



Santander Consumer USA Holdings Inc.
Second Quarter 2017 Earnings Conference Call
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Chris Donat, *Sandler O’Neill*

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PRESENTATION

Operator:

Good morning and welcome to the Santander Consumer USA Holdings Second Quarter 2017 Earnings Conference Call. At this time, all parties have been placed into listen-only mode. Following today’s presentation, the floor will be open for your questions. Please dial star, one to enter the Q&A queue.

It is now my pleasure to introduce your host, Evan Black, Vice President of Investor Relations. Evan, the floor is yours.

Evan Black:

Good morning everyone and thanks for joining the call. On the call today, we have Jason Kulas, President and Chief Executive Officer, and Izzy Dawood, Chief Financial Officer.

Before we begin, as you are aware, certain statements made today, such as projections for SC's future performance, are forward-looking statements. Actual results could be materially different from those projected. SC has no obligation to update the information presented on this call. For further information concerning factors that could cause these results to differ, please refer to our public SEC filings.

Also on today's call, our speakers may reference certain non-GAAP financial measures that we believe will provide useful information for investors. A reconciliation of those measures to U.S. GAAP is included in the earnings release today, issued July 28, 2017

For those of you listening to the webcast, there are a few user-controlled slides to review, as well as a full Investor Presentation on the website.

Now I'll turn the call over to Jason Kulas. Jason?

Jason Kulas:

Thank you, and good morning, everyone. Today, I'll start by discussing our second quarter highlights and provide an update on our key strategic priorities. I'll then turn the discussion over to Izzy for a detailed review of this quarter's results, before we open the call for questions, following a few closing remarks.

Turning to Slide 3, to share some of the key highlights from the second quarter of 2017, we are pleased to report solid results for the quarter. Our assets are continuing to produce strong risk-adjusted cash flows, our capital base remains solid, and our focus on keeping our business simple, personal and fair is positioning us for continued success.

During the quarter, SC earned net income of \$265 million, or \$0.74 per diluted common share. As we've discussed in prior quarters, our efforts continue in Puerto Rico with Santander Consumer International, or SCI, a wholly-owned subsidiary of SC, to enhance vendor management oversight and de-risk our business via geographic and time zone diversification. SCI also manages the servicing strategy of the performing portion of our loan and lease portfolio. During the quarter, we realized a lower overall effective tax associated with SCI's results.

During the quarter, following SCUSA's CCAR results, we announced proposed dividends to shareholders, beginning in Q4 2017. The improvements we have made through our capital planning processes over the last several quarters have allowed us to begin returning excess capital to our shareholders. All of our capital distributions remain subject to our internal governance protocols.

Auto originations, including loan and leases, totaled \$5.5 billion this quarter, in line with the prior year quarter. We are pleased with the growth in our non-prime originations year-over-year, which I will detail shortly.

Return on average assets for the quarter was 2.7%, including SCI's results. During the quarter, we executed asset sales of \$536 million through the Banco Santander flow agreement, following last quarter's sale of \$700 million.

Turning to Page 4, here are some key economic indicators that influence our originations and credit performance. U.S. auto sales remained elevated, but continued to trend down; consumer confidence remain high; U.S. GDP growth is in line with the recent historical range; and U.S. unemployment levels continue to be very low. These metrics are strong indicators of the health of the economy and the U.S. consumer. While the consumer remains strong, we are closely monitoring non-mortgage consumer debt trends, which continue to rise.

On Page 5, there are a few key factors can influence our loss severity and credit performance. As expected, our Auction Only recovery rates are trending down and in line with NADA trends. Our Auction Plus recovery rates, which include insurance proceeds, bankruptcy and deficiency sales, were 54% in the quarter. We continue to model lower recovery assumptions and current experience and believe we are adequately reserved. Additionally, non-prime industry securitization data, including net loss and delinquency trends, continue to be relatively stable to moderately higher. SC Auto ABS remains structurally sound and we continue to have successful execution on our deals. Izzy will highlight SC's latest ABS activity.

Slides 7 and 8 illustrate the diversification of SC's underwriting across the full credit spectrum.

Turning to Page 7, our core retail and non-prime Chrysler Capital auto loan originations with FICO scores below 640 increased 36% and 11%, respectively, compared to the prior quarter. The prime environment remains highly competitive, with Chrysler Capital loans above 640 and leases decreasing 30% and 16%, respectively, versus Q2 2016.

Turning to Page 8, and further drilling down into our originations mix, originations with FICO scores below 640 increased approximately \$500 million to \$2.7 billion during Q2 2017, compared to Q2 last year. The increase is primarily contributable to competitive easing in the non-prime space over the last several quarters. As you would expect, we continue to remain disciplined in our approach across the credit spectrum. In addition, our proportion of used vehicles originated during the quarter increased, compared to the prior year quarter, with lower average loan balances in line with more non-prime originations.

Moving to Slide 9, the Chrysler Capital penetration rate as of the end of Q2 was 20%, up from 19% at the end of last quarter. During the quarter, we completed the national rollout of our dealer VIP program, with more than 2,500 FCA dealers enrolled, which, combined with our second Banco Santander asset sale in Q2 and the continued increase in dealer floorplan support, improved penetration rates. Over time, we expect these strategies to further advance our relationship with FCA, by providing a more stable framework for originations, which will, in turn, support our Service For Others business. In addition, our dealer receivables originations increased 3% during the first six months of this year, compared to the same period last year. It's also important to note that our Chrysler Capital volume and penetration rates are influenced by strategies implemented by FCA, including product mix and incentives.

Turning to Slide 10, servicing fee income totaled \$32 million this quarter, as we continue to deliver value through SC's capital-efficient platform. While still a differentiator and focus for our business, our Serviced For Others balance continues to decrease, due to lower prime originations and lower asset sales. Moving forward, we expect to drive the Serviced For Others platform by increasing our Chrysler Capital penetration, supported by the strategies I mentioned previously.

I would now like to turn the call over to Izzy for a more detailed review of our financial results. Izzy?

Ismail "Izzy" Dawood:

Thank you, Jason, and good morning, everyone. Let's turn to Slide 11 to review this quarter's results.

Net income for the second quarter was \$265 million, or \$0.74 per diluted common share. As Jason mentioned, this quarter's results were positively impacted by a lower effective tax rate associated with SCI's results, leading to a \$41 million positive impact, or \$0.11 per diluted common share, of which \$14 million, or \$0.04 per diluted common share, is attributable to Q2 2017.

Net leased vehicle income increased 5% in Q2, compared to Q2 last year, as we continue to see growth in our leasing portfolio with FCA.

Total other income this quarter was \$24 million, which is net of approximately \$90 million of lower of cost or market adjustments related to personal lending and \$2 million in other losses. I will provide further details on a subsequent slide.

Moving on to Slide 12, which highlights our performance excluding the impact of personal lending, further details can also be found in the appendix of the presentation. Our Q2 2017 interest on finance receivables and loans decreased 4% year-on-year, driven by lower average retail installment contract balances. Interest expense increased 17% versus the prior year quarter, primarily driven by the increase in benchmark rates, but also an increase in term debt, as we strengthen the liability side of our balance sheet. Average one-month LIBOR increased approximately 60 basis points from June 2016 to June this year. This increase is in line with the three short-term rate hikes by the Federal Reserve since Q2 2016. Cost of funds and newly issued term ABS increased approximately 36 basis points, driven by benchmark rate increases, and partially offset by spread tightening. Servicing fee income decreased 26% year-over-year, due to lower prime originations and lower asset sales, as Jason mentioned. Average lease assets were up 8% year-over year.

Turning now to Slide 13, we further drill down into total other income. Reported total other income was \$24 million in the quarter. The impact of lower of cost or market adjustments for personal lending of \$90 million includes \$104 million in customer defaults, offset by a net reduction of market discounts of \$14 million, as balances decreased versus prior quarter, in line with seasonal patterns. Normalized investment losses for the quarter were \$2 million, primarily driven by losses on asset sales and customer defaults associated with auto assets held for sale. After including servicing fee income and fees, commissions and other, normalized total other income was approximately \$122 million.

Turning to Slide 14 to review vintage performance, this is an update to a slide we covered during our last Investor Day in February. This slide displays gross and net losses for the full year 2014, 2015 and 2016 retained vintages, or up to 18 months of actual performance. Consistent with our presentation in February, our 2016 vintage continues to outperform the 2015 vintage on a gross, as well as net loss basis.

Turning our attention to provisions and reserves, on Page 15, at the end of the Q2 2017, the allowance figure totaled \$3.5 billion, relatively flat compared to the end of the prior period. There was a \$199 million increase associated with new originations, a \$101 million increase due to troubled debt restructuring, or TDR migration, meaning the additional allowance coverage required for loans that now qualify for TDR treatment, per our definition, which we are not classified as TDRs during the prior period, and a \$35 million increase due to performance adjustments. These increases were almost fully offset by \$330 million in liquidations, which includes pay-offs and charge-offs.

As we discussed at our Investor Day, TDRs are an accounting classification for assets that meet certain loan modifications or extension criteria. Our Loans Servicing Team uses loan modifications and extensions on a case-by-case basis to offer assistance to some customers experiencing temporary financial hardship. Under GAAP, the allowance requirement on an asset classified as a TDR takes into consideration lifetime losses, and even if the loan performs, it will continue to be classified as a TDR for the remainder of its life.

Additionally, the allowance ratio is one of our most critical estimates and follows a very controlled process for historical inputs driving future expectations. One of these processes is how we arrive at our recovery rate. The analysis provides a range of expected outcomes and we are anchored at the lowest point of our range, which currently is at 44%. As the analysis drives the future change, we'll provide further updates, as well. As a reminder, our recovery rate for full year 2016 was 52%.

Continuing to Slide 16, delinquency rates, including the 31 to 60 and 61-plus buckets, increased 40 and 50 basis points in Q2 2017, respectively, from the prior year quarter, as a result of slower portfolio growth since Q2 2016. Our retail installment contract gross and net charge-off ratios increased 16.4% and 7.5% in Q2 2017, respectively, from 14.9% and 6% in Q2 last year. The increase in SC's net charge-off ratio is primarily attributable to a lower recovery rate. Recovery rates increased from the prior quarter, as expected, but decreased year-over-year. Used car prices are trending lower, which impacts recovery rates, and we are seeing that in our recoveries. Industry consensus is that the softening in used prices is expected to continue at a measured pace. Additional factors that impact recovery rates include vehicle type and age. We continue to see a bifurcation of performance between sedans and larger vehicles, such as SUVs and trucks, which have performed better, but still continue to face declines in value. Other drivers of the increase are attributable to a combination of slower portfolio growth since Q2 2016, the acceleration of bankruptcy-related charge-offs, and changes we have made to our business processes. Note that these bankruptcy-related charge-offs are timing related and would have likely otherwise occurred in future quarters, and as such, not changing SC's overall view of vintage losses. Additionally, this impact is materially offset in our allowance for credit loss.

Turning to Page 17, to review the loss figures in dollars, net charge-offs for individually acquired retail installment contracts increased \$100 million in the quarter to \$513 million, which is primarily driven by lower recoveries of \$62 million. This quarter, we also incurred \$25 million in losses attributable to the acceleration of bankruptcy-related charge-offs, as mentioned previously. Another \$29 million of the overall increase is due to portfolio aging and mix shift. The primary driver was portfolio aging, as the average unpaid principal balance decreased approximately 2%, versus the prior year quarter.

As mentioned, losses in the quarter were further impacted by recent changes to our business processes. To elaborate further, in the process of improving our operations, losses in a subset of customer accounts increased, driven by modification approvals and certain contract strategies, including the frequency and manner in which we interact with these customers. After refining our process, we are satisfied that performance is now line with expectations. The net result is an improvement to our industry-leading servicing platform and enhancement to our culture of compliance.

Turning to Slide 18, operating expenses this quarter totaled \$282 million, an increase of 4%, versus the same period last year. This increase was driven by continued investment in compliance and control functions. The expense ratio for the quarter was 2.2%, up from 2% in the prior year quarter and down from 2.4% in Q1.

Turning to Slide 19, total committed liquidity increased 2% to \$42.1 billion at the end of the quarter, versus prior quarter end. During the quarter, we executed one DRIVE and one SDART securitization, totaling approximately \$2.3 billion. As with our other DRIVE and SDART non-prime securitizations, these typically remain on our balance sheet and we retain the first loss position. Also, our track record of rating agency upgrades continued, demonstrating the strength of ABS platforms. In total, 18 ABS sponsors were upgraded this quarter, positively impacting more than \$2.2 billion in securities.

In June, our DRIVE securitization platform was registered with the SEC as a public shelf. Our inaugural public DRIVE issuance was very well received, resulting in more than \$300 million in orders from new investors that were previously unable to participate in non-public securitization. We believe there are several benefits in having public securitization platforms, including increased transparency with our investors and more efficient funding. SDART and DRIVE combined, which are now both public, represent approximately 70% of our retail installment contract balance as of the end of the quarter, with summary data available on our website. As you are aware, securitization vintages do not equate to origination vintages.

Asset sales in the quarter totaled \$566 million, primarily driven by our second Banco Santander flow transaction of \$536 million, as Jason mentioned.

Briefly turning to Page 20, our CET1 ratio for this quarter is 14.3%, which is 170 basis points higher than Q2 last year. Our tangible assets also increased during the period, demonstrating SC's ability to generate capital and support growth. Our capital levels remain well above the revised required minimum capital of 12.5% CET1 ratio, as determined by SCUSA's most recent CCAR submission.

Looking ahead to Q3 2017, my comments will be relative to Q2, unless otherwise noted, and include the impact of personal lending. The personal lending assets remain on the balance sheet and are still classified as held for sale. We will update our comments, if necessary, based on any new developments in our sale process.

We expect net interest income to be down 2% to 4% in the third quarter, driven by lower portfolio yield and higher interest expense. We expect our allowance for credit losses to be down \$90 million to \$110 million. Net charge-offs are expected to be \$220 million to \$240 million higher, as charge-offs seasonally increase in the third quarter. Therefore, incorporating the outlook on net charge-offs and allowance for loan loss, overall provision expense is expected to be \$110 million to \$150 million higher in Q3, relative to Q2. Other income is expected to be flat. Operating expenses are expected to be up \$5 million to \$10 million next quarter. Our tax expense will be positively impacted by \$7 million to \$10 million associated with SCI's results.

Before we begin Q&A, I would like to turn the call back over to Jason. Jason?

Jason Kulas:

Thanks, Izzy. I would like to provide a brief update on RoadLoans.com, our digital direct-to-consumer platform. Volume through this channel totaled \$69 million this quarter, up 30% sequentially and up 35% versus the prior year quarter. We expect this online portal to be incremental to our originations as the market evolves.

This quarter, we have included a new slide regarding consumer practices and income verification to address some of SC's key practices around these topics. Please turn to Slide 22, as we address some of these points.

Setting up the consumer for success and ensuring a customer's ability to repay their loan are both part of an effective consumer practices program and are directly tied to our financial success. We continuously review our consumer and business practices to ensure that we are providing responsible financing to consumers who want a vehicle to meet their personal needs.

To highlight some of these practices, one factor is income verification. We consider a wide range of quantitative and qualitative factors to manage and price for risk. Income verification is only one of those factors. SC relies on other credit and loan attributes that help mitigate and compensate for overall credit risk. Variables, including down-payment, maximum monthly payment, Credit Bureau history and loan to value, contribute to SC's credit approval decision and allow us to structure loans customers have the highest likelihood to repay.

Other validation methods we use prior to funding a loan include identifying risks through our Know Your Customer and fraud income verification processes, by leveraging third-party solutions to complement our efforts. These other validation methods provide additional controls and checks and balances which create additional layers to our risk-based pricing, such as identifying inaccuracies on the customer's application during the loan origination process.

Another critical step in our approach to credit is our ongoing review process after a loan has been funded, which includes welcome call attempts to 100% of our customers and, if appropriate, providing assistance,

such as loan extensions or temporary reductions in payments to certain customers experiencing temporary financial hardship.

Our process also includes our comprehensive Dealer Performance Management, or DPM, Program. To briefly address a few components of our DPM program, SC monitors its dealers on an ongoing basis to determine whether a dealer should be placed in an enhanced monitoring environment, which may include additional stipulations, such as verifications of income and employment. Stipulations vary by DPM severity level. Also, dealers are assigned a DPM level based on certain quantitative portfolio metrics, as well as qualitative behavior triggers, such as consumer complaints, negative media and fair lending monitoring.

All of these steps feed back into our originations process and help us ensure that we are setting our customers up for success. While I'm proud of everything SC has done over the years to improve the customer experience and putting a strong focus on a customer's ability to repay their loan, there's still work to be done as we endeavor to maintain the highest standards of governance, compliance and risk management, while remaining committed to generating long-term shareholder value.

In closing, I would like to restate several of our second quarter accomplishments. First, SCUSA passing CCAR and receiving regulatory approval for the dividends in our capital plan is an important first step. The progress we are making on our many SC initiatives, including prime flow to Santander, dealer floorplan and dealer VIP rollout, will position us to increase our penetration and grow this relationship over time. Yields and structures on our most recent originations are showing that we can effectively price for the risk we're taking and react to changes in the environment as they occur. Compliance and consumer practice initiatives are making our Company stronger and enhancing our control environment. These accomplishments, combined with a strong consumer, macroeconomic and financing environment, and global bank ownership, position SC to continue to execute on our strategic goals.

With that, I'd like to open the call for questions. Operator?

Operator:

We will now open the call for questions. Please limit yourself to one question and one follow-up question. Thank you.

Our first question comes from John Hecht with Jefferies.

John Hecht:

Thanks, guys. Real quick, on the tax rate—I think it's been a little lower more recent quarters—is there some permanent adjustment, I guess, maybe related to Puerto Rico's strategy that we should think about, or how should we just think about the tax rate over the course of a few quarters here?

Ismail "Izzy" Dawood:

Yes, sure, John. It's Izzy. Thanks for the question. Yes, what I would do is assume prior to this quarter the effective rate, and then, as I mentioned, somewhere between a \$7 million to \$10 million reduction of that tax expense. As we get more comfortable with our overall analysis, we will write a more effective tax rate guidance, but right now it's just a quarter-over-quarter view on the tax expense. Just a reminder, obviously, you know, the Puerto Rico strategy is being driven by, obviously, our ability to reduce the risk in our operations by having that time zone diversification, oversight of our vendors, and driving the strategy around the performing part of our loan portfolio.

Jason Kulas:

And geographic diversification, as well. We're really pleased with what we're seeing so far in Puerto Rico. It's been a good operation so far, the people are great people, and we're really pleased to have a presence there. The tax benefit is just an incremental benefit for us.

John Hecht:

Okay, thanks for that. Then, I guess the second question is going to be more commentary on the market opportunities. You guys boosted some of the—I guess the more sub-prime originations in the quarter, and I think I saw that the LTV and the recent DRIVE securitization was relatively high, particularly relative to recent vintages, and I wonder if you can discuss are you seeing really good opportunities there, has the competition reverted, and how that affects your outlook for originations in the near term?

Jason Kulas:

Sure, thanks, John. What we're seeing on the originations front is really what we have, which is month to month, week to week, quarter to quarter. We price up and down the credit spectrum, because we're a full spectrum lender, and we take what the market will give us, based on what we think is the right credit structure across that credit spectrum. We did see an incremental opportunity in the quarter to book some incremental core non-prime business. What's really interesting, though, is if you look at what's happening in July, that's really gone back a little bit the other way. So, if you look at July versus July 2016, the way it's shaping is we're actually up across the board in all of the Chrysler categories year-over-year, so for Chrysler prime, for Chrysler non-prime and leased, and then down in the core business. If you look at where July is coming in relative to June, the core business is also down, Chrysler non-prime is slightly down, and then Chrysler prime and leased look like they're up, versus June.

So, this is a story that continues to ebb and flow based on what people are doing in the market. There's no real discernible trend in terms of across the market. You have individual companies who will announce that they are retreating or pursuing certain parts of the credit spectrum, but there's a real diverse set of answers to that question, as I'm sure you're seeing as people announce their results.

For us, on—I'm glad you brought up the credit metrics. If you look across our business, we're actually real proud of the fact that from—if you look at LTV, if you look at PTI, if you look at how we're structuring our credit, on a like-for-like basis, we've maintained a real conservative stance on LTV and PTI. As you go down the credit spectrum, you do tend to see LTV go up, and so that's something we would expect, but if you look at our business in terms of trends in LTV and PTI trends, and the terms that we're putting in place at origination, we feel like the credit trends are still very solid and we've made no decision to lighten our approach on credit.

John Hecht:

I appreciate the color, guys. Thanks very much.

Jason Kulas:

Thanks, John.

Operator:

Our next question comes from Chris Donat with Sandler O'Neill.

Chris Donat:

Hi. I wanted to ask something else related to the Chrysler relationship, which is that, as you've seen interest rates—or as we've seen interest rise here, is that starting to affect any of the originations you're seeing, you know, the relative benefits, the cash on the hood, versus subvented? Are we seeing signs yet?

Jason Kulas:

We're not seeing a significant move at this point. As it stands today, the percentage of our business that is subvented is still relatively low. We do expect—I think you're right on—we do expect, as the environment continues to shift and rates continue to go up, at whatever pace they do, that that story will shift, as well, and that an increasing percentage of our business will be done with subvented rates. Right now, there's much more of focus on bonus dollars that go to the general market and on incentives that are—what we're seeing across the board for most manufacturers is a focus on that. But, we do still have certain incentives that benefit our business, and we're constantly working with FCA, with Chrysler to put more of those in place and figure out ways that we can book more good business and also help them sell incremental cars. So, those are ongoing discussions and I hope in future quarters we'll continue to report that we're making progress. The foundational elements we're putting in place, we feel like really set us up to continue to perform on Chrysler. We feel like we've found a base of performance and we're growing from that base. The incremental growth we saw in Q2 versus Q1, even though it's just incremental, from 19 to 20, we think is evidence of that.

Chris Donat:

Okay, and then I just want to ask Izzy one more on the tax issues in Puerto Rico. As we think about 2018, and all else equal with U.S. federal tax policy, should we be thinking of a tax rate sort of like the normalized 35%, or is there is likely downward pressure because of what you're doing in Puerto Rico, or is it too soon to tell?

Ismail “Izzy” Dawood:

No, there should be downward pressure, assuming we're comfortable with our analysis, and pretty much in the same range I gave for next quarter, if you want to make a forward-looking assumption, but like I said, we'll update every quarter going forward.

Chris Donat:

Okay, understood. Thank you.

Operator:

Our next question comes from Michael Tarkan with Compass Point.

Michael Tarkan:

Thanks. Just getting back to credit a little bit, relative to your expectations for the second quarter—the numbers came in a little bit higher, and I know recovery rates may be part of that—just any kind of color on that, and then how you're thinking about the third quarter, and, more importantly, I guess, from a provisioning and reserving standpoint, how should we be thinking about 2018, are you still thinking TDRs are going to peak later this year or early next? Thank you.

Jason Kulas:

Okay, thank you. I'll start with the first part and then maybe, Izzy, you can follow up with the second part of the question. If you look at losses relative our expectations at the end of Q1, they have come in a little bit higher, and I think we've discussed all the reasons, but I'll go into a little more detail. We've got the

typical reasons where we've seen softness in recoveries, and that certainly works its way through. There's a small element of this that is a little bit of degradation in like-for-like performance, as we see a little bit of an increase in frequency of loss, combined with that severity that we're seeing in the recovery markets. There's also some timing impact from BK accounting strategy, and those kinds of things, bankruptcy accounting strategy that we mentioned. So, all those things sort of roll through and impact through to the increase in loss. But, there is another element of it that's operational, and if you look at the difference between our guidance on loss for the quarter versus where we came in, we think about half of that difference is a result of those operational changes we mentioned in the prepared comments, and there's a few statements we'll make about that, that I think are really relevant for the forward look that you're asking about.

We think a portion of that impact, by the way, is timing, just to a bring-forward of some of the future expected losses, but the important thing for us on the operational changes that were made is that these changes were decisions that we make on an ongoing basis to continue to optimize the performance of our servicing business. When we saw performance come in a little bit different than what we expected, we acted very quickly and very decisively to respond to those differences, and we have our arms around the differences. So, I think that's the really good news, is as we make ongoing efforts to continue to tweak our servicing strategy, to make sure it's the right thing for consumers and also maximizes performance on our side, we're going to continue to find those opportunities and continue to, we think, sort of build our lead in our servicing platform. But, when we see something come in a little bit different, we react pretty quickly to it.

I think that's the key message, is we did have an impact in the quarter, we don't expect it to have any meaningful impact on the business going forward. In fact, it's not material to our operations. It doesn't change our capital distribution strategies, or anything like that, but it did impact the quarter a little.

Ismail "Izzy" Dawood:

Just following up on the other comment on TDRs, we're still thinking the same, TDRs should peak later this year and early next year. As you probably note in the disclosure, the TDR growth is still growing, but growing at a slowing rate, as we have said, and so that continues. Looking out to 2018, personally, I just think it's a little too early. Given the changing dynamics in the non-prime space, the improvement of Chrysler penetration, I think this all will influence our provisioning and the loss expectations, so we'll update that as time goes on.

Michael Tarkan:

Okay, and just as a follow-up, I mean, you're sitting there at 12.6% reserve levels, running well ahead of peers, and I'm just kind of wondering, do you guys have a sense for where that normalizes on a percentage basis, you know, how to think about that longer term, what you think the right level is? Thank you.

Ismail "Izzy" Dawood:

Sure. So, two questions there, Mike. One is, on the 12.6%, you have to understand, relative to our peers, we probably have the lowest FICO and probably more non-prime credit on our balance sheet. That drives the higher coverage ratio. So, that's one aspect. In terms of what's normalized, I think will depend on people's expectation of recovery rates, credit performance, and the like. At the end of the day, our goal is to ensure that, from a methodology and from a model perspective, that we follow the control process we have in place, and so for the quarter, it is the appropriate level of allowance.

Michael Tarkan:

Thank you.

Operator:

We'll take our next question from Jack Micenko with SIG.

Jack Micenko:

Good morning. Looking at the portfolio transition over the year, usually gone up as a percentage. You had nice growth in the lower FICO bands. The loan yields still are in about 50 bps year-over-year. Should we think about loan yields maybe improving as the pull-through of some of that portfolio shift occurs, or is that just competition and the pricing is where it is and we're not going to move on credit, but the pricing is driving the loan yields?

Jason Kolas:

Well, it's interesting. My comment about what we're seeing in July is the result of some of that. So, we're constantly looking, feeding information we're seeing on performance of the back book into new originations, and we did make some pricing and structure changes late in the second quarter, that as they roll through, you know, work to increase yields in some pockets of our originations, but we also saw a little bit of a pullback in volume related to that. It's, once again, not a conscious decision on our part to either get more or less of the deeper subprime higher yielding volume at any given point, but just trying to make the right decisions along the way and seeing what the market gives us.

But, yes, I mean, if we continue to see rational competition in subprime, which is what I would describe, on a relative basis—obviously, it's still very competitive, but if we continue to see a little bit of a pullback in subprime for maybe some of the larger institutions who dip down and have seen losses come in and maybe have retreated a little bit from what they were doing before, the business should benefit from that and you would see yields go up. What we just don't know is how long that sustains, because people can shift and turn and decide they want more of it at any given point, and we tend not to chase it when we see that happen.

Ismail "Izzy" Dawood:

Jack, I'll add, there's a table that we have in our press release, Table 5, that we provide some FICO information, discount, APR, and you'll see trends kind of move accordingly. Lower FICOs will drive higher APRs and higher FICOs will drive lower APRs, and you see those trends. To your point, those trends will eventually inform our top line high yields.

Jason Kulas:

Yes, that's a great point, Izzy. On that table Izzy's referring to, in Table 5, you can see the APRs going up year-over-year on originations. That obviously does work its way through the system, and it's both APR and discount incrementally higher, credit incrementally lower, but all of those pieces are moving in the right direction.

Jack Micenko:

Okay. Then, on the flow deal, you had 700 in the first quarter, five and change. What's the right number? How do we think about what that number is. I mean, it was down on a percentage basis, but there could have been some backlog or some pent-up accumulation on the 700. How do we think about that number on a flow basis?

Ismail "Izzy" Dawood:

Sure, I'll take that, Jack. So, really, the flow is all prime originations, and prime has a certain credit characteristic that, you know, we work with our partners, and prime, for us, as Jason mentioned, is really

driven by the FCA, and some strategy, as well. So, as subvention becomes more prevalent, we will see, hopefully, an increase. But, the right number, we hope it'll be at least \$700 million a quarter, if not higher, and as we continue to work with FCA, we hope that number continues to increase.

Jason Kulas:

Everything we're doing is to make that number as high as possible.

Jack Micenko:

Okay, great, and then any update on the retail portfolio sale?

Jason Kulas:

You mean the Bluestem sale, Jack?

Jack Micenko:

Yes.

Ismail "Izzy" Dawood:

Well, I'll tell you, I know this sounds like a broken record, and it probably is. We're still engaged in the process. One development is that I think the financing package for the bidders has been finalized, which is a big step forward in Q2. Obviously, what complicates stuff is that we have three parties involved, not two. We all agree it's gone on longer than we think and we hope to conclude it sooner rather than later. So, we're still held for sale and still in the process.

Jack Micenko:

Okay. Thanks, guys.

Operator:

We'll go to our next question from Moshe Orenbuch with Credit Suisse.

Moshe Orenbuch:

Great, thanks, and thanks for continuing to provide that vintage data performance. Maybe, if you could kind of just amplify on that, because obviously the '15 vintage, which is the one that's performing worse, is larger, but yet you've got on a gross basis kind of 100 basis points lower (inaudible). So, how should we think about when that starts to kind of best itself in terms of the overall portfolio, because I assume it seems to be growing faster than your expectations for '17, and kind of better than—more in line with the '16 vintage, kind of amplify on that a little bit?

Ismail "Izzy" Dawood:

So, Moshe, thanks for that question, and you're right. This quarter, we actually saw an inflection where the 2015 net losses are just slightly below the 2016 net losses. When we've talked about that being the biggest contributor in past quarters, that's actually reaching a point where it's not becoming the biggest contributor. However, at the same time, we are seeing recovery rates come down, and you see that's the biggest contributor in NCL year-on-year for us, in terms of the impact to that. So, overall, our view on losses for 2017 is a little different, driven by two factors. One is recovery rates being lower and the second one is, at least on the NCL side only, the acceleration of bankruptcy charge-offs will make that NCL number look higher. Obviously, that entire acceleration is materially offsetting the allowance ratio.

So, relative to 2016, we believe 2017 losses now will be higher, given that we have two quarters in and given the guidance we gave for Q3.

Moshe Orenbuch:

Just to follow up on that, if you were to kind of think about that growth—or, excuse me, the decline in used car values continuing, but at a more moderate pace, how should we think about the effect the next few quarter (inaudible) this year and into '18?

Ismail “Izzy” Dawood:

Obviously, we all have our assumptions. The industry thinks it's anywhere, if you read, anywhere from a 3% to 7% decline in used car prices, which, effectively work up to like a 1.5% to 3.5% decline in recovery rates, assuming you recover half the monies. It depends on the mix of the vehicles, the age of the vehicles. The more non-prime we get, obviously, we have greater severity. The more prime or new cars we have, it's less severity. But, we're going to continue to see a downward trend and we fully expect 2017 recovery rates to be lower than 2016. As I mentioned, 2016 was 52%, and so the range of the outcomes for 2017 can be anywhere from 1.5% to 3.5% lower.

Moshe Orenbuch:

Thanks.

Operator:

We'll go to our next question from Mark DeVries with Barclays.

Mark DeVries:

Yes, thanks. I realize you had a modest uptick in the penetration at Chrysler Q-over-Q, but are you seeing any encouraging signs that either the VIP program or the Banco Santander flow agreement is going to help you kind of meaningfully improve your competitiveness in the Chrysler prime channel and effectively kind of widen out your funnel?

Jason Kulas:

Mark, we are starting to see some signs of that, but I think the real answer to that is it plays out over a longer period of time. Focusing on the floorplan business, for example, there's incremental growth every quarter in that business, incremental dealers being added to the program, but it's going to take some time as we continue to build that. What's important about that is that does drive incremental retail volume. I think our efforts to become more competitive in how we price that business and operate that business with group floor arrangements, and those kinds of things, leveraging our majority ownership by a large bank, we think over time will also have a positive impact.

Then, the VIP, it's not been rolled out to all of the dealers, but optimizing that is an ongoing process. So, what we do see is the dealers who actively embrace the loyalty program, we're seeing more volume out of them, and that's a really good thing, but we have to constantly make sure we're evaluating where we set the targets, how we set the targets, so that we truly are driving more volume and better behavior, in terms of our getting business, and we'll continue to do all of those things, but as we talked about earlier on the call, another big driver of this is the rate environment, because right now, you know, there's just not a big difference between an incentive interest rate and where the market in general is, given how low cost of funds is and where the prime market is. The prime market—we mentioned a little bit of competitive easing in subprime. The prime market is extremely competitive, and so that's an issue, as well. We haven't seen really letup in competition at the upper end of the market at this point, but we still very confident long term we'll see real progress there.

Mark DeVries:

Okay, great. When you think about FCA's satisfaction with you as a financing partner, are they more focused on your ability to support them and lend to subprime customers versus prime, or do they care equally about kind of both?

Jason Kulas:

I think they care across the board. We constantly work together on all facets of the business, if you want to broadly categorize it into leased, prime and non-prime. We're constantly working on strategies for all of those. I do think you're right, in that our historical value has been heavily weighted toward incrementally helping on non-prime transactions, but the future growth in the platform is heavily weighted away from that to prime and leased strategies, not that we won't continue to focus on non-prime, because we absolutely will, we want that business, but the incremental opportunities are going to come upmarket.

Mark DeVries:

Okay. Thanks.

Jason Kulas:

Sure.

Operator:

We'll go to our next question from Steven Kwok with KBW.

Steven Kwok:

Hi, guys. Thanks for taking my questions. Just the first one I had was around vintage. When we look at the 2014, 2015 and 2016 vintages, on a risk-adjusted return basis, how would you characterize the returns there?

Ismail "Izzy" Dawood:

Sure. Let's take each one in a row. Obviously, losses are better—look at net losses—are better in 2016 versus '15, but slightly higher than 2014, and recovery rates will be a big driver of that. So, that's one aspect. On a risk-adjusted deal, market dynamics are different, as well as the credit aspects. Let's compare to 2014. 2014, definitely less competitive, we're able to get better net loss rates, so slightly higher returns for like-for-like credit. 2015, higher losses, obviously, but the yields on those assets were also higher, so earning a slightly higher than normal risk-adjusted margin. Then, 2016, what we're seeing combined for the entire portfolio, and even for our non-prime, that even though losses are lower than 2015, the risk-adjusted yield is also just slightly lower, as well, and that's consistent with higher losses, higher risk, but potentially higher return, and vice-versa. Clearly, we saw some deterioration in credit, our expectations in 2015 not coming in line with what we expected. We took the right credit actions, as we always do almost every day, and as a result, the loss profile improved, and also we would expect slightly lower yields, as well, the risk-adjusted yield, as well.

Jason Kulas:

Izzy, I would add, we're doing the same thing in 2017. As we see 2016 age, we're factoring in what we see to new originations, sort of constantly reacting to that.

Steven Kwok:

Any early read into how 2017 will perform on a risk-adjusted basis?

Ismail “Izzy” Dawood:

It's way too early. I mean, we think six months gives us good indication, but to be perfectly honest, it's 12 to 18 months before you get an answer that you feel really, really comfortable with. The other thing that obviously impacts it is your assumption of recovery rates, and that will vary, obviously, by the mix, as well, as every competitor has a view on what recovery rates could be. It's very, very early on 2017.

Steven Kwok:

Got it, and lastly, when I take your guidance for the third quarter and just use that, I get to like a mid-30s EPS number. Is that in the right ballpark?

Ismail “Izzy” Dawood:

That should be the range, yes.

Steven Kwok:

Okay, great. Thanks for taking my questions.

Operator:

We'll take our next question from Betsy Graseck with Morgan Stanley.

Betsy Graseck:

Hi, good morning.

Jason Kulas:

Good morning.

Ismail “Izzy” Dawood:

Good morning.

Betsy Graseck:

I had a question regarding the NII outlook. I know we talked a little bit earlier on the call around how NII and NIM came in on a year-on-basis, but if I recall correctly, I think you guided to slightly lower NII. This quarter, obviously, NII was up. I just wondered what the main drivers of that was on a Q-on-Q basis, given the fact that loan yields did increase, but APRs went down, so I just want to make sure I understand what happened in the quarter to get to that outcome on a Q-on-Q basis.

Ismail “Izzy” Dawood:

Betsy, it's Izzy, and thanks for keeping us honest, because you're right on all those counts and how you described it. First of all, we did not anticipate a higher balance sheet, or even a flat balance sheet sequentially, and that was part of our guidance, that our balance would shrink a little bit, so we were pleasantly surprised that our RIC balance actually grew. So, that was one aspect. The second piece, we talked a little bit the last quarter about interest accruals on our TDR loans, and what we saw is that we had higher interest accruals because the TDRs were actually still performing. That means they were less

then 60 days delinquent. When you combine those two aspects, which came in a little different than what we expected, it led to slightly higher net interest income than we had guided to. Not meaningfully, but a small factor is also the ABS markets came in much, much stronger, we took advantage of it, and that contributed a little bit to having lower interest expense than we anticipated.

Betsy Graseck:

You had tighter spreads, right, okay.

Ismail “Izzy” Dawood:

Yes, exactly.

Betsy Graseck:

What about the forward look here? I mean, are we still being relatively conservative on the forward look, and how are you thinking about the TDRs this quarter going into next quarter?

Ismail “Izzy” Dawood:

Well, I wouldn't say conservative, but definitely prudent. We would expect the TDR performance to be in line with what we've historically experienced. That could be better or it could be worse. But, we're still seeing the credit mix still being affected by the fact that we're taking credit actions. If you just look at kind of our last quarter's originations APR versus Q1, the APR is lower, the FICO is higher, and, again, it's that balance between what we're seeing in what the market's giving us and our acceptable yield.

Jason Kulas:

Our view on cost of funds also impacts that, because we—while we're very pleased with the executions we're seeing in the capital markets right now, we tend to take a view that's in line with yield curves, and those kinds of things, and assume that that has impact going forward, as well.

Betsy Graseck:

Okay. So, you're keeping the tight spreads in ABS as it exists today, but flexing it for the yield curve, and TDRs, you're assuming historical as opposed to the better than expected that you got in 2Q. Is that accurate for the outlook into 3Q?

Ismail “Izzy” Dawood:

That's correct.

Betsy Graseck:

Okay.

Ismail “Izzy” Dawood:

Yes, and that's what's driving kind of our guidance, that's fair.

Betsy Graseck:

Okay.

Operator:

We'll take our next question from David Scharf with JMP Securities.

David Scharf:

Hi, good morning. Thanks for taking my questions. I just wanted to revisit maybe some of the comments around competition and some of the pockets of opportunities you saw. Obviously, every lender is different, but it feels like we're still hearing commentary by many that the deeper bands within subprime is still a very competitive environment, and you noted competitive easing. Is there any kind of metric or anecdotal data points that you can provide us that help form that opinion? Is it just based on the amount of credit apps per dealer, or anything else that gives you comfort that things are easing a bit?

Jason Kulas:

Yes, and let me qualify, when we talk about easing, it's all on a relative basis. So, I agree with your statement that the market is still extremely competitive up and down the credit spectrum. When we refer to competitive easing on non-prime, what we can see is pretty telling. Because, if we're not making significant changes in how we're pursuing non-prime business and our capture rates goes up—in the absence of a new partnership or some other special offering in the market or some strategy to really increase non-prime, if, in the absence of all of those things, we get more capture, we view that as a—because we're a pretty big sample size, we view that as some competitive easing in the market, and then we try to drill down by competitor to really see what's going on, and that's why I mentioned earlier it's a really mixed story.

You have some people who have come out publicly and said that they're retreating and really moving upmarket and reining what they're doing on the auto side. On the other hand, you have people who are benefiting from that pullback and they're competitors of all sizes. I think that's the reason why you can both say that there's some competitive easing, but it still remains very competitive. But, for us, the reason we know definitively that there's been some sort of easing, is that we got additional volume that we weren't necessarily pursuing or changing terms to get.

Now, the caveat to all of that is that, as I mentioned, in July, we've seen our core capture go down incrementally, not to a significant degree, but if that continued through the course of the third quarter, we might be telling a different story and saying that we've seen competition pick back up. It's probably too early to say that. I can just say that our experience in July was a little bit a different than in Q2.

David Scharf:

Got it, that's helpful context. Switching to credit, Izzy, I guess you reiterated the belief that sort of TDR allowances, that they should peak late this year or early next year. When I just look at the TDR migration—I want to make sure I'm interpreting this correctly. When you provide the TDR migration and the allowance each quarter—you know, it was \$128 million in Q1, it was just \$101 million this quarter—is there something seasonal to that improvement or is that part of the story behind your conviction that those peak by the end of this year?

Ismail “Izzy” Dawood:

It's less about seasonal patterns. It's really about the size of the portfolio and the credit mix, and our conviction is more—or my conviction is more driven by the fact that the 2015 vintage, as it enters its peak loss in aging, there's a TDR component that kind of evens out, and that's what's been driving the acceleration. So, really, that's what's driving it. If every vintage was the same credit mix and the same volume, we would really not see any change in TDRs, but we have not had that, and that's what's really driving some of the analysis and the conviction.

David Scharf:

Okay, got it, and then lastly—and I apologize for probably being the third person to ask about the tax rate. Jason, I seem to recall—I can't remember if it was two or three years ago—I mean, at one of your Investor Days you first discussed this emerging tax strategy you were looking at in Puerto Rico. I'm still a little unclear how exactly this brings the effective tax rate down. Maybe we can leave that for offline discussion. But, did I hear correctly, Izzy, should we be looking at the third quarter effective rate, after we apply the historical, subtract \$7 million to \$10 million, is that new effective rate an adequate assumption going forward, is there a structural change here?

Ismail "Izzy" Dawood:

For the following quarter, yes, I would take the effective rate, say, from Q1 this year or Q4 last year, apply that and deduct \$7 million to \$10 million from that, but we'll give you a new effective tax rate for Q3.

David Scharf:

But beyond that, should we be—

Ismail "Izzy" Dawood:

Yes, I mean, right now—we do an analysis every quarter to ensure that we're comfortable with the benefit that we are recording, and we'll continue to do so, but for the foreseeable future we expect that sort of benefit.

Jason Kulas:

An ongoing benefit.

Ismail "Izzy" Dawood:

Yes.

Jason Kulas:

Just to clarify the description—we have been talking about this for some time, but we don't think of it as a tax strategy. Going back to my earlier comments, we really have many reasons to be in Puerto Rico and there are many operational reasons that we think make our business stronger. The way the tax benefit does work, though, is, basically, on eligible income, you pay a reduced tax rate, and servicing fees for performing loans and leases are eligible for that lower tax rate, and so that's why we're seeing a benefit. The benefit is obviously larger in this quarter because there's a little bit of a catch-up dating back to part of 2016, and we absolutely do—now that we have this in place and it's active and operating and being very successful, we do expect an ongoing quarterly tax benefit. We'll continue each quarter to guide to what we expect that forward look to be as it shifts, but we think the guidance for the Q3 is pretty solid on that point.

David Scharf:

Got it. Thank you very much.

Jason Kulas:

Sure.

Operator:

We'll take our next question from Rick Shane with JPMorgan.

Rick Shane:

Thanks, guys, for taking my questions. First of all, I appreciate the guidance and the accountability on a quarter-by-quarter basis. I think that really helps. Two questions. I'd love to—and I know you touched on this with Moshe, but there's an interesting snippet on Slide 17. The 2015 vintage represents the largest portion of gross losses and the second largest portion of net losses. Can you explain the differential there and what vintage is actually experiencing the largest portion of net losses, so we can think about that rolling forward?

Ismail "Izzy" Dawood:

Rick, this is Izzy. Nice pickup there, by the way. Yes, gross loss and net loss recoveries, as I mentioned, is a function of the age of the vehicle, the mix of credit, loan to value, all those items. So, what we see is 2015 still has a deeper—I call it a more deeper subprime credit, so the losses, the gross losses are higher, but on a net basis, as you've aged, 2016 is becoming a slightly higher contributor of net losses. It's really mix-driven item more than anything else. Fast-forward two quarters, I believe those distinctions go away and 2016 is still becoming a bigger contributor.

Rick Shane:

Got it, Izzy, and thank you for that. It actually segues pretty nicely to a topic I'm pretty interested in. When you guys underwrite loans, how do you know if a potential customer is using their vehicle for ride-share. In my mind, ride-share vehicles have a substantially different risk profile, because you may be repossessing at some point a vehicle with a disproportionately high number of miles on it. I'm also wondering, ultimately, if that's one of the things that generally is impacting recovery values.

Jason Kulas:

Rick, this is Jason, I'll answer that one. That is something we look at, and what we're seeing is that we're not seeing that impact roll through. If you look at our core non-Chrysler business, the mileage on cars that are coming through the auction lane are pretty consistent, it's in that kind of high 80s range, in terms of thousands of miles, and that hasn't really moved or shifted over the last several years. On the Chrysler business, it is increasing, but that's just because that business is aging. So, we're not seeing any impact. Our opinion is, at this point, one of the reasons we're not seeing an impact is that when those cars are used for that purpose, what we're seeing is, at least currently, that tends to be relatively short-lived. They may use it for some period of time and, to answer your first part of the question, we don't really know if they're going to choose to do that or not, but as we see it come through, one of the reasons we think we're not seeing an impact is that it may not be sustained, it may be something they do for a short period of time.

As we—and this goes back to a comment we make from time to time. One of the benefits of having these assets with such a short average life is that as we see that come through, if we do—so, if we start seeing any interesting pickup in mileage of cars repossessed and we don't think it has to do with the fact that cars are lasting longer or we're repo-ing later in the cycle, and those kinds of things, and we can correct for all those things and still see an increase, we have the ability to price that in on an asset with a very short average life, and we will absolutely will.

But, sorry, the short answer to your question is we're not seeing it right now.

Rick Shane:

Got it, and one last follow-up to that—and, again, geographically, I might be a little bit more sensitive to this than I should be. Are there particular vehicles that you think are special, that are potentially more sensitive to this, and do you price that accordingly?

Jason Kulas:

You know, at this point, we're not, because we're not seeing it roll through, but you're right on in how we would address that, because we do have the ability to look at underwriting by vehicle, and we would absolutely do that as we saw it come through. At this point, I wouldn't want to say which ones we would expect to come through or not come through, because it may be a different environment and a different set assets as we see that pick up, if it does pick up, but it's something—I agree with you, it's something we need to make sure we watch, as that becomes a more acceptable form of transportation, particularly in larger markets, and we watch that, along with some of the other trends that we want to make sure we're on the forefront of, including digital initiatives in the industry, and those kinds of things.

Rick Shane:

Got it. Hey, guys, thank you for taking all these questions, I appreciate it.

Jason Kulas:

Thanks, Rick.

Operator:

As there are no further questions at this time, I will now turn the call over to Jason Kulas for final comments.

Jason Kulas:

Thank you, everyone, for joining the call today and for your interest in SC. Our Investor Relations Team will be available for follow-up questions and we look forward to speaking with you again next quarter.

Operator:

This concludes today's conference. We appreciate your participation. You may now disconnect.