Notes payable	35,893	34,443
Dividends paid	(355)	(240)
Repurchase of shares	-	(993)
	(90,203)	90,280
Increase (decrease) in cash and cash equivalents	(35,534)	94,410
Cash and cash equivalents, beginning of year	207,831	113,421
Cash and cash equivalents, end of year	\$ 172,297	\$ 207,831
Supplementary cash flow information:		
Interest paid during the year	\$ 77,598	\$ 65,425
Income taxes paid during the year	\$ -	\$ 68

See accompanying notes to consolidated financial statements.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

Pacific & Western Credit Corp. (the "Corporation"), through its subsidiaries, is involved in the business of providing financial solutions to clients in selected niche markets. Pacific & Western Bank of Canada ("PWB" or the "Bank"), its principal subsidiary, operates as a bank under the *Bank Act* (Canada).

1. Significant accounting policies:

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The significant accounting principles used in the preparation of these consolidated financial statements are summarized below:

a) Investments:

The Corporation holds 100% of the common shares of Pacific & Western Bank of Canada, Arctic Financial Ltd., PW Capital Inc., Pacific & Western Public Sector Financing Corp. and Versabanq Innovations Inc. The consolidated financial statements include the accounts of these subsidiaries.

All significant intercompany accounts and transactions have been eliminated.

b) Variable Interest Entities:

Variable Interest Entities ("VIE's") are consolidated in situations where the Corporation is determined to be the primary beneficiary. A VIE is defined as an entity which either does not have sufficient equity at risk to finance its activities without additional subordinated financial support or where the holders of the equity at risk lack the characteristics of a controlling financial interest.

c) Cash and cash equivalents:

Cash and cash equivalents include government treasury bills and deposits with Canadian chartered banks with less than ninety days to maturity from the date of acquisition, net of cheques and other items in transit.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

1. Significant accounting policies - continued:

d) Securities:

The Corporation holds securities for investment purposes with the original intention of holding the securities to maturity or until market conditions render alternative investments more attractive. The Corporation accounts for securities as either held-to-maturity or as available-for-sale (see note 1(m)). Any impairment in the underlying value of securities, other than a temporary impairment, is recorded as a charge to income in the year in which it occurs.

Settlement date accounting is used for all securities.

e) Loans:

Loans are initially measured at fair value plus incremental direct transaction costs. Loans are subsequently re-measured at their amortized cost, net of allowance for credit losses, using the effective interest method.

Interest income is accounted for on the accrual basis, except on loans classified as impaired. A loan is classified as impaired when, in management's opinion, there has been deterioration in credit quality to the extent that there is no longer reasonable assurance as to the timely collection of the full amount of principal and interest. Loans where interest or principal is contractually past due 90 days are automatically recognized as impaired, unless management determines that the loan is fully secured, in the process of collection and the collection efforts are reasonably expected to result in either repayment of the loan or restoring it to a current status within 180 days from the date the payment has become contractually in arrears. All loans are classified as impaired when interest or principal is past due 180 days, except for loans guaranteed or insured by the Canadian government, provinces, territories, or a Canadian government agency, which are classified as impaired when interest or principal is contractually 365 days in arrears.

When a loan is classified as impaired, accrual of interest on the loan ceases and the carrying amount of the loan is reduced to its estimated realizable amount. Estimated realizable amounts are measured by discounting the expected future cash flows, if they can be reasonably estimated, using the effective interest rate inherent in the loan. When the amounts and timing of cash flows cannot be reasonably estimated, the carrying amount of the loan is reduced to its estimated net realizable value based on either:

- i) the fair value of any security underlying the loan, net of expected costs of realization, and,
- ii) observable market prices for the loan.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

1. Significant accounting policies - continued:

e) Loans - continued:

As long as the loan remains classified as impaired, payments received will be credited to the carrying value of the loan. A loan will be returned to accrual status only when the timely collection of both principal and interest is reasonably assured and all arrears payments of principal and interest are brought current.

Loan fees in excess of estimated administrative costs are considered to be adjustments to loan yields and are recognized in income over the appropriate lending or commitment period.

Real estate acquired as settlement of loans is stated at fair value based on appraised values or prices for similar assets.

f) Allowance for credit losses:

The Corporation maintains an allowance for credit losses which, in management's opinion, is adequate to absorb all credit related losses in its portfolio of both on and off-balance sheet items. The allowance for credit losses consists of specific provisions, being provisions against specific credit exposures determined on an item-by-item basis, and a general provision for losses which have occurred but where such losses cannot be determined on an item-by-item basis.

In assessing existing credit losses, management must rely on estimates and exercise judgement regarding matters for which the ultimate outcome is unknown. Changes in circumstances may cause future assessments of credit risk to be significantly different than current assessments and may require an increase or decrease in the allowance for credit losses.

g) Capital assets:

Capital assets are carried at cost less accumulated amortization. Costs of additions and betterments are capitalized.

Amortization is calculated using the straight-line method over the estimated useful lives of assets ranging from five to twenty years.

h) Securities sold under repurchase agreements:

Securities sold under repurchase agreements represent short term financing transactions where the Corporation sells securities that it already owns and simultaneously commits to repurchase the securities at a specified price on a specified date in the future.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

1. Significant accounting policies - continued:

i) Income taxes:

The Corporation follows the asset and liability method of accounting for income taxes. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years when temporary differences are expected to be recovered or settled.

j) Stock-based compensation:

Employee stock options are accounted for using the fair value method which recognizes the fair value of the stock option over the applicable vesting period as an increase in salaries and benefits expense. The Corporation's stock option plan is described in note 10.

For deferred share units that call for settlement in cash, the Corporation records a charge to salaries and benefits expense for the difference between the market value of the Corporation's common shares and the option price, if any. Changes in the market value of the Corporation's common shares result in a change in the measure of compensation for the units. Deferred share units granted by the Corporation are described in note 11.

The Corporation also accounts for grants of warrants to non-employees in accordance with the fair value method.

k) Derivative instruments:

Derivatives are carried at fair value and are reported as other assets when they have a positive fair value and as other liabilities when they have a negative fair value. Derivatives may be embedded in other financial instruments. Derivatives embedded in other financial instruments are valued as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a derivative if it was a free standing instrument; and the combined contract is not held for trading or designated at fair value.

Interest rate swap agreements are entered into for asset liability management ("ALM") purposes.

When hedge accounting criteria are met, derivative contracts are accounted for as described below.

To meet the criteria for hedge accounting, the Corporation documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives to specific assets or liabilities on the Consolidated Balance Sheets or to specific

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

1. Significant accounting policies - continued:

k) Derivative instruments (continued):

firm commitments or forecasted transactions. The Corporation also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair values or cash flows of hedged items.

There are three main types of hedges: (i) fair value hedges, (ii) cash flow hedges and (iii) net investment hedges.

At October 31, 2009 and 2008, the Corporation had only fair value hedges outstanding. In a fair value hedge, the change in the fair value of the hedging derivative is offset in the Consolidated Statements of Operations by the changes in the fair value of the hedged item relating to the hedged risk. The Corporation utilizes fair value hedges primarily to convert fixed rate financial assets to floating rates. The main financial instrument designated in fair value hedging relationships consists of loans. If the derivative expires or is sold, terminated, no longer meets the criteria for hedge accounting, or the designation is revoked, hedge accounting is discontinued. Any adjustment up to that point to a hedged item for which the effective interest method is used, is amortized to the Consolidated Statements of Operations as part of the recalculated effective interest rate of the item over its remaining term.

Any hedge ineffectiveness is measured and recorded in the current period net interest income in the Consolidated Statements of Operations.

l) Administrative and other income:

Administrative and other income is recognized on an accrual basis as services are performed.

Derivative contracts which do not qualify for hedge accounting are marked-to-market and the resulting net gains or losses are recognized in other income in the Consolidated Statements of Operations in the current year.

m) Financial instruments

All financial assets are classified as one of the following: held-to-maturity, loans and receivables, held for trading or available-for-sale. All financial liabilities are classified as held for trading or other liabilities. Financial assets and liabilities held for trading are measured at fair value with gains and losses recognized in net income. Financial assets held-to-maturity, loans and receivables and financial liabilities other than those held for trading, are measured at amortized cost based on the effective interest method. Available-for-sale instruments are measured at fair value with gains and losses, net of tax, recognized in other comprehensive income.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

1. Significant accounting policies - continued:

n) Transaction costs

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability. Transaction costs related to available-for-sale, held-to-maturity securities, loans and deposit liabilities are capitalized and amortized over the expected life of the instrument using the effective interest method.

2. Newly adopted standards and future accounting changes:

a) Newly adopted standards:

Financial instruments:

The Accounting Standards Board has amended Handbook 3862 - *Financial Instruments – Disclosures*, by adopting the amendments to International Financial Reporting Standards (IFRS) 7 Financial Instruments: Disclosures, recently issued by the International Accounting Standards Board. The amendments include enhanced disclosure requirements for fair value measurement of financial instrument and liquidity risks.

The amendments require additional disclosure for fair value measurements including the following:

- The level in the fair value hierarchy into which the fair value measurements are categorized in their entirety (note 3(d));
- Any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers; and
- Reconciliation of the beginning balances to the ending balances for those fair value measurements that result from the use of significant unobservable inputs in valuation techniques (Level 3), disclosing separately changes during the period.

b) Future accounting changes:

International Financial Reporting Standards:

The Canadian Institute of Chartered Accountants will transition Canadian GAAP for publicly accountable entities to IFRS. The Corporation's consolidated financial statements will be prepared in accordance with IFRS for the fiscal year commencing November 1, 2011.

The Corporation is carrying out a project to identify and evaluate the impact of the transition to IFRS on its consolidated financial statements and develop a plan to complete the transition. This plan includes the following phases; diagnostics, design and planning, implementation and training.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

2. Newly adopted standards and future accounting changes (continued):

b) Future accounting changes (continued):

The impact of the transition to IFRS on the Corporation's consolidated financial statements is not yet determinable.

3. Securities:

a) Portfolio analysis:

(thousands of dollars)

	2009	2008
Available-for-sale securities		
Securities issued or guaranteed by:		
Canadian federal government	\$ 88,873	\$ 64,930
Canadian provinces	46,256	6,439
Canadian municipalities	21,406	157
Corporate debt	43,702	21,383
Corporate equity	69,489	64,900
Total available-for-sale securities	269,726	157,809
Held-to-maturity security		
Corporate debt	\$ 6,121	\$ 5,353
Total securities	\$ 275,847	\$ 163,162

On August 1, 2008, the Corporation reclassified an investment in a collateral debt obligation (CDO), that is included in corporate debt, from its available-for-sale portfolio to its held-to-maturity portfolio at its fair value on the date of reclassification, which was \$5,353,000. Management determined that carrying the investment at amortized cost was more appropriate given the lack of verifiable inputs for the valuation model used to determine fair value and the Corporation's intention to hold the investment to maturity.

This CDO matures in 2013 and has a fair value of \$564,000 (2008 - \$1,115,000). The fair value for the CDO is determined by the use of external valuation models which incorporate observable market parameters. These include observable interest rates, credit spreads and loss expectations. The fair value amount determined based on the above may not ultimately reflect what the Corporation would receive if it were to sell the CDO in the market. The CDO is secured by corporate credits and does not have any direct residential sub-prime exposure.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

3. Securities – continued:

b) Maturities and yields:

(thousands of dollars)

Maturity dates	2009	Yield	2008	Yield
Available-for-sale securities				
Floating	\$ 26,224	1.95%	\$ 30,674	4.21%
Within 3 months	33	5.93%	12,429	3.89%
3 months - 1 year	8,609	1.93%	14,187	3.18%
1 year - 2 years	99,536	1.52%	15,162	3.57%
2 years - 5 years	113,486	3.65%	80,512	5.70%
Over 5 years	21,838	4.29%	4,845	3.72%
Total available-for-sale securities	269,726	2.70%	157,809	4.78%
Held-to-maturity security				
2 years – 5 years	\$ 6,121	1.94%	\$ 5,353	10.33%
Total securities	\$ 275,847	2.68%	\$ 163,162	4.96%

Average effective yields are based on carrying values and contractual interest or stated dividend rates adjusted for amortization of premiums and discounts.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

3. Securities – continued:

c) Unrealized gains and losses on securities:

(thousands of dollars)

	2009				2008			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Carrying Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Carrying Value
Available-for-sale securities								
Securities issued or guaranteed by:								
Canadian federal								
government	\$ 87,930	\$ 996	\$ (53)	\$ 88,873	\$ 65,012	\$ 403	\$ (485)	\$ 64,930
Canadian provinces	46,159	120	(23)	46,256	6,340	99	–	6,439
Canadian								
municipalities	21,230	198	(22)	21,406	153	4	–	157
Corporate debt	45,954	837	(3,089)	43,702	22,250	221	(1,088)	21,383
Corporate equity	86,324	–	(16,835)	69,489	86,575	–	(21,675)	64,900
Total available-for-sale securities	\$ 287,597	\$ 2,151	\$ (20,022)	\$ 269,726	\$ 180,330	\$ 727	\$ (23,248)	\$ 157,809
Held-to-maturity security								
Corporate debt	\$ 6,121	\$ –	\$ –	\$ 6,121	\$ 5,353	\$ –	\$ –	\$ 5,353
Total securities	\$ 293,718	\$ 2,151	\$ (20,022)	\$ 275,847	\$ 185,683	\$ 727	\$ (23,248)	\$ 163,162

The carrying values of available-for-sale securities are represented by fair values and are based on quoted market prices.

The Corporation conducts a quarterly review to identify and evaluate investments that show indications of possible impairment. An investment is considered impaired if its fair value falls below its cost, and a writedown to fair value is recorded when the decline is considered other than temporary. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been below cost, financial conditions and near-term prospects of the issuer, and the ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery.

Recent market conditions have resulted in a significant decline in the market value of equity securities held by the Corporation for investment purposes. These securities, consisting primarily of preferred shares of major Canadian banks and insurance companies, are subject to market fluctuations and, at October 31, 2009, traded at a value approximately (\$16,835,000) (2008 – (\$21,675,000)) below their amortized cost. The Corporation has recorded this decline in market value, net of applicable income taxes, in accumulated other comprehensive income (loss). The Corporation intends to hold these securities until a recovery in value is achieved. The securities have provisions that will allow the issuer to redeem the securities at various dates commencing over the years 2010 to 2013; however, there is no promise or legal requirement for the issuers of the preferred shares to redeem these shares on those dates.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

3. Securities – continued:

c) Unrealized gains and losses on securities (continued):

Recovery of the market value declines is dependent upon future market conditions or the ultimate future redemption of the shares by the issuers.

d) Fair value hierarchy:

The Corporation follows a fair value hierarchy to categorize the inputs used to measure fair value for available-for-sale securities. The fair value hierarchy is based on quoted prices in active markets (Level 1), models using inputs other than quoted prices (Level 2), or models using inputs that are not based on observable market data (Level 3).

Securities are classified into the fair value hierarchy as follows:

	2009			
	Total	Level 1	Level 2	Level 3
Available-for-sale securities:				
Equity securities	\$ 69,489	\$ 69,489	\$ –	\$ –
Debt securities ⁽¹⁾	200,237	135,129	65,108	–
	<u>\$ 269,726</u>	<u>\$204,618</u>	<u>\$ 65,108</u>	<u>\$ –</u>

⁽¹⁾ Level 1 debt securities include Canadian federal and provincial government debt and insured mortgage-backed securities. Level 2 debt securities include municipal government and corporate debt.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

4. Loans:

a) Portfolio analysis:

(thousands of dollars)

	2009	2008
Residential mortgages:		
Insured	\$ 60,165	\$ 207,268
Uninsured	124,558	170,580
Corporate and government loans	738,009	715,959
Personal loans	12,656	18,038
	935,388	1,111,845
Allowance for credit losses:		
General	(8,401)	(5,212)
Specific	(1,133)	(830)
	(9,534)	(6,042)
	925,854	1,105,803
Accrued interest	3,977	5,004
	\$ 929,831	\$ 1,110,807

The general allowance for credit losses relates to the following loan portfolios: residential mortgages - \$381,000 (2008 - \$386,000); corporate and government loans - \$2,259,000 (2008 - \$792,000) personal loans - \$5,761,000 (2008 - \$4,034,000).

Loans are secured primarily by collateral mortgages against real estate with respect to real estate lending and specific charges against equipment being financed for other lending activities.

b) Allowance for credit losses:

The allowance for credit losses results from the following:

(thousands of dollars)

			2009	2008
	General	Specific	Total Allowance	Total Allowance
Balance, beginning of year	\$ 5,212	\$ 830	\$ 6,042	\$ 3,206
Provision for credit losses	3,189	260	3,449	2,815
Recoveries (write-offs)	-	43	43	21
Balance, end of year	\$ 8,401	\$ 1,133	\$ 9,534	\$ 6,042

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

4. Loans – continued:

c) Maturities and yields:

(thousands of dollars)

	Floating	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Over 5 years	2009 Total	2008 Total
Total loans	\$ 199,151	\$ 43,522	\$ 49,677	\$ 80,607	\$ 347,541	\$ 214,890	\$ 935,388	\$ 1,111,845
Average effective yield	4.11%	5.31%	5.19%	6.06%	5.55%	5.54%	5.25%	5.39%
Adjusted for related derivatives	4.11%	5.31%	4.96%	6.06%	4.05%	3.01%	4.11%	5.06%

Average effective yields are based on book values and contractual interest rates, adjusted for the amortization of any deferred income.

d) Impaired loans:

(thousands of dollars)

	2009			2008		
	Gross Impaired	Specific Allowance	Net Impaired	Gross Impaired	Specific Allowance	Net Impaired
Residential mortgages	\$ 1,076	\$ 811	\$ 265	\$ 1,188	\$ 711	\$ 477
Corporate and government loans	1,629	–	1,629	6,327	–	6,327
Personal loans	3,690	322	3,368	276	119	157
	\$ 6,395	\$ 1,133	\$ 5,262	\$ 7,791	\$ 830	\$ 6,961

Impaired loans include foreclosed real estate held for sale with a gross carrying value of \$1,844,000 (2008 - \$215,000) and a related allowance of \$71,000 (2008 - \$71,000).

Loans past due but not impaired totaled \$969,000 (2008-\$248,000).

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

5. Other assets:

(thousands of dollars)

	2009	2008
Future income tax asset (note 13)	\$ 11,291	\$ 11,009
Capital assets	6,731	7,814
Prepaid expenses and other	8,108	7,474
Investment in Discovery Air Inc.	2,603	3,470
Accounts receivable	5,017	900
	<u>\$ 33,750</u>	<u>\$ 30,667</u>

At October 31, 2009, the investment in Discovery Air Inc. (DA) had a fair value of \$2,603,000 (2008-\$3,470,000) with fair value being determined based on quoted market prices and therefore falls into Level 1 on the fair value hierarchy (note 3(d)).

The investment in DA is held primarily in a VIE which has been consolidated in these financial statements.

6. Deposits:

(thousands of dollars)

		Within	3 months to	1 year to	2 years to	Accrued	2009	2008
	Floating	3 months	1 year	2 years	5 years	Interest	Total	Total
Total deposits	\$ 40,387	\$ 170,778	\$ 613,786	\$ 247,285	\$ 131,794	\$ 13,106	\$ 1,217,136	\$ 1,389,455
Average effective interest rate	1.05%	2.83%	2.24%	2.62%	4.12%	-	2.57%	4.05%

Average effective interest rates are based on book values and contractual interest rates.

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7. Notes payable:

(thousands of dollars)

	2009	2008
Ten Year Term Series C Notes unsecured, maturing 2018, net of note issue costs of \$1,305 (2008 - \$907), effective interest of 10.71%	\$ 50,220	\$ 46,580
Ten Year Term Series A Notes, unsecured, maturing 2010, net of note issue costs of \$15 (2008 - \$225), effective interest of 10.47%	2,597	11,275
Notes payable, unsecured, maturing 2010, net of note issue costs of \$30 (2008 - \$nil) effective interest of 7.8%	5,170	12,550
Ten Year Term, unsecured, subordinated notes payable, payable by Bank to a third party, maturing 2019, net of note issue costs of \$1,554, effective interest of 12.37%	19,946	–
	<u>\$ 77,933</u>	<u>\$ 70,405</u>

During the year, \$5.6 million of Series A Notes were converted into \$6.8 million of Series C Notes. In addition, \$3.3 million of Series A Notes and \$27.4 million of Series C Notes were converted into Class B Preferred Shares (note 10(b)).

8. Other liabilities:

(thousands of dollars)

	2009	2008
Securities sold under repurchase agreements	\$ 46,578	\$ –
Fair value of derivatives (note 15)	17,887	21,327
Accounts payable and other	6,828	7,149
	<u>\$ 71,293</u>	<u>\$ 28,476</u>

The fair value of derivatives was determined using models with observable market data and therefore falls into Level 2 on the fair value hierarchy (note 3(d)).

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Notes to Consolidated Financial Statements

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9. Preferred share liabilities:

As described below, on August 31, 2009, the Corporation issued 1,326,558 Class B Preferred Shares with a total value of \$33.2 million less issue costs of \$2.3 million. The issuance of these Class B Preferred Shares was a result of the conversion of Class A Preferred Shares, Series A Notes and Series C Notes. As these Class B preferred shares carry certain redemption features and are convertible into common shares of the Corporation, an amount of \$27.9 million, net of issue costs, representing the fair value of the Corporation's obligation to make future payments of principal and interest, and being the most easily measured component, has been classified on the Corporation's Consolidated Balance Sheet as a preferred share liability. In addition, an amount of \$3,022,000 representing the equity element of the Class B Preferred Shares, net of issue costs, has been classified in share capital on the Consolidated Balance Sheet (note 10 (b)).

As the preferred shares can be redeemed by the Corporation for approximately \$33.2 million, the preferred share liability amount of \$27.9 million will be increased over the remaining term to redemption, until the liability amount is equal to the estimated redemption amount with the increase included in interest expense in the Consolidated Statement of Operations calculated using the effective interest rate of 11.8%.

10. Share capital:

a) Authorized:

Common shares:

The Corporation is authorized to issue an unlimited number of common shares.

Class A preferred shares:

The Corporation is authorized to issue an unlimited number of Class A Preferred Shares. These shares are entitled to receive a cumulative dividend at the rate of \$0.21 per share per annum. These shares are non-voting, non-participating and redeemable at the option of the Corporation at the issue price and are convertible into common shares on the basis of 4.608 preferred shares for 1 common share. At October 31, 2009, cumulative and unpaid dividends on the Class A Preferred Shares totalled \$62,000 (2008 - \$207,000).

Class B preferred shares:

During the year, the Corporation was authorized to issue an unlimited number of Class B Preferred Shares. The shares are non-voting and are subordinate to the Class A Preferred Shares with respect to the payment of dividends and the distribution of assets on dissolution, liquidation or winding-up. The Class B Preferred Shares have preferential rights over the common shares with respect to the payment of dividends and the distribution of assets on dissolution, liquidation or winding-up.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

10. Share capital – continued:

a) Authorized (continued):

The Class B Preferred Shares are convertible, at any time, into common shares of the Corporation on the basis of five (5) common shares for each Class B Preferred Share. Upon conversion, all accrued and unpaid dividends, calculated by excluding the date fixed for conversion, shall be payable by the Corporation in cash/common shares, in the manner described below with respect to dividends.

The holders of Class B Preferred Shares are entitled to receive, and the Corporation shall pay thereon, as and when declared by the Board of Directors of the Corporation, fixed subordinated cumulative dividends at the rate of \$2.25 per share per annum. Out of the total dividend of \$2.25 per annum per Class B Preferred Share, \$0.84 will be paid by the Corporation in cash with remaining dividends to be paid by the Corporation in cash or common shares of the Corporation, at the Corporation's sole discretion.

The Class B Preferred Shares are redeemable by the Corporation, at its discretion, on or after June 30, 2014, but will be redeemed by the Corporation by no later than June 30, 2019, in each case for \$25.00 per Class B Preferred Share (the "Redemption Price"). Any redemption price would be paid by the Corporation in cash, and any accrued but unpaid dividends on the Class B Preferred Shares that are redeemed shall be payable by the Corporation in cash/common shares, in the manner described above with respect to dividends.

PACIFIC & WESTERN CREDIT CORP.

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10. Share capital – continued:

b) Issued and outstanding:

(thousands of dollars)

	2009		2008	
	Shares	Amount	Shares	Amount
<i>Common shares:</i>				
Outstanding, beginning of year	13,642,452	\$ 35,663	13,685,552	\$ 35,743
Shares issued on payment of Class B preferred share dividend	37,960	154	–	–
Shares issued on exercise of options	–	–	96,000	288
Repurchase of shares	–	–	(139,100)	(368)
Outstanding, end of year	13,680,412	\$ 35,817	13,642,452	\$ 35,663
<i>Class A preferred shares:</i>				
Outstanding, beginning of year	1,142,556	\$ 3,545	1,142,556	\$ 3,545
Converted during the year	(827,984)	(2,484)	–	–
Outstanding, end of year	314,572	\$ 1,061	1,142,556	\$ 3,545
<i>Class B preferred shares:</i>				
Issued during the year (note 9)	1,326,558	\$ 3,022	–	\$ –
Outstanding, end of year	1,326,558	\$ 3,022	–	\$ –
<i>Contributed surplus:</i>				
Balance, beginning of year		\$ 179		\$ 182
Fair value of stock options granted (note 11)		147		622
Repurchase of shares		–		(625)
Balance, end of year		\$ 326		\$ 179
Total share capital		\$ 40,226		\$ 39,387

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

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10. Share capital - continued:

c) Normal course issuer bid:

On July 18, 2008, the Corporation announced that it filed a Notice of Intention to make a Normal Course Issuer Bid, pursuant to which the Corporation may purchase for cancellation up to 500,000 of its common shares. The bid commenced on July 22, 2008 and was completed on July 21, 2009. The Corporation did not repurchase any common shares during the year ending October 31, 2009. During the year ended October 31, 2008, the Corporation repurchased 139,100 common shares for a total cost of \$368,000.

d) Accumulated other comprehensive income (loss):

Balance consists of:

(thousands of dollars)

	2009	2008
Net unrealized losses on assets held as available-for-sale ⁽¹⁾	\$ (16,301)	\$ (19,052)
Balance, end of year	\$ (16,301)	\$ (19,052)

⁽¹⁾ Net of income tax benefit of \$6,658 (2008-\$8,165).

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Notes to Consolidated Financial Statements

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11. Stock-based compensation:

a) Stock options:

The Corporation has a stock option plan for its employees. Options are granted at an exercise price set at the closing market price of the Corporation's common shares on the day preceding the date on which the option is granted and are exercisable within ten years of issue. Options granted prior to September, 2000 vested immediately and options granted after September, 2000 typically vest over a two year period.

Options outstanding and options exercisable as of October 31, 2009 by range of exercise price are as follows:

Range of exercise prices	Options Outstanding			Options Exercisable	
	Number of stock options	Weighted-average remaining contractual life (years)	Weighted-average exercise price	Number of stock options	Weighted-average exercise price
\$3.00 - \$6.00	222,700	3.10	\$ 4.38	189,033	\$ 4.27
\$6.00 - \$9.00	237,648	7.72	7.78	163,115	7.76
\$9.00 - \$12.00	391,585	2.89	11.56	391,585	11.56
\$12.00 - \$15.00	—	—	—	—	—
\$15.00 and over	7,100	0.18	16.02	7,100	16.02

Stock option transactions during 2009 and 2008 are as follows:

	2009		2008	
	Number of options	Weighted-average exercise price	Number of options	Weighted-average exercise price
Outstanding, beginning of year	1,077,110	\$ 9.02	1,054,345	\$ 8.58
Granted	50,000	5.00	250,398	7.82
Exercised	—	—	(96,000)	3.00
Expired	(268,077)	9.33	(131,633)	7.59
Outstanding, end of year	859,033	\$ 8.69	1,077,110	\$ 9.02

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

11. Stock-based compensation - continued:

a) Stock options - continued:

The fair value of options granted during the year was determined using the Black-Scholes option pricing model with the following weighted-average assumptions:

	2009	2008
Options granted	50,000	250,398
Exercise price per share	\$ 5.00	\$ 7.82
Risk-free interest rate	2.41%	4.02%
Dividend yield	0%	0%
Expected volatility	45%	30%
Expected option life	5 years	5 years
Expected forfeiture rate	5%	5%
Fair value per option	\$ 1.26	\$ 2.66

During the year ended October 31, 2009, the Corporation recognized \$147,000 (2008 - \$622,000) of compensation expense relating to options granted by the Corporation.

b) Deferred share units:

The Corporation has granted 49,080 (2008 – 22,499) deferred share units (“DSU”). Each DSU entitles the holder to a cash distribution equal to the closing market price of the Corporation’s common shares upon retirement of the holder. During 2009, \$48,000 (2008 - \$nil) was paid out relating to 13,496 DSU’s. At October 31, 2009 there were 91,583 (2008 – 55,999) DSUs outstanding. For the year ended October 31, 2009, the Corporation recognized \$130,000 (2008 - \$7,000) of compensation expense relating to DSUs.

12. Other income (charges):

(thousands of dollars)

	2009	2008
Gain on sale of assets held-for-trading	\$ 1,025	\$ –
Gain on real estate held for sale	626	–
Administrative and other income	94	509
Impairment writedown on securities	–	(3,703)
Impairment writedown on other assets	–	(11,341)
Mark to market adjustment for derivatives	(296)	(197)
	\$ 1,449	\$ (14,732)

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Notes to Consolidated Financial Statements

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13. Income taxes:

Income taxes, including both the current and future portions, vary from the amounts that would be computed by applying the statutory federal and provincial tax rates aggregating 32% (2008 – 33%) to income before income taxes. Income taxes have been computed as follows:

(thousands of dollars)

	2009	2008
Tax recovery at basic rates	\$ (3,877)	\$ (7,596)
Changes in taxes resulting from:		
Non-taxable income from securities	(1,232)	(1,408)
Non-taxable portion of capital gains	–	1,871
Other permanent differences	340	284
Tax rate differential	301	1,248
Valuation allowance	606	2,673
Benefit of losses not recognized	1,640	–
Income tax recovery	\$ (2,222)	\$ (2,928)

The income tax recovery is comprised of:

Current income tax (recovery) provision	\$ –	\$ –
Future income tax recovery	(2,222)	(2,928)
	\$ (2,222)	\$ (2,928)

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

13. Income taxes - continued:

The components of future income tax balances are as follows:

(thousands of dollars)

	2009	2008
Future income tax assets:		
Investments assets	\$ 1,535	\$ 1,535
Allowance for credit losses	2,489	1,610
Loss carry-forwards	11,232	10,895
Other	589	1,105
	15,845	15,145
Less: Valuation allowance	(3,309)	(2,673)
	12,536	12,472
Future income tax liabilities:		
Capital assets	324	399
Deposit commissions	921	1,064
	1,245	1,463
Net future income tax asset	\$ 11,291	\$ 11,009

The Corporation's future income tax asset is represented primarily by income tax loss carry-forwards which total \$39,806,000 (2008 - \$36,362,000) and expire in years from 2010 to 2029 if unutilized. A significant portion of the income tax loss carry-forwards relates to the decline in market value of the preferred shares described in note 3 (c) which are deducted from income for income tax purposes.

The realization of the future income tax asset is dependent upon the Corporation being able to generate taxable income during the carry-forward period sufficient to offset the income tax losses and deductible temporary timing differences outstanding at October 31, 2009. Among other things, the ability to generate sufficient taxable income is dependent upon the Bank converting non-taxable income sources to taxable income sources during the carry-forward period and upon the Bank's continued ability and intent to hold the preferred shares until they recover in value or until they are redeemed as they are carried at market value for income tax purposes with mark to market adjustments being added to or deducted from taxable income. At October 31, 2009 the unrealized loss on preferred shares was (\$16,413,000) compared to (\$21,122,000) at October 31, 2008. While management is of the opinion that it is more likely than not that the Bank will be able to realize the future income tax asset, there is a risk that the Bank may be unable to generate sufficient taxable income during the carry-forward period from its existing level of capital. In this case, utilization of the income tax losses and deductible temporary differences may be dependent upon the Bank increasing its capital to facilitate growth in its treasury and loan portfolios.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

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13. Income taxes - continued:

Loss carry-forwards of the Corporation and its subsidiaries will expire, if unused, as follows:

(thousands of dollars)

2010	\$	1,358
2014		1,075
2026		1,032
2027		6,187
2028		25,493
2029		4,661

14. Per share amounts:

Basic earnings (loss) per share

(thousands except per share amounts)

	2009	2008
Net loss	\$ (9,895)	\$ (20,089)
Less dividends on Class A preferred shares	(211)	(240)
Net income (loss) available to common shareholders	(10,106)	(20,329)
Average number of common shares outstanding	13,646	13,633
Basic earnings (loss) per share	\$ (0.74)	\$ (1.49)

Diluted earnings (loss) per share

(thousands except per share amounts)

	2009	2008
Net income (loss) available to common shareholders	\$ (10,106)	\$ (20,329)
Average number of common shares outstanding	13,646	13,633
Dilutive effect of employee stock options	–	–
Dilutive effect of conversion of Class B preferred shares	–	–
Average number of common shares outstanding assuming dilution	13,646	13,633
Diluted earnings (loss) per share	\$ (0.74)	\$ (1.49)

Employee stock options exclude options totalling 859,033 (2008 – 1,077,110) as the result would be anti-dilutive. The effect of converting 1,326,558 Class B preferred shares has also been excluded as the result would be anti-dilutive.

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Notes to Consolidated Financial Statements

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15. Derivative instruments:

As at October 31, 2009, the Corporation had outstanding contracts for ALM purposes to hedge fair value exposure attributed to interest rate risk. The Corporation only enters into these interest rate contracts for its own account and does not act as an intermediary in this market. The credit risk is limited to the amount of any adverse change in interest rates applied to the notional amount in the contract should the counterparty default. Approved counterparties and maximum limits on notional amounts are established by corporate policy. At October 31, 2009, the counterparties to these agreements consisted of Canadian chartered banks.

At October 31, 2009, these contracts had notional amounts totalling \$263,128,000, all of which qualified for hedge accounting. These contracts were in an unfavorable fair value position of \$17,887,000 with this amount being included in other liabilities (note 8) and the offsetting amount included in the carrying values of the asset to which they relate. These contracts have a current replacement cost of \$1,025,000 with this amount being included in other assets (note 5), a credit equivalent amount of \$3,799,000, and a risk weighted balance of \$760,000.

At October 31, 2008, these contracts had notional amounts totalling \$241,410,000 all of which qualified for hedge accounting. These contracts were in an unfavorable fair value position of \$21,327,000.

The current replacement cost represents the positive fair value for all contracts without taking into account any master netting or collateral arrangements that have been made. The current replacement cost does not reflect actual or expected losses. The credit equivalent amount is the current replacement cost plus an add-on for potential future exposure based on a formula prescribed in the Capital Adequacy Guideline of the Office of the Superintendent of Financial Institutions. The risk weighted balance is the credit equivalent amount multiplied by counterparty risk factors prescribed by this Guideline.

The contracts mature as follows:

(thousands of dollars)

2010	\$	2,914
2011		–
2012		100,000
2013		12,862
2014		–
Thereafter		147,352

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16. Nature and extent of risks arising from financial instruments:

Risk management involves the identification, ongoing assessment, managing and monitoring of material risks that could adversely affect the Corporation. The Corporation is exposed to credit risk, liquidity risk, and market risks.

Senior management is responsible for establishing the framework for identifying risks and developing appropriate risk management policies and framework. The Corporation's Board of Directors, either directly or indirectly through its committees, reviews and approves corporate policies, including specific reporting procedures. This enables them to monitor ongoing compliance with policies, delegate limits and review management's assessment of risk in its major risk taking activities. An independent internal auditor is employed to provide a continuing review of policies and procedures to ensure they are appropriate, effective and being followed and that adequate controls are in place in order to mitigate risk to acceptable levels. The internal auditor reports directly to the Audit Committee of the Board of Directors. In addition, the Corporation has an ongoing compliance management program with a Compliance Officer who reports to the Board of Directors on a quarterly basis.

Credit Risk

Credit risk is the potential for loss due to the failure of a counterparty or borrower to meet its financial obligations. The Corporation manages its credit risk using policies that have been recommended by management to the Risk Review Committee, who then recommends the policies to the Board of Directors for approval. These policies consist of approval procedures and limits on loan amounts, portfolio concentration, geographic concentration, industry concentration, asset category, loans to any one entity and associated groups, a risk rating policy that provides for risk rating each asset in its total asset portfolio, and early recognition of problem accounts (watch list accounts) with an action plan for each account. The Risk Review Committee reviews these policies on an ongoing basis. Additionally, credit risk is managed with an emphasis on lower risk assets that include public sector borrowers, investment grade corporations and well established commercial enterprises.

A Risk Review Committee comprised entirely of unrelated directors performs the following functions related to credit risk:

- Recommends policies governing management of credit risks to the Board of Directors for approval and reviews credit risk policies on an ongoing basis to ensure they are prudent and appropriate given possible changes in market conditions and corporate strategy.
- Ensures that procedures and controls for managing credit risk are in place.
- Concurs with credits exceeding the levels delegated to management, prior to commitment.
- Reviews, on a regular basis, watch list accounts, impaired loans and accounts that have gone in to arrears.

See note 3 for information relating to credit risk associated with securities and note 4 for information relating to credit risk associated with loans.

PACIFIC & WESTERN CREDIT CORP.

Notes to Consolidated Financial Statements

Years ended October 31, 2009 and 2008

16. Nature and extent of risks arising from financial instruments:

Liquidity Risk

Liquidity risk is the risk of the Corporation being unable to honour all cash outflow obligations as they come due. The Corporation has established policies to ensure that its cash outflows and inflows are closely matched and that its sources of deposits are diversified between funding sources and over a wide geographic area. The Risk Review Committee recommends policies governing management of liquidity risk to the Board for approval and reviews liquidity policies on an ongoing basis. It receives and reviews quarterly securities portfolio reports and liquidity risk reports from management relating to its liquidity position. Additionally, an Asset Liability Committee, consisting of members of senior management, monitors liquidity risk, reviews compliance with policies and discusses strategies in this area.

Cash and securities

(thousands of dollars)

	2009	2008
Cash and cash equivalents	\$ 172,297	\$ 207,831
Securities	275,847	163,162
Total cash and securities	\$ 448,144	\$ 370,993
Total assets	\$ 1,411,725	\$ 1,512,467
Cash and securities as a percentage of total assets	31.74%	24.53%

Market Risk

Market risk is the risk of a loss resulting from changes in interest rates, foreign exchange rates, and market prices and volatilities that arise from the Corporation's funding and investment activities. The Corporation's principal risk arises from interest rate risk as the Corporation does not undertake foreign exchange or trading activities. The Risk Review Committee is charged with recommending policies that govern market risk to the Board of Directors for approval and with reviewing the policies on an ongoing basis.

Interest Rate Risk

Interest rate risk is the risk that a movement in interest rates could negatively impact spread, net interest income and the economic value of assets, liabilities and shareholders' equity. The Bank manages interest rate risk by employing a number of methods including income simulation analysis, interest rate sensitivity gap and duration analysis and the use of interest rate swap agreements to assist in matching cash inflows and outflows. Management prepares regular reports to the Board to allow for ongoing monitoring of the Bank's interest rate risk position.

Management's Asset Liability Committee reviews the results of these analyses on a monthly basis and monitors compliance with limits set by corporate policy. The interest rate risk position and results of the Bank's duration analysis are presented in the table below.

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Notes to Consolidated Financial Statements

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16. Nature and extent of risks arising from financial instruments – continued:

Interest Rate Position

(thousands of dollars)

	2009		2008	
	Increase 100 bps	Decrease 100 bps*	Increase 100 bps	Decrease 100 bps
Maximum interest exposure during a 12 month period	\$ 1,884	n/m	\$ 2,795	\$ (2,810)
Maximum interest exposure during a 60 month period	2,469	n/m	1,188	(1,023)
Duration difference between assets and liabilities (months)	2.2		4.0	

*n/m – not meaningful due to current level of market interest rates

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17. Interest rate risk:

The Corporation is exposed to interest rate risk as a consequence of the mismatch, or gap, between assets, liabilities and off-balance sheet instruments scheduled to mature or reset on particular dates. The gaps, which existed at October 31, are as follows:

	(thousands of dollars)							Total
	Floating rate	Within 3 months	3 months to 1 year	1 year to 2 years	2 years to 5 years	Over 5 years	Non-interest rate sensitive	
at earlier of maturity or reset date of interest rate sensitive instruments								
Assets								
Cash resources	\$ 172,127	\$ 170	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 172,297
Effective yield	0.25%	1.35%						
Securities	26,224	33	8,609	99,536	119,607	21,838	-	275,847
Effective yield	1.95%	5.93%	1.93%	1.52%	3.56%	4.29%		
Loans	199,151	43,522	49,677	80,607	347,541	214,890	(5,557)	929,831
Effective yield	4.11%	5.31%	5.19%	6.06%	5.55%	5.54%		
Other	-	-	-	-	-	-	33,750	33,750
Total assets	\$ 397,502	\$ 43,725	\$ 58,286	\$ 180,143	\$ 467,148	\$ 236,728	\$ 28,193	\$ 1,411,725
Liabilities								
Deposits	\$ 40,387	\$ 170,778	\$ 613,786	\$ 247,285	\$ 131,794	\$ -	\$ 13,106	\$ 1,217,136
Effective rate	1.05%	2.83%	2.24%	2.62%	4.12%	-		
Notes payable	-	-	7,767	-	-	70,166	-	77,933
Effective rate	-	-	8.67%	-	-	11.18%		
Other	-	46,578	-	-	-	-	24,715	71,293
Effective rate	-	0.29%	-	-	-	-		
Preferred share liabilities	-	-	-	-	-	27,892	-	27,892
Effective rate	-	-	-	-	-	11.80%		
Shareholders' equity	-	-	-	-	-	-	17,471	17,471
Total liabilities and shareholders' equity	\$ 40,387	\$ 217,356	\$ 621,553	\$ 247,285	\$ 131,794	\$ 98,058	\$ 55,292	\$ 1,411,725
On balance sheet gap	\$ 357,115	\$ (173,631)	\$ (563,267)	\$ (67,142)	\$ 335,354	\$ 138,670	\$ (27,099)	\$ -
Derivatives used for ALM	-	248,270	11,944	(50,000)	(62,862)	(147,352)	-	-
Effective rate	-	1.67%	5.24%	5.10%	5.23%	5.48%		
2009 gap	\$ 357,115	\$ 74,639	\$ (551,323)	\$ (117,142)	\$ 272,492	\$ (8,682)	\$ (27,099)	\$ -
Cumulative 2009 gap	\$ 357,115	\$ 431,754	\$ (119,569)	\$ (236,711)	\$ 35,781	\$ 27,099	\$ -	\$ -
2008 gap	\$ 273,947	\$ 221,827	\$ (712,728)	\$ (125,796)	\$ 314,844	\$ 68,231	\$ (40,325)	\$ -
Cumulative 2008 gap	\$ 273,947	\$ 495,774	\$ (216,954)	\$ (342,750)	\$ (27,906)	\$ 40,325	\$ -	\$ -

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17. Interest rate risk - continued:

Interest rate swap agreements to exchange interest terms are entered into for the purpose of limiting exposure to changes in interest rates. A positive interest rate gap exists when interest sensitive assets exceed interest sensitive liabilities for a specific maturity or repricing period. A positive gap will tend to lead to an increase in net interest income when market rates rise since assets are repricing earlier than liabilities. The opposite impact will occur when market interest rates fall.

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18. Fair value of financial instruments:

The amounts set out in the table below represent the fair value of the Corporation's on and off-balance sheet financial instruments.

(thousands of dollars)

	2009			2008		
	Book Value	Fair value of assets and liabilities	Fair value over (under) book value	Book Value	Fair value of assets and liabilities	Fair value over (under) book value
Assets						
Cash resources	\$ 172,297	\$ 172,297	\$ -	\$ 207,831	\$ 207,831	\$ -
Securities	275,847	270,333	(5,514)	163,162	158,975	(4,187)
Loans	929,831	928,176	(1,655)	1,110,807	1,108,904	(1,903)
Other financial assets	7,620	7,620	-	4,370	4,370	-
	\$ 1,385,595	\$ 1,378,426	\$ (7,169)	\$ 1,486,170	\$ 1,480,080	\$ (6,090)
Liabilities						
Deposits	\$ 1,217,136	\$ 1,206,181	\$ (10,955)	\$ 1,389,455	\$ 1,377,748	\$ (11,707)
Notes payable	77,933	80,324	2,391	70,405	68,501	(1,904)
Other financial liabilities	71,293	71,293	-	28,476	28,476	-
Preferred share liability	27,892	33,695	5,803	-	-	-
	\$ 1,394,254	\$ 1,391,493	\$ (2,761)	\$ 1,488,336	\$ 1,474,725	\$ (13,611)
Total			\$ (4,408)			\$ 7,521

The fair value amounts have been determined using the valuation method and assumptions described below:

- The fair values of securities and other financial assets are determined based on quoted market prices and external valuation models.
- The fair value of loans is based on net discounted cash flows using market interest rates for loans and appraised values for real estate.
- The fair value of deposits is determined based on discounted cash flows using market interest rates.
- The fair value of notes payable and Class B Preferred Shares are determined by referring to current trading values.
- The fair value of other financing obligations is approximately equal to their book value due to the short-term nature of the instruments.
- The fair value of ALM derivatives is derived from the use of cash flow modeling techniques.

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19. Segmented information:

The operations of the Corporation consist primarily of one business segment (Banking) which provides lending services to corporate and public sector markets and deposit services to retail depositors through a well diversified broker network.

20. Commitments and contingencies:

a) Credit commitments:

The amounts of credit related commitments represents the maximum amount of additional credit that the Corporation could be obliged to extend. Under certain circumstances, the Corporation may cancel loan commitments at its option. The amounts with respect to letters of credit are not necessarily indicative of credit risk as many of these arrangements are contracted for a limited period of usually less than one year and will expire or terminate without being drawn upon.

(thousands of dollars)

	2009	2008
Loan commitments	\$ 109,378	\$ 186,657
Letters of credit	30,133	31,910
	\$ 139,511	\$ 218,567

b) Lease commitments:

The Corporation has obligations under leases for rental of premises. Minimum future lease commitments for each of the five succeeding years and thereafter are as follows:

(thousands of dollars)

2010	\$	595
2011		359
2012		273
2013		273
2014		37
Thereafter		-

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20. Commitments and contingencies - continued:

c) Legal proceedings:

In the ordinary course of business, there are actions pending against the Corporation and its subsidiaries. Management of the Corporation believes that the resolution of outstanding actions will not be material to the financial position of the Corporation or the outcome is not determinable at this time.

d) Pledged assets:

In the ordinary course of business, securities and other assets are pledged against liabilities and off-balance sheet items.

Details of assets pledged at October 31 are as follows:

(thousands of dollars)

	2009	2008
Obligations related to securities sold under repurchase agreements (note 8)	\$ 46,578	\$ -
Collateral related to derivative transactions	14,271	15,867
Collateral related to letters of credit	2,940	2,907
	\$ 63,789	\$ 18,774

21. Related party transactions:

At October 31, 2009, the Corporation had loans to officers and directors totalling \$3,786,000 (2008 - \$2,942,000). These loans have terms similar to those offered to non-related parties.

22. Capital management:

a) Overview:

The Corporation's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The impact of the level of capital on shareholders' return is also important and the Corporation recognizes the need to maintain a balance between the higher returns that might be possible with greater leverage and the advantages and security afforded by a sound capital position.

The Corporation's primary subsidiary is Pacific & Western Bank of Canada, (the "Bank") and as a result, the following discussion on capital management is with respect to the capital of the Bank. The Bank operates as a bank under the *Bank Act* (Canada) and is regulated by the Office of the Superintendent of Financial Institutions Canada (OSFI). OSFI sets and monitors capital requirements for the Bank.

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22. Capital management – continued:

Capital is managed in accordance with policies and plans that are regularly reviewed and approved by the Board of Directors and take in to account forecasted capital needs and markets.

The goal is to maintain adequate regulatory capital to be considered well capitalized, protect consumer deposits and provide capacity for internally generated growth and strategic opportunities that do not otherwise require accessing the public capital markets, all the while providing a satisfactory return to shareholders. The Bank's regulatory capital is comprised of share capital, retained earnings and unrealized gains (losses) on available-for-sale equity securities (Tier 1 capital) and face value of subordinated notes (Tier 2 capital).

The Bank monitors its capital adequacy and related capital ratios on a daily basis and has policies setting internal maximum and minimum amounts for its capital ratios. These capital ratios consist of the assets-to-capital multiple and the risk-based capital ratio.

During the year ended October 31, 2009, there have been no material changes in the Bank's management of capital.

b) Assets-to-Capital Multiple:

The Bank's growth in total assets is limited by a permitted assets-to-capital multiple which is prescribed by OSFI and is defined as the ratio of the total assets of the Bank to its regulatory capital. The Bank's assets-to-capital multiple is calculated as follows:

(thousands of dollars)

	2009	2008
Total assets (on and off-balance sheet)	\$ 1,441,012	\$ 1,545,437
Capital		
Common shares	\$ 95,365	\$ 87,365
Retained earnings	4,588	8,513
Unrealized loss on available-for-sale equity securities	(12,821)	(15,173)
Subordinated notes	41,500	20,000
Total regulatory capital	\$ 128,632	\$ 100,705
Assets-to-capital ratio	11.20	15.35

For a period of time during the quarter ended January 31, 2009, the Bank estimated that it had on a temporary basis exceeded, by a minor amount, the assets-to-capital ratio that had been established by OSFI. This exception took place primarily as a result of a decrease in the market value of preferred shares held in the Bank's securities portfolio and which are primarily those of major Canadian banks and insurance companies. This decrease took place as a result of market volatility versus any credit impairment in the issuers of the securities. In January 2009, the Bank's adherence to this requirement was re-established and has been adhered to since that date.

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22. Capital management – continued:

c) Risk-Based Capital Ratio:

OSFI requires banks to measure capital adequacy in accordance with guidelines for determining risk adjusted capital and risk-weighted assets including off-balance sheet credit instruments. Based on the deemed credit risk for each type of asset, a weighting of 0% to 150% is assigned to determine the risk-based capital ratio. OSFI recommends that banks maintain a minimum total risk-based capital ratio in excess of 10% and a Tier 1 risk-based capital ratio in excess of 7%.

In June 2004, the Basel Committee on Banking Supervision released its report entitled “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” (Basel II). The new framework is designed to more closely align regulatory capital requirements with underlying risks by introducing changes in the treatment of credit risk. An explicit new capital charge for operational risk was introduced, as well as increased supervisory review of capital adequacy and expansion of the related public disclosure. The new Basel II Framework was effective November 1, 2007 for Canadian banks.

The Bank’s risk-based capital ratios are calculated as follows:

(thousands of dollars)	2009		2008	
	Notional Drawn Amount	Risk Weighted Balance	Notional Drawn Amount	Risk Weighted Balance
Balance sheet assets	\$ 1,410,659	\$ 848,686	\$ 1,513,456	\$ 809,747
Off-balance sheet assets	402,639	63,477	459,977	57,706
Charge for operational risk		16,936		39,698
Total risk-weighted assets		\$ 929,099		\$ 907,151
Regulatory capital		128,632		100,705
Total risk-based capital ratio		13.84%		11.10%
Tier 1 risk-based capital ratio		9.38%		8.90%

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23. Subsidiary company information:

The following table presents summary financial information regarding the Bank on a consolidated basis:

Consolidated balance sheets

<i>(thousands of dollars)</i>	2009	2008
Cash and cash equivalents	\$ 170,650	\$ 207,095
Securities	275,847	163,162
Loans, net of allowance for credit losses	929,831	1,110,807
Other assets	34,331	32,392
	\$ 1,410,659	\$ 1,513,456
Deposits	\$ 1,217,136	\$ 1,389,455
Subordinated notes payable	39,946	19,969
Other liabilities	69,925	27,206
	1,327,007	1,436,630
Share capital	95,365	87,365
Retained earnings	4,588	8,513
Accumulated other comprehensive income (loss)	(16,301)	(19,052)
Shareholder's equity	83,652	76,826
	\$ 1,410,659	\$ 1,513,456

Consolidated statement of operations

<i>For the year ended October 31</i>	2009	2008
Interest income	\$ 78,984	\$ 72,176
Interest expense	68,502	61,556
Net interest income	10,482	10,620
Provision for credit losses	3,449	2,836
Net interest income after provision for credit losses	7,033	7,784
Other income (charges)	1,449	(14,769)
Net interest income and other income (charges)	8,482	(6,985)
Non-interest expense	14,630	12,794
Loss before income taxes	(6,148)	(19,779)
Income taxes	(2,223)	(4,838)
Net loss	\$ (3,925)	\$ (14,941)

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24. Subsequent event

Subsequent to October 31, 2009 the Corporation completed the closing of two private placements of Class B Preferred Shares. Pursuant to these private placements, 454,500 Class B Preferred Shares were issued for net proceeds of \$10.7 million after issue costs, which will be used for working capital purposes in the parent company and to provide additional capital in the Bank to fund further growth.

25. Comparative figures:

Certain comparative figures have been reclassified to conform to the current period's presentation.