



Santander Consumer USA Holdings Inc.

First Quarter 2018 Earnings Call

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C O R P O R A T E P A R T I C I P A N T S

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Vincent Caintic, *Stephens, Inc.*

Rick Shane, *JPMorgan*

Moshe Orenbuch, *Credit Suisse*

Betsy Graseck, *Morgan Stanley*

Geoffrey Elliott, *Autonomous Research*

Eric Wasserstrom, *UBS*

Chris Donat, *Sandler O'Neill*

Kevin Barker, *Piper Jaffray*

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P R E S E N T A T I O N

Operator:

Good morning and welcome to the Santander Consumer USA Holdings First Quarter 2018 Earnings Conference Call. At this time all parties have been placed in a 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 and thanks for joining the call today. On the call today we have Scott Powell, President and Chief Executive Officer, and JC, Chief Financial Officer.

Before we begin today, 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 info 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 issued today, April 24, 2018.

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 Investor Relations website.

Now I'll turn the call over to Scott Powell. Scott?

Scott Powell:

Great. Thanks, Evan. Good morning everybody. Thanks for joining the call. I'll start out by reviewing our first quarter highlights before turning it over to Juan Carlos for a more detailed review of the first quarter.

Let's start on Slide 3 in the presentation. You'll see that the first quarter was a really strong quarter for Santander Consumer. Our results demonstrated our continued success and strengthening in our management team, operations and risk management. Our net income totaled \$242 million, which was \$0.67 per share. Our return on average assets was 2.4% compared to 1.5% in the first quarter of 2017, and we're also declaring a dividend of \$0.05 per share to be paid in May.

Looking at originations, we had a really strong quarter in originations in total and across all of our channels compared to the first quarter of '17. Total originations were \$6.3 billion which is up 18%. Our core originations were \$2.3 billion, up 4%, and Chrysler loans came in at \$1.9 billion, up 24%. Leases, \$2.1 billion, up 31%, and importantly, our Chrysler penetration rate improved to 28% versus 23% in the first quarter of '17.

Our originations do reflect some seasonality, but they also reflect the initiatives that we talked about on the last call. We've been focused on optimizing our pricing and credit risk management, and improving our dealer and customer service. We've done this by streamlining the underwriting process and reducing funding time, which make it easier for dealers to do business with us. So all in all, we feel really good about the quality of the originations that we booked in the first quarter. There's been no change in our target ROA and there's been no significant change in our credit box.

Turning to the credit metrics, you'll see that delinquency ratios remained flat to the first quarter of last year. If you take a look at the dollars that are delinquent you'll see that they're down 6% year on year. Now, our overall balances were also down 4% year over year, but still, that's a pretty good story.

Our Auction Plus recovery rate improved 400 basis points to 55.1% versus the first quarter of last year. Our net charge-off ratio improved by 50 basis points to 8.3% versus the first quarter of last year. Significantly, our TDR balances were lower by \$263 million versus the fourth quarter, which is more than we expected. Juan Carlos will cover that one in more detail and then I'm sure we'll have some questions during the Q&A portion of this call to talk about that.

All of these things and lower balances led to more reserve release than we had previously anticipated.

With respect to used car prices, our outlook hasn't changed. We still expect less than 5% decreases in prices in 2018. We feel really good about the U.S. economy and we feel really good about the strength of the U.S. consumer in both prime and non-prime.

You'll see that our results continue to reflect the benefit of being part of Santander U.S. and Santander Group. The floor plan business at Santander Bank grew to \$2.1 billion in the first quarter which is up 9% from the fourth quarter. SB&A also launched a pilot in the first quarter to leverage Santander consumer to originate and service prime loans, and we expect the full rollout of that program in the third quarter of this year.

We also did a flow transaction with the Group in the quarter for \$1.5 billion. It's the fourth transaction we've done with the Group since 2017, and both of these things, both the pilot and the flow agreement with the Group are positive for our prime business and also our Service for Others business. In addition, after the first quarter ended, we completed a prime auto loan portfolio conversion for a new third party for us, which will increase our Service for Others balance by a billion dollars, and it demonstrates our ability to do the Service for Others business. We'll look for more opportunities to capitalize on that capability.

Just a brief update on our digital strategy before I turn the call over to Juan Carlos. In the first quarter, we reached an agreement with AutoGravity. This was in addition to the agreement we reached with AutoFi in January, and the goals of these two initiatives are very similar. We want to simplify the car buying process by aligning consumer preferences to our capabilities, and we want to make our finance offers digitally available to more customers nationwide.

With that, I'll turn it over to Juan Carlos for a more detailed walkthrough of the presentation.

Juan Carlos Alvarez:

Thanks, Scott. Good morning everyone. Turning to Slide 4 for some key economic indicators that influence our originations and credit performance. The overall macroeconomic environment remains stable and supportive of our business. Consumer confidence is high. GDP growth is in line with the recent historical range. Unemployment levels continue to be very low and job creation is healthy. These metrics are strong indicators of the state of the economy.

Despite their gradual downward trend, total auto sales remain robust and are indicative of a stable and healthy market for new vehicles.

On Slide 5, there are a few key factors that can influence our loss severity and credit performance. As Scott mentioned, we've had very good recovery performance. In Auction Plus, recovery rates improved this

quarter compared to Q1 last year. Our Auction Only recovery rate ended the quarter at 46.8%, up from 44.9% at the end of Q1 last year, driven by improved performance across almost all of our vehicle types including sedans, trucks and SUVs. Our Auction Plus recovery rates, which includes insurance proceeds, bankruptcy and efficiency sales were 55.1% in the quarter, up from 51.1% the same quarter last year.

We turn to Slide 6, our total core retail auto loan originations increased 4% in the quarter compared to the prior year quarter. Total Chrysler loan originations increased 24% during the same period, including growth for both the greater and less than 640 FICO channels. Lease originations continue to be strong, increasing 31% compared to Q1 last year.

Our strategy remains to increase nonprime volume by targeting the appropriate risk return profile, leveraging the Santander programs for prime originations and maintaining a strong presence in lease.

As Scott said, this was a strong quarter for originations and we are encouraged by the results. We will continue to fine-tune our pricing and credit risk management, streamline our underwriting process and work to improve our dealer and customer experience.

Turning to Slide 7, we are pleased to report that our average quarterly FCA penetration rate was 28% for the quarter, up from 23% in the prior year quarter. We continue to optimize our full spectrum blending and servicing platform across loans, leases, floor plan and third party service.

Turning to Slide 8, our Service for Others balance increased in Q1 compared to the prior year quarter but (inaudible) increased sequentially as we executed another flow transaction with Santander for \$1.5 billion in Q1.

Service and Fee Income totaled \$26 million this quarter. Moving forward, we expect to drive this platform by continuing to increase prime originations, and also next quarter you will see the additional assets from the third party portfolio conversion that we completed in April.

Let's move to Slide 9 and review our financial performance for the quarter. We've had an encouraging start to the year with net income for the quarter of \$242 million, up from \$143 million during Q1 of 2017. Interest on finance receivables and loans decreased 8% year-over-year, primarily driven by lower average rate balances. Interest expense increased 6% versus the prior year quarter, primarily due to higher market rates in the period, partially offset by favorable derivatives which decreased interest expense \$17 million compared to Q1 last year.

Provision for credit losses decreased to \$459 million in the quarter from \$635 million in Q1 last year. This decrease in provision is driven by a combination of lower balances, stabilizing credit performance and higher recovery rates.

Total other income was \$25 million in the quarter and included \$59 million of lower of cost or market adjustments related to the held-for-sale personal lending portfolio. This comprises of \$106 million in customer charge-offs partially offset by a \$47 million benefit in market discount, consistent with seasonal patterns.

Turning to Slide 10, we will review vintage performance. This slide displays gross and net losses for 2014 through 2016 vintages, and consistent with our update from last quarter, our 2016 vintage continues to outperform the 2015 vintage on a gross as well as net loss basis. We still believe the 2017 vintage will likely fall somewhere between the 2015 and 2016 vintages in terms of gross and net losses.

Continuing to Slide 11, the 31 to 60 and 60-plus delinquency rates in the quarter were flat compared to Q1 last year. Gross charge-off dollars decreased \$25 million in the quarter compared to Q1 last year, however, the rate gross charge-off ratio of 18.5% in the quarter increased 40 basis points from Q1 last year due to average RIC, the denominator in the ratio decreasing by approximately \$1.2 billion or 4% over the period.

On a net basis, net charge-off dollars also decreased this quarter down \$61 million versus Q1 last year. Our RIC net charge-off ratio of 8.3% is down 50 basis points from Q1 last year.

As evidenced by our flat delinquency ratios and lower net charge-off ratio, we are seeing continued stabilization in credit performance supported by improved recoveries. In addition, and as predicted, some of the hurricane-related benefits that we experienced during Q3 and Q4 of last year have begun to reverse in Q1.

Turning to Slide 12 to review the loss figures for the quarter in dollars, net charge-offs for individually acquired RICs decreased \$61 million in the quarter to \$538 million which was primarily attributable to lower RIC balances, stabilizing credit performance and improving recovery rates.

Let me briefly address the components of the walk: \$24 million in higher losses is due to higher gross charge-off rates. It was more than offset by \$42 million in lower losses due to better recovery rates, for a net decrease of \$18 million. The \$27 million decrease in balance is a result of lower average RIC balances over the same period and therefore lower opportunity for losses. Then, the \$16 million decrease in the Other category is primarily driven by fewer bankruptcy loan writedowns compared to the prior year quarter.

Turning our attention to provisions and reserves on Slide 13, at the end of Q1 '18 the allowance for credit loss totaled \$3.2 billion, decreasing \$80 million from last quarter, which represents an allowance to loan ratio of 12.3% at the end of the quarter, down 30 basis points versus the same period.

I'll now go over the components of our reserve walk. The allowance increased \$140 million due to new originations in the quarter and \$59 million due to TDR migration. These increases were more than offset in our allowance by a \$70 million decrease due to favorable performance adjustments and a \$209 million decrease due to liquidations and others which includes payoffs and charge-offs.

Let's now turn to Slide 14 to discuss TDRs in more detail. We provided a similar update during our Investor Day in February of last year. TDR balances decreased \$263 million in Q1 2018 to \$6 billion from \$6.3 billion in the prior quarter. This is the second consecutive sequential decline. As you can see, there are a considerable amount of older vintage TDRs that remain on our balance sheet dating back to 2013 and prior vintages, demonstrating that these modified loans continue to perform. In addition, while the contribution of the 2015 vintage of TDRs is decreasing, this still represents 35% of the TDR balance as of the end of Q1. As a reminder, once a loan becomes a TDR it will remain a TDR unless it pays off or charges off.

Turning to Slide 15, operating expenses this quarter totaled \$288 million, a decrease of 6% versus the same period last year. This decrease was primarily attributable to disciplined expense management and severance and legal expenses in Q1 last year. The expense ratio for the quarter totaled 2.4%, flat versus the prior year quarter.

Turning to Slide 16, our funding and liquidity position remains strong with total committed funding of more than \$42 billion. SC continues to demonstrate consistent and deep access to the capital markets, having offered and sold \$3.3 billion of new ABS transactions in the quarter, including SDART and DRIVE transactions. Subsequent to quarter end, we also completed a \$1 billion SDART transaction and in Q1 we also completed our second SRT lease ABS securitization which continues to optimize our funding structure and to improve the cost of funds for Chrysler lease assets.

Also of note, we renewed \$1.8 billion of our nonprime revolving warehouse facilities in the quarter, extending those maturities for our core business.

Finally, turning to Slide 17, our CET1 ratio for the quarter is 16.9%. As Scott mentioned, we are declaring a cash dividend of \$0.05 per share for the second quarter. Earlier this month SHUSA submitted its updated capital plan to the Federal Reserve and we look forward to updating you once the results for the upcoming capital planning cycle are released.

In terms of guidance, we'll provide guidance for the second quarter. My comments will be relative to Q1 unless otherwise noted, and will include the impact of personal lending.

We expect net finance and other interest income to be up 1% to 3%, primarily driven by higher loan and lease balances. Provision expense is expected to be down \$20 million to \$60 million, attributable to seasonally strong credit performance in the second quarter. We expect total other income to be flat to \$20 million lower in line with seasonal patterns. Operating expenses are expected to be flat to down \$20 million, attributable to seasonally lower repossession expense and disciplined expense management.

Before we begin Q&A, I'd like to turn the call back to Scott.

Scott Powell:

Thanks, Juan Carlos. To sum things up, we're off to a good start of the year with strong originations, I'd say stable to improving credit trends, which is good to see, as well as the initiatives that we've been focused on paying off in terms of strengthening our management team and optimizing around credit and pricing for risk in our business. We've also seen improvements in our efforts to improve the dealer experience when they deal with us. That all feels pretty good to us.

I'd also like to announce that Santander Consumer is launching a new corporate social responsibility program at the end of the second quarter. It's going to include about a million dollars of targeted charitable giving in our communities. We're going to get our employees engaged through volunteer opportunities with nonprofits that promote economic mobility and financial inclusion. This is part of Santander's broader corporate social responsibility commitment in the United States.

With that, we'd like to open it up to questions. Over to you, Operator.

Operator:

Ladies and gentlemen, as a reminder that is star, one to ask questions. If you are using a mute function, please make sure it is turned off to allow your signal to reach our equipment. We'll go first to John Hecht with Jefferies.

John Hecht:

Morning guys, thanks very much. I guess the first question is maybe seeking advice as much as anything. Our interpretation of the trust status during the quarter led us to believe that charge-offs would be a little bit higher than they actually came out to be. I'm just wondering is there a different characteristic of loans that

aren't in any ABS structure right now that are generally stronger than those in the ABS trusts? Is there any other way we should be thinking about that at this point in time?

Juan Carlos Alvarez:

Thanks. I think one of the key drivers of the discrepancy, if you will, is the fact that in the trust data you have a growing percentage of DRIVE in there, which as you know is a deeper type of nonprime product, so that might be swaying the overall charge-offs. I think it's a matter of mix in the trust data versus what we actually have on the balance sheet.

John Hecht:

Okay, appreciate that. It's helpful. Then second question, I guess to JC as well, TDR migration, two sequential quarters with this coming down. We've seen the performance of '15 versus '16. At this point is it fair to think that the TDR migration should be linearly down every quarter or is there some reason where this would be variable depending on the quarter?

Juan Carlos Alvarez:

We still expect the trend to be very gradually down. One thing to note, if we look at Q1 performance, we've had overall as we just discussed a very good credit performance. Q1 does tend to see seasonally higher paydowns across the board and also on TDRs. We also have some of the increase in TDR balances came back in Q3, some of those have reversed into Q1, so I would say that the delta during Q1 is reflective of the general direction but probably the magnitude in Q1 was a little bit larger than it would have been otherwise, okay? The overall trend, we do expect it to gradually trend down.

Scott Powell:

Especially as 2015 becomes a smaller and smaller part of the TDR portfolio. Now the offset to that, which is a year or so down the road, is if we have strong originations for the rest of the year. That is, all things being equal and unchanged, that will obviously increase the influence of the TDRs as well, but that's down the road a fair piece.

John Hecht:

Great. I appreciate all that color. Thanks guys.

Operator:

Ladies and gentlemen, as a reminder we ask that you please limit yourself to one question and one follow-up question. We'll go next to Vincent Caintic with Stephens.

Vincent Caintic:

Hey, good morning. Thanks very much, guys. First on the Chrysler penetration rates, that was a nice improvement from last quarter and last year. I'm just wondering if you could maybe describe some of the execution that you've done in order to improve that penetration rate and what, should we maybe expect that to continue to move higher and what's sort of your target levels over time?

Scott Powell:

Thanks for the question. It is what I've been describing kind of as a general improvement in our optimizing pricing for risk across all our channels, and especially with Chrysler. We're taking a much more granular approach to how we're pricing for risk and finding those opportunities for improvement. We do work very closely with the Chrysler team around promotions they have and making sure we're closely collaborating with them on how to drive business in the peak selling seasons, so there isn't any real—there is no magic to it. As I said we are not expanding our credit buy box and we're not changing our ROA target, so this is really being more focused on originating the right business at the right price, and then being very focused on the Chrysler dealers too. Making it easier for them to do business with us, understanding issues that get in the way of them working with us, including our speed to funding. So it's kind of a whole series of things which are starting to pay off now. They started to pay off in the fourth quarter and we'll continue to move forward those things. I would—we're going to look for ways to increase it and I can't guide you to anything much different than where we're at today, but we are hard at work on it and very focused on it.

Vincent Caintic:

Great, that's helpful. Maybe relatedly, have you seen more engagement from the Chrysler side? Is that been pushing more—and I guess I'm particularly interested with a rising interest rate environment how that plays out. Thank you.

Scott Powell:

Yeah, we have since I joined in September, and Juan Carlos joined in September and then Rich Morin moved into a different role which really focuses on Chrysler. Yeah, it's fair to say there is a lot more engagement with the Chrysler team around, like I said, their initiatives, things that are important to them, the models that are important to them, both on the lending and leasing side, and I think we've got ourselves into a pretty good rhythm with them. You know, rising rates are going to be a challenge. We also do a lot of used car financing so I don't see that as a big impediment on the production side.

Vincent Caintic:

Okay, great. Thank you.

Operator:

Our next question comes from Rick Shane with JPMorgan.

Rick Shane:

Hey guys, thanks for taking my question. Given the Auction-plus platform, I think you guys have unique access to data about what's going on in the used car market. I am very curious if you are seeing any changes over time related to ride share. Are there certain cars that are showing up with more miles that you're more concerned about, or anything that you're altering in your strategy as we see ride share sort of disrupt the way Americans use cars.

Juan Carlos Alvarez:

Look, I can't say that it's related to ride share, but remember that we do get stable high mileage on the vehicles that we take to auctions, just by the nature of our portfolio. The improved performance has been pretty much across almost all of our vehicles and we do have—also we have seen lower balances at the

time of repossession, so implying that customers are staying in those vehicles for a bit longer, but as a whole it's an improvement in terms of recovery rate.

Rick Shane:

Got it. You're not seeing cars show up with higher mileage?

Juan Carlos Alvarez:

No, they've trended to have them but also a lower balance, okay? All in all it's an improved recovery rate.

It's also important to note that if we give some thought to your question on ride share, the bulk of our portfolio is focused on Texas and Florida, California and ride share is probably more focused on metropolitan areas.

Scott Powell:

Yeah, I think we haven't really gone through and taken a look at it that way. It might be kind of interesting for us to go do that. We certainly can go parse the data and take a look at it that way. We haven't seen a big driver. I mean it is true that from '16 to '17 demand for used cars has clearly gone up and I'd say more than offsets the decline in new cars being sold. It's an interesting question, Rick. We'll go look at it. We'll go dig through the detailed data on that point. We haven't really seen it so far though.

Rick Shane:

Okay, great. Thank you, guys.

Scott Powell:

You bet.

Operator:

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

Moshe Orenbuch:

Great, thanks. Maybe given that you guys have been able to increase your originations in the core subprime without expanding the credit box, you talk a little about the competitive environment. We've talked to some competitors who said things are pretty good and then some who are saying that it's really tough to make loans. Maybe talk a little bit about what you're seeing and how you've been so successful.

Scott Powell:

Moshe, you know it's a really fragmented marketplace, so it's a little hard to read the ins and outs of the competitors. You know the guys that are in and out. Some of the big name brands are pulling back but it remains a very, very competitive space, and so we do look at what other people do for pricing and compare prices across different sales but it feels just as competitive as it's always been to us. I mean there aren't any big movers in the market one way or the other, but there are people going in and out. Because there are so many players in the space that it's hard to say whether the tide is going out or coming in on this one.

Moshe Orenbuch:

Okay, thanks. But it does feel like given the level of originations and kind of the paydowns that you're seeing that we're likely to see the balance sheet grow through 2018. Maybe—I know you've given guidance for Q2 but could you kind of just talk through what the implications are from the standpoint on a slightly longer term basis, net interest income and provisioning? Any kind of additional color you can kind of give.

Juan Carlos Alvarez:

You're right. We've had a very good start to the year in terms of originations and credit performance. We feel good about where we are at the start of the second quarter. But in terms of balance sheet growth, remember that these are assets that paydown fairly quickly so replacing the back book is not easy. We hope to continue to take advantage of the opportunities that the market will give us at the right risk adjusted returns. That's what I can tell you in terms of replacing.

In terms of provisions, we guide for a quarter out, but again, we feel good about what we've seen in Q1 at this point in time.

Moshe Orenbuch:

Thank you very much.

Operator:

We'll go next to Betsy Graseck with Morgan Stanley.

Betsy Graseck:

Hi, good morning.

Scott Powell:

Good morning.

Betsy Graseck:

A couple of questions. One is on just questions around the submission you mentioned that you put the submission in. I was just wondering was there anything left to do to satisfy regulatory requirements this year. Anything that you're still working to complete for the regulators from your end? I'm just wondering if there's anything going on there?

Scott Powell:

Well, yeah. I mean there are regulatory issues we're working on. There's one public written agreement out there related to compliance with the Federal Reserve, so that is certainly on the horizon for something to work on. But where you started your questions, the existence of that agreement doesn't have anything directly to do with our capital plan submission that just went in. It's not an impediment. It's out there though, it's a big regulatory issue that we're working to address.

Juan Carlos Alvarez:

(Inaudible). Go ahead, sorry.

Betsy Graseck:

That's all right, go ahead.

Juan Carlos Alvarez:

I was going to add that in terms of the capital plan, SHUSA's capital plan submission, like we said last quarter, all the different capital alternatives and capital actions were available to us and we look forward to seeing those results come June.

Betsy Graseck:

Okay. The other question is, obviously there was a rule change in Europe that is requiring Santander to not count some of the capital that they count for you, they're holding in you already, and so the question is whether or not that matters to you or not. Just wondering how you read that ECB rule change for your parent's parent.

Juan Carlos Alvarez:

It doesn't impact how we treat our capital ratios or anything of that kind here locally or at the SHUSA level. It hasn't impacted our capital planning for capital plan submission. It's at the foreign parent level.

Betsy Graseck:

Okay, so then the other question just on recoveries, recoveries obviously really strong this quarter. I know you had some conversation earlier on about the type of product that you're underwriting, but is that the only reason for the recovery improvement, or is there anything else going on there?

Juan Carlos Alvarez:

No, it's been a pretty performance pretty much across the entire spectrum of vehicles. Yeah, I think we've seen a general trend in Q1, both in metal as well as nonmetal.

Betsy Graseck:

Okay, thanks.

Operator:

We'll go next to Geoffrey Elliott with Autonomous Research.

Geoffrey Elliott:

Good morning. Thanks for taking the question. Maybe first on that Santander capital change that Betsy mentioned, if you just explain for everybody exactly what has changed, and then does that in any way change the thinking about putting Santander Consumers minorities getting bought out. It kind of feels like it might change the discussion there a bit.

Juan Carlos Alvarez:

I really can't—look, I think the Group had their earnings call earlier today. I believe they had some materials related to this, so you should review those. Like I said, it hasn't changed in any way, shape or form our capital planning process here locally, nor our operations at all. For details on the change, you should talk to Santander SA.

Geoffrey Elliott:

Okay. Thank you.

Operator:

We'll go next to Eric Wasserstrom with UBS.

Eric Wasserstrom:

Great. Thank you for taking my question. Juan Carlos, just to follow up on the TDR discussion for a moment, how do we think about—given the trend that you've signaled which is obviously very constructive—how do we think about the incremental contribution to provision expense from TDRs going forward?

Juan Carlos Alvarez:

TDRs carry a higher coverage ratio, as you would expect. Primarily it's been—we've had good performance, but it will be primarily a function of the balance, right, as we discussed earlier today and it in previous calls. In terms of the keys, the balance strength that we discussed earlier and we expect those for the rest of the year to gradually trend down, okay? There will be ebbs and flows, right? The Q1 move was relatively large, larger than we expected, and as I alluded to earlier, particularly the hurricane-related TDRs did pay down faster than we expected, but that aside, the trend should remain for the rest of the year.

Eric Wasserstrom:

Great. Thank you for that. If I just may follow up on one piece of guidance, the expectation around net interest income? Can you help me to understand to what extent that's a function of changes in spread or changes in the size of the balance sheet? Or I guess really the core of my question is, given the strong originations, how should we think about balance sheet growth from here?

Juan Carlos Alvarez:

I'm glad you asked because I should have mentioned this to the earlier question. In terms of NIM, we are able to pass along the higher rates to our customers, right, in our underwriting. As Scott said, it's still a competitive environment, but we have been able to do some of that with a certain lag, if you will. But the higher rates continue to be a headwind for us. The cost of funds has increased year on year. With some hedging on our side, we've been able to moderate that impact but that continues to be a headwind on our spread.

As we go and look ahead, it will be primarily a function of balances and given the strong start that we've had in originations, we should see that flow through to the top line in the coming quarters.

Eric Wasserstrom:

Okay. Thank you very much.

Operator:

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

Chris Donat:

Good morning. Thanks for taking my question. Wanted to revisit one issue related to the securitizations which is the rapid growth in the balances on the DRIVE securitization platform and the relative shrinkage in the SDART securitization. Is that reflective of a strategy on your part or the actual originations and the mix there, or what investor demand is for securitizations? I'm just trying to understand the dynamics of why those two platforms are moving in opposite directions for balances.

Juan Carlos Alvarez:

It's just reflective of remember that we have the DRIVE tends to be, like I said, deeper in terms of credit. We tend to—remember that DRIVE hadn't been active for quite some time, so some catch-up there, and now the sequence is a little bit more normalized, so it just represents a bigger share of what it used to be, but it's not representative of any particular intent or strategy of going deeper, more towards the DRIVE platform.

Chris Donat:

Okay. Then just for my follow-up, just to be clear on that 55.1% recovery rate for Auction-plus, there's nothing unusual or sort of one-time in there related to insurance proceeds or anything like that, right? That's just that's a strong number.

Juan Carlos Alvarez:

Yeah. No one time.

Chris Donat:

Okay. Just checking.

Scott Powell:

No one-timers.

Operator:

We'll go next to Kevin Barker with Piper Jaffray.

Kevin Barker:

Hi. Thank you for taking my questions. In regards to the changes in your servicing practices to now count borrowers with at least 90% of payment versus 50%, has this impacted your expectations for TDRs going forward, and has it impacted your expectation for recovery rates like we've seen this quarter?

Juan Carlos Alvarez:

Hold on. Run that by me again.

Evan Black:

Kevin, you're just talking about the... in order for a payment to be considered complete it was changed on the SC side to 90% instead of 50%. In the past it's always been Chrysler has always been 90% so I think we were just aligning the two platforms.

Juan Carlos Alvarez:

They're both 90% now. So the question was? (Inaudible).

Kevin Barker:

Has that had an impact on your expectations for TDRs and recovery rates?

Juan Carlos Alvarez:

Not meaningfully, no. We're just aligning the two.

Kevin Barker:

Okay. Then one of your competitors mentioned big changes to their accounting policy due to CECL. Going forward, what is your expectations in how you're going to address CECL and the impact to your reserving methodology?

Juan Carlos Alvarez:

We saw that. We are not—still sometime away. It's too early at this moment to give guidance in terms of the impact. What we saw was also we had a little bit more clarity in terms of what is the intended. You might have seen the NPR, what is the intended treatment for excess reserves on capital. It's still too early to give you an estimate. At this point in time we are not considering any change in accounting, specifically for CECL or otherwise. Don't forget, I think the company that did it is a smaller standalone company. We align perhaps our accounting principles also to SHUSA and across Santander, so it's not something that we are considering at this time.

Kevin Barker:

Okay. Thank you.

Operator:

We'll go next to Jack Micenko with SIG.

Jack Micenko:

Hey, good morning guys. Wanted to ask a bit about the allowance. I hear you on the TDR piece and really being driven by the top line of those balances, but it looked like the TDR allowance ratio came down pretty significantly quarter to quarter. Obviously, you're growing the non-TDR piece as you're growing originations, but is there something more pronounced on the TDR side specifically to bring that in about 100 basis points? I know you have the \$70 million positive adjustment too; just trying to reconcile all that and what your thinking is. Is 26, 27 ratio kind of the new normal, or how do we think about that?

Juan Carlos Alvarez:

No, I think overall credit performance and balance were the key factors, but as we've mentioned before there are many variables that impact our allowance, and frankly, as we look ahead we have to think about the strong originations in the quarter and expectations for continued strong originations in the future, and all those other factors. The key drivers is balances and credit performance in this quarter.

Jack Micenko:

Okay, so think about the TDR allowance ratio this quarter as more of an output than an input?

Juan Carlos Alvarez:

Yeah.

Jack Micenko:

Okay. Then Scott, 16.9 Tier 1, I think you've said in the past you think you need to 12 run the business the right way, does that 16.9 come down over the next 12, 18 months? Can you talk about sort of broad strokes what your thoughts are there?

Scott Powell:

Sorry, I didn't quite follow that one.

Evan Black:

He's saying that the Tier 1 capital, 16.9, is that going to—what are our expectations for that?

Juan Carlos Alvarez:

We talked about our capital targets being 12.5%. Obviously we're running with a significant amount of excess capital at this point. That is what we incorporate into our analysis as we submitted our capital plan.

Scott Powell:

Yes, and what—sorry, JC. What we said last time was going into this capital stress testing cycle would be a different—we would take a different approach than we did in the previous one, right? Because that was the first time we expected to pass. And so we did take a very conservative approach for the capital plan that got approved for these past four quarters. I would just tell you we've taken a different approach for the capital plan we've submitted this time; call it a step in the right direction or more towards a normalized way to think about and manage capital distributions. Jack, does that help?

Jack Micenko:

Appreciate that color, yeah. That's very helpful. Thank you.

Scott Powell:

It's evolving. It's evolving and maturing, you bet.

Jack Micenko:

That's helpful. Thank you.

Operator:

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

David Scharf:

Hi, good morning. Most of my questions have been answered, but maybe just a couple of follow ups. First, regarding the spread between Auction and Auction-plus, I know somebody asked whether there were any one-timers and it sounds like the answer is no. But can you comment on whether or not, looking ahead, you're generally planning on selling more charge-offs? Are those becoming a more prominent part of recoveries?

Juan Carlos Alvarez:

No, we haven't changed our strategy there. We do that on a regular basis so we haven't (inaudible).

Scott Powell:

Opportunistic basis is the way I would describe it, but no change in our strategy.

David Scharf:

Okay, great. I know there are only a few buyers of those secured losses, so there are no flow deals or anything like that, got it.

Then just a follow-up on credit. JC, are you able to share with us what the implied ending allowance rate that supports the provision guidance? I mean is 12.3 the right ballpark we ought to be thinking about for the next few quarters?

Juan Carlos Alvarez:

We don't guide on the ratio. I gave you a range for the quarter because as you know well it's just a number of factors that goes into that calculation. We're adequately served and intend to remain so, so it's hard to give you more than that.

David Scharf:

Perfect. Thank you.

Operator:

We'll go next to Mark DeVries with Barclays.

Mark DeVries:

Thanks. A few more questions on recoveries for you. Have you seen signs that both kind of the contraction in supply and increase in demand as a result of vehicle destruction under the hurricane had any impact on recoveries? Kind of what are your expectations going forward for where recoveries are going to trend?

Juan Carlos Alvarez:

We saw some and we talked about it last quarter. We wanted to make sure that the support in terms of recoveries was out of the way. We saw some of that normalization in Q4, so we think that for the most part it's played through. In terms of our outlook going forward, just used car prices last quarter we talked about our expectation was more or less in line with the industry, and we're looking for a overall drop of less than

5%. I think that view generally remains, although we've seen some moderation in terms of those expectations from industry players, but we're still incorporating a overall drop in used car prices throughout the year.

Scott Powell:

Certainly it helped the demand for our used cars, especially trucks, right? We've seen industry-wide a pick up in demand for trucks and the sales were for pick-up trucks, related to those vehicles. I don't know if that's hurricane related but there certainly are a lot more trucks being sold than previous periods.

Juan Carlos Alvarez:

But the lift that we saw in Q3, we sort of saw it normalizing in Q4 and we think it's played through.

Mark DeVries:

Okay, that's helpful. Is there any update you can provide us on the sales process for the Bluestem portfolio?

Juan Carlos Alvarez:

Nothing new to report. We are still at it and continue to work with our partners at Bluestem to optimize that relationship as well.

Mark DeVries:

Got it. Thank you.

Operator:

We'll go next to Steven Kwok with KBW.

Steven Kwok:

Great. Thanks for taking my questions. Just a follow-up around CECL. Can you comment around how should we think about the weighted average life of the portfolio?

Juan Carlos Alvarez:

The weighted average life of our portfolio is a little bit over two. That's more or less the rule of thumb that we go by, for the entire portfolio.

Steven Kwok:

What about just on the retail installment auto loans?

Juan Carlos Alvarez:

It's roughly the same thing, yeah.

Steven Kwok:

Okay. Then have you seen any impacts around tax reform or on the consumer and how that's been evolving?

Juan Carlos Alvarez:

Yeah, we're looking for signs but generally it's too early to tell. Definitely a benefit that folks have more dollars in their pockets, but it's still too early to say.

Steven Kwok:

Thanks for taking the questions.

Juan Carlos Alvarez:

For us, the key things—that's why we put it in the deck every time, the key macro points to look at continues to be the employment market, right? Job creation, that is critical to us.

Scott Powell:

Yeah, and we do believe that for folks, they are starting to see the impact of tax in their paychecks. Has that translated into demand for cars? It's hard to see, but certainly not going to hurt us, right? In addition, this season is big. For our core nonprime business, tax season, tax refund season is a big part of that driver, so our volume tends to decline in core nonprime for the rest of the year. Not so much so for the Chrysler part of the business.

We're reading those tea leaves too. We think it will help; it's just hard to see.

Steven Kwok:

Got it. Thanks for taking my questions.

Operator:

We'll take our next question from James Fotheringham with Bank of Montreal.

James Fotheringham:

Thank you. Two more questions on capital, if I may? I'm wondering about the general scope of SCUSA's CCAR submission. Did it include a request to buy in the SC minorities in additions to dividends and buybacks? Secondly, I wanted to know did you know about the ECB's derecognition of the SC minorities to Banco's CET1 before or after you submitted your capital plan to the Fed?

Scott Powell:

Boy, those are some good questions.

Juan Carlos Alvarez:

And they're all confidential. I mean (inaudible) the SHUSA capital plan-

Scott Powell:

Look, we certainly had discussions. I'm on the Executive Committee of Santander Group too, so there's certainly conversations about how that change was going to impact the capital ratios of our group because

it is a pretty significant change, but as it relates to the minorities here, first of all we can't tell you what we stuck in our capital plan; that's confidential supervisory information. Just like Jose Antonio Alvarez, the Group CEO said this morning, you know? There's nothing happening.

James Fotheringham:

Okay it was worth a try.

Scott Powell:

We've got to be on our guard all the time, you know.

Juan Carlos Alvarez:

Scott, rate to rate, that doesn't impact our capital planning here.

Scott Powell:

Not at all, exactly.

James Fotheringham:

Thanks guys. Thank you.

Operator:

Our next question comes from Michael Tarkan with Compass Point.

Michael Tarkan:

Thanks. Most of my questions have been asked, but I do have one follow-up. Just on DFAST this year, any impact from tougher treatment of subprime auto that we should expect?

Juan Carlos Alvarez:

We talked about that. We got I think one question on that during the last earnings call. As you might remember from looking at last year's results, all our stress assumptions have been higher than the Fed's own stress assumptions, and we think we have—we're looking at it the right way. We're always higher than them, so it will be interesting to see how they've updated their results. We never know exactly what is under the hood. Those models continue to run. We don't see a lot of detail on it.

Like we said last time, it hasn't impacted how we've gone about our analysis, which we think is adequate and conservative.

Michael Tarkan:

Thank you. That's all I got.

Operator:

We'll take our final question from Arren Cyganovich with Citi.

Arren Cyganovich:

Thanks. Yet another question on capital. Can you remind me what the process is relative to SHUSA and how that impacts your requests for capital? Kind of just the dynamics there and if there's any limitations whatsoever for you to get your capital plan approved through them? Thanks.

Juan Carlos Alvarez:

I think we've commented on this before. The capital plan submission to the Federal Reserve is the SHUSA consolidated capital plan, just like every other bank holding company of that size. Our capital plan is analyzed here locally and then it's submitted to SHUSA for then SHUSA to make that consolidated submission to the Federal Reserve. So our capital analysis, like we said, our 12.5 is a reflection of what we view here at the Company at SC and then any capital actions have to make sense for us at SC but also on the consolidated view, on the consolidated SHUSA capital plan.

Arren Cyganovich:

Great. Thank you.

Operator:

With no further questions in queue, I'll now turn the call over to Scott Powell for final comments.

Scott Powell:

Great, thanks. Thanks everyone for joining the call today. Appreciate the questions. We appreciate your interest in our company. As always, the Investor Relations team will be around for follow-up questions, so feel free to reach out to that team. Thank you, guys. See you soon.

Evan Black:

Thank you.

Operator:

Ladies and gentlemen, this does conclude today's conference. We thank you for your participation. You may now disconnect.