



Santander Consumer USA Holdings Inc.

Fourth Quarter 2017 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

Evan Black, *Vice President, Investor Relations*

Scott Powell, *President and Chief Executive Officer*

Juan Carlos Alvarez, *Chief Financial Officer*

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

John Hecht, *Jefferies*

Chris Donat, *Sandler O'Neill*

Steven Kwok, *KBW*

Mark DeVries, *Barclays*

David Scharf, *JMP Securities*

Arren Cyganovich, *Citi*

Jack Micenko, *SIG*

Rick Shane, *JPMorgan*

Moshe Orenbuch, *Credit Suisse*

Geoffrey Elliott, *Autonomous Research*

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

Operator:

Good morning and welcome to the Santander Consumer USA Holdings Third 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 press 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:

Thank you, Melanie. Good morning and thank you for joining the call. On the call today, we have Scott Powell, President and Chief Executive Officer, and Juan Carlos Alvarez, CFO.

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.

On today's call, our speakers will reference certain non-GAAP financial measures that we believe will provide useful information for investors. A reconciliation of these measures to U.S. GAAP is included in the earnings release issued today, January 31, 2018. Please reference Tables 8 and 9 of today's press release for the appendix of today's presentation for further details.

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'd like to start with a review of our 2017 highlights and some of the notable events before I turn the call over to Juan Carlos for a detailed walk-through of the fourth quarter.

If you go to Page 3 in the presentation, I'll hit some of these high points. 2017 was a pivotal year for us and we're really proud of the progress we've made across a broad range of regulatory and business issues and I'll talk about some of those in a minute.

Our full-year net income was \$1.3 billion, which was impacted by a number of items that we'll discuss and reconcile for you. The biggest item was the impact of the tax law change, which added \$652 million to our 2017 net income. You should know that going forward our tax rate is going to decline significantly from 36% to just over 21%, and we believe that the tax law change will be a very positive thing for our economy, our customers and for our shareholders. Our adjusted net income was \$627 million and that's excluding the tax law impact, the settlement with our former CEO and fourth quarter legal reserves.

Some other notable items for 2017 include the fact that we launched a prime flow loan program with Santander Group, we executed \$2.6 billion of sales, and we retain the servicing on those loans. We remain a leading ABS issuer with \$7.9 billion in sales including our first-ever lease securitization for a billion dollars. We are very happy to report that credit has stabilized, kind of evidenced by loss, delinquency and recovery trends, and then notably our TDR balances are basically flat. From third quarter to fourth quarter we're flat at \$6.3 billion. Our 61-plus delinquency rate from third quarter to fourth quarter of this year only increased from 5.1% to 5.4%. Our year-over-year net losses were up 60 basis points but if you can compare that to the change from '15 to '16, that change was up 140 basis points. Our recovery rate, if you look at the fourth quarter of '16 to the fourth quarter of '17, they are down a little bit from 48% to 46% but we feel pretty good about that, so that's pretty solid.

We've continued to strengthen our management team here at Santander Consumer, and we're very focused on deepening our relationship with Chrysler and improving our overall service to dealers.

On Chrysler, we originated \$12.7 billion in 2017 and if you look at our fourth quarter originations this year versus the fourth quarter originations last year, you'll see that we are up about 12% in terms of our originations in the Chrysler program.

We launched the VIP program for dealers, we increased our floor plan business that was done through SB&A by 14% and we had a very strong year for lease originations. We will continue to be very focused on increasing volume and penetration for our partner, Chrysler.

As I mentioned, we did complete the purchase of the stock of the former CEO of Santander Consumer, which takes SHUSA's ownership to 68%.

Of course the biggest news in 2017 was that Santander US passed the Federal Reserve's capital stress test and the Federal Reserve also closed our 2014 written agreement related to dividend payments, so we were able to resume our dividend payments for the first time since 2014, and then you'll note that we are declaring a dividend of \$0.05 per share that we'll be paying in February.

That said, on the regulatory front, we do have a lot more work to do. There are two written agreements outstanding with the Federal Reserve, one from 2015 and one from 2017. We continue to work on those issues and we are making progress. Santander Consumer, as the biggest business for Santander US is absolutely critical to our future progress on regulatory issues and is critical to success in that category.

Just a couple of more comments about our immediate priorities. We are very focused on optimizing our credit and pricing model to increase our originations for Chrysler, and in our core non-prime business. As always, we maintain our discipline around expenses.

I guess last comment before I turn it over to Juan Carlos is we feel really good about the strength of the U.S. economy and the car market. You all know that unemployment is very, very low and the economy is growing, and then on the car market, new car sales are expected to be down a bit from 2017. I guess it's 17.6 million so it's 17.3 million, but that's still very robust. Then used car prices are expected to be down a bit as well, and I'm not exactly sure what the number will be but somewhere less than 5% I would say, so we feel really good about the macro environment for our business.

Then just as a reminder, there is a headwind as rates rise for us.

With that, maybe we should turn to Q&A.

Juan Carlos Alvarez:

Thanks, Scott. I'd like to start with a few highlights for the quarter. Q4 '17 was a good quarter for us. We generated net income of \$580 million for \$1.60 per diluted common share. Adjusted net income in Q4 totaled \$98 million for \$0.27 per diluted common share. I will elaborate on these and other financial metrics in more detail.

Let's turn to Slide 4 for some key economic indicators that influenced our originations and credit performance. Building on what Scott said, the overall macroeconomic environment remains stable and supportive of our business. Consumer confidence remains high, GDP growth is strong and unemployment levels continue to be very low. These metrics are strong indicators of the health of the economy.

Used auto sales remain robust with industry experts expecting a moderate decrease in 2018 from 2017, but are still at a level that is, as Scott said, indicative of a stable and healthy market for new vehicles.

We are also optimistic about tax reform and the help that it will provide to consumers. At the same time, tax reform will also lead to a more competitive pricing environment and potentially higher interest rates which can be headwinds for SC.

On Slide 5, there are few key factors that can influence our loss severity and credit performance. We are pleased to that our auction only recovery rate, which represents auto-related recoveries from the auction lanes increased slightly to 43.4% from 43% in Q4 last year. Our auction-plus recovery rate which includes insurance proceeds, bankruptcy and deficiency sales was 46.4% in the quarter compared to 47.9% the same quarter last year. Additionally the non-prime industry securitization data including net loss and delinquency trends continued to be relatively stable to moderately higher.

Let's turn to Slide 6 to cover originations. Our total Core loan originations decreased in the quarter compared to 27% in the quarter compared to the prior year quarter. Total FCA quarterly originations were higher year-on-year as Scott mentioned. Total Chrysler loan originations were flat in the quarter compared to the prior year quarter, while Chrysler lease originations continued to be strong, increasing 34% compared to Q4 last year. As we clearly communicated last quarter, our goal is to increase non-prime volumes, that's our bread and butter, as well as increase prime volume by continuing to leverage our flow agreement with Santander while we are pricing for the appropriate risk return profile on all originations.

During the second half of 2017, we set forth new initiatives to improve our pricing as well as dealer and customer experience, which we believe will increase our competitive position in the market. We are confident in our ability to effectively execute our originations strategy in 2018 and look forward to updating you on our progress in the quarters to come.

Moving to Slide 7, the Chrysler Capital quarterly penetration rate for Q4 '17 has been relatively stable since September at 18%, down from 21% last quarter. A reminder, in the past we provided the point-in-time penetration rates at the end of the quarter, but a quarterly penetration rate is more representative of our performance with FCA.

Chrysler Capital volume and penetration rates are influenced by strategies implemented by FCA including product mix, source, higher margin vehicles and incentives. With rates increasing, we anticipate that subvented rate offerings in the market will become more competitive, which should in turn lead to higher originations with Chrysler dealers as opposed to cash incentives offered directly to customers which are more prevalent in a low rate environment.

Turning to Slide 8, our Service For Other balances have decreased versus the prior year due to lower prime originations and the timing of asset sales. Looking ahead, we expect to drive the Service For Others platform via our flow agreement with Santander.

In 2017, we executed \$2.6 billion in prime auto loan sales through this agreement. While we did not execute a sale in the fourth quarter, we expect to have a sale completed during Q1. Additionally, during the first quarter of 2018, we expect to complete a prime auto loan portfolio conversion with a new third party, which would increase our Service For Others balance by more than a billion. We intend to pursue similar opportunities in the future.

Let's move to Slide 10 and review our financial performance for the quarter. Interest on finance receivables and loans decreased 8% year-over-year primarily driven by lower average rate balances partially offset by the timing of prime asset sales. Interest expense increased 9% versus the prior year quarter, primarily driven by the increase in benchmark rates over the period.

Provision for credit losses decreased to \$562 million in Q4 '17 from \$686 million in Q4 '16. This decrease in provision is driven by a combination of lower balances, stabilizing credit performance and recovery rate.

This quarter, the Other Income line had a loss of \$38 million driven by \$140 million in personal lending customer charge-offs and \$23 million detriment to the market discount. These are consistent with typical season patterns in this held-for-sale portfolio.

Turning to Slide 11 we will review vintage performance. This slide displays gross and net losses for 2014, 2015 and 2016 vintages. 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. While it is a bit premature to accurately measure the performances of the 2017 vintage, we believe 2017 will likely fall somewhere between the 2015 and 2016 vintages in terms of gross and net losses.

We move to Slide 12, the 31 to 60 and 61 plus delinquency rate packets of 10.3% and 5.4% in the quarter are both up 30 basis points compared to Q4 last year. Our rate gross and net loss ratios increased 20 and 40 basis points respectively in the quarter compared to Q4 last year. The year-over-year increase in both of these ratios were driven by the aging of the more non-prime 2015 vintage and a lower portfolio balance.

Regarding hurricanes, on the Q3 call we mentioned that we provided relief to our customers via loan modifications, primarily in the form of extensions and mostly in the earlier stage delinquency packets. As a result of those modifications, we experienced a slight benefit to our reported delinquency and loss figures during Q3. Now, towards the end of Q4, as we expected, we started to experience some normalization in delinquency and loss. In 2018 we expect the hurricane benefits to reverse, mostly in the first quarter, and believe that we remain adequately reserved. As a reminder, last quarter we had an incremental \$53 million reserve for the hurricanes.

Let's move to Slide 13 to review the loss figures in dollars. Net charge-offs, for RICs remained relatively flat compared to Q4 last year. Let me briefly address the main components of the net charge-off walk. The \$31 million decrease is driven by lower balances versus the prior year quarter, as average rates held for investment decreased approximately \$1.1 billion or 4% and also by loan mix. The \$18 million increase in the Other category is primarily driven by loans in bankruptcy which were written down in Q4. These bankruptcy-related charge-offs are primarily timing related and would have likely otherwise occurred in future quarters.

Turning our attention to provisions and reserves on Slide 14, at the end of Q4 2017 the allowance for credit loss totaled \$3.3 billion which is a decrease from \$3.4 billion last quarter. The allowance increased \$103 million due to new originations and \$80 million due to TDR migration. As Scott highlighted earlier, the outstanding TDR balance in Q4 is relatively flat compared to last quarter and the increase in TDR migrations have stabilized versus the prior quarter increase of \$130 million. These increases were more than offset by a \$90 million decrease in the allowance due to favorable performance adjustments and \$204 million due to liquidations in Others. Those include pay-offs and charge-offs.

The allowance to loans ratio was 12.6% as of the end of this quarter, down 20 basis points from the end of the prior period.

Turning to Slide 15, operating expenses this quarter totaled \$426 million. Adjusted operating expenses excluding the settlement with the former CEO and legal reserves were \$259 million, down 9% from the \$296 million in the prior year period. This year-over-year improvement in adjusted operating expenses is driven by our disciplined expense management but also lower compensation expense and favorable merits on a portion of our derivative portfolio. The expense ratio for the quarter was 3.5%. The adjusted expense ratio was 2.2%.

Turning to Slide 16, our funding and liquidity position remains strong with total committed funding of more than \$40 billion. During the quarter we offered and sold \$2 billion in asset backed securities including our inaugural lease ABS securitization, ticker SRT. As Scott highlighted, the successful launch of the ABS platform totaled more than—the lease ABS platform, totaled more than \$1 billion in securities offered and sold and was a significant milestone for SC as it creates additional funding at a lower cost for our lease business. While there were no asset sales during this quarter, as I mentioned earlier, we expect to close another flow transaction with Santander during Q1.

Finally, turning to Slide 17, our CET1 ratio at quarter end was 16.3% or 14.8% excluding the significant items mentioned at the beginning of the call. Please reference Tables 8 and 9 of today's press release for the appendix for further details on those significant items and reconciliation to GAAP.

Our capital levels remain above our internal capital target and we look forward to further optimizing our balance sheet in the future. As Scot mentioned, we're also declaring a cash dividend of \$0.05 per share for the first quarter of 2018.

Now, looking ahead to Q1, I'll make some comments that will be relative to Q4 of 2017. We expect net finance and other interest income to be flat to up 2%, depending on origination volumes including leases and the timing of Santander sales. Provision expense is expected to be down \$20 million to up \$20 million depending on new originations and credit performance. Total Other Income we expect to be up \$55 million to \$75 million, in line with seasonal patterns and lower Bluestem balances. Operating expenses are expected to be up \$20 million to \$40 million compared to the adjusted operating expenses in Q4 which were \$269 million.

Turning to taxes, over the last several quarters we talked about the benefit of SCI, our Puerto Rico operation on our effective tax rate. As stated in our disclosure, we have changed the classification of earnings and we no longer intend to permanently reinvest SCI related earnings. This decision will have no impact on our servicing operation in Puerto Rico which provides geographic diversification and enhance our side of our Caribbean (inaudible).

Looking ahead, we expect our effective tax rate to be slightly above 21%. As mentioned earlier, we expect most of the tax benefits to support SC's growth, increase shareholder returns and further increase professional development initiatives for our employees.

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

Scott Powell:

Thanks, Juan Carlos. Just a couple of more comments, a couple of more topics I'd like to hit. One is the impact of Hurricane Maria on the island of Puerto Rico. We mentioned this on the last earnings call but I'm very proud of the fact that the Company and with our employees we donated over \$2 million for relief efforts in Puerto Rico as well as direct assistance to our employees in Puerto Rico. It's very important, and we also assisted 81,000 Santander Consumer customers on the island. As Juan Carlos said, even though our tax position related to Puerto Rico has changed, we are still committed to the service center that we operate in Puerto Rico.

Then the other exciting news this morning was the announcement about AutoFi. InnoVentures, which is Santander Groups' venture fund is making an investment in AutoFi and at the same time Santander Consumer will become part of their platform as one of their lenders, and so we're very excited about that because that really enhances our digital product offering along with our own RoadLoans offering. It's one of those things that is positioning us well for the future, so we're very excited to be working with AutoFi.

I think with that we'll go to Q&A.

Operator:

Thank you. We will now open the call for questions. As a reminder, please limit yourself to one question and one follow-up question. Thank you.

Our first question comes from John Hecht with Jefferies. Please go ahead.

John Hecht:

Thanks very much guys. First question, the credit, the allowance, and the provisions pursued some of the guidance you gave us but the provision was a bit higher on the dollar basis than you guided. Just wondering, given that dollar net charge-offs were down and the TDR migration is stabilizing, I'm wondering what drove that elevated provision relative to the guidance you gave us last quarter.

Juan Carlos Alvarez:

Thanks, John. There are a few things. We were expecting a somewhat higher ALLL release. As we've discussed before in our calls, there are many variables, models that impact our allowance including gross performance, recovery and a number of other things and outlook. It's driven by ALLL expectations really.

The outlook on our credit, as we have highlighted, we see the stabilizing in credit performance. That doesn't change versus—the number in ALLL doesn't change that view of the underlying trend.

John Hecht:

(Inaudible) and TDR migration and you're giving us some information that the '16 vintage versus the '15 vintage performance, how should we think about just generally speaking the ALLL trends as we step through 2018?

Juan Carlos Alvarez:

Our ALLL is going to continue to be driven by the same methodologies we've had. As Scott mentioned, our TDR balances, in line with our expectations, are starting to level off. That's something that we've been discussing for most of 2017. We still expect that to be confirmed in the early part of 2018, and that we'll have everything else the same a leveling impact on our ALLL which will also be affected by our portfolio growth expectations and originations.

John Hecht:

Great. Thanks very much, guys.

Operator:

We'll go next to Chris Donat with Sandler O'Neill. Please go ahead.

Chris Donat:

Good morning. Thanks for taking my questions. Wanted to ask about with the comments on stabilization in credit and then also the likely benefit from tax reform for consumers, is it reasonable to assume that credit quality will be stable here without some sort of shock, or can we even be aggressive and assume that we might see year-over-year decreases in charge-offs and delinquencies because of the benefit the tax reform, or am I getting ahead of myself there?

Scott Powell:

Chris, I think you might be getting ahead of yourself a little bit there. I wish it were true. I mean I think there is a marginal positive impact on our target customers disposable income. There's kind of a wide range of estimates out there, it's going to be positive. I think it will help certainly on the credit side. I wouldn't expect a dramatic impact but I do think it helps with the stabilization of credit, and for all the other reasons too that we touched on, yeah, I think we feel really good about the environment. Our target customer is really—the delinquency rates there when you look at the macroeconomic drivers is really tied to unemployment, so given where unemployment is, given the growing economy, given consumer confidence and then the tax law change, putting some extra money in people's pockets, I think it's going to have a positive impact. It's a little hard to know how fast and how much, but it's got to be good at the end of the day.

Chris Donat:

Got it. Thanks on that. Then just one small one on the Service for Others portfolio. With the expected addition of the billion dollars, JC, can you comment on the timing of that? Is that something that's going to be late in the first quarter or do we see a partial impact in the first quarter? I'm just trying to get an understanding how it might affect second quarter too.

Juan Carlos Alvarez:

Yeah. We expect it to close during the first quarter, so call it in the middle of the first quarter, but still the impact to Q1 will be relatively small.

Chris Donat:

Okay. Thank you.

Operator:

We'll go next to Steven Kwok with KBW.

Steven Kwok:

Hi. Thanks for taking my questions. I guess could you talk about the competitive environment, and when we look at originations in the fourth quarter, what's your baseline expectation on that?

Scott Powell:

On the competitive environment, I think it has been pretty stable. There's nothing too much to highlight there. There are some bigger players who have noted pullback from the non-prime space, but there are still lots of competitors out there to fill in. We don't see anything crazy happening on pricing or anything really new to note in the competitive frame.

Juan Carlos Alvarez:

It would be a good occasion to highlight the initiatives that we put in place.

Scott Powell:

Yeah, to your question about originations, baseline originations in the fourth quarter, we expect to improve our originations going forward. We've been working really hard, Steven, on optimizing our pricing models and optimizing our credit models so we can capture more in the segments where we do business. We've seen some good early results from that and so we fully expect as we move forward to be growing off the numbers you see in the fourth quarter.

Steven Kwok:

Got it. Then just around CECL, I know it's kind of early, but can you talk about what the expected impacts are that you're seeing? Are you guys trying to get ahead of that by elevating your capital ahead of CECL happening in 2020?

Juan Carlos Alvarez:

Not specifically. As you know, we have excess capital compared to our internal targets. The ratios have been boosted by the DTL adjustment, so we're not building capital specifically to CECL. We're not getting guidance either but it should be incorporated into our 2018 CCAR summation, but it's something that we do—we are analyzing, you can imagine, in detail. It's not something that is going to drive our capital expectations or planning in 2018.

Steven Kwok:

Got it, but how should we think about the impact on CECL? Is there a way you could walk us through that?

Juan Carlos Alvarez:

We still haven't finalized the numbers and we still haven't talked about them, so ...

Steven Kwok:

Got it. Just last question is if I plug in all your guidance for the first quarter, I get to about a \$0.40 EPS. Is that in the right ballpark?

Juan Carlos Alvarez:

We will limit ourselves to the guidance that we've given you. We've talked about the key trends that we expect quarter-on-quarter as it relates to net finance and other interest income, provisions and total other income, as well as operating expenses where we're starting to see the impact of disciplined management, and then take into account the impact of the lower effective tax rate that we highlighted.

Steven Kwok:

Got it. Thanks for taking my questions.

Operator:

We'll go next to Mark DeVries with Barclays.

Mark DeVries:

Thank you. Could you discuss what plans you have for using the substantial excess capital that's been building? Is there anything you can do to distribute that to shareholders outside of the dividends that you've declared so far?

Scott Powell:

Well, the answer to the last question is no. I mean we have to go through the normal capital cycle with Federal Reserve, like everyone else. It's nothing special we can do outside of that so it all flows through the Fed's Capital Planning process.

In terms of what we're going to do with it, we will be investing more in our employees. We've done a number of things, for example, around improving tuition reimbursement. We've been taking opportunity to do more training, work on career development. You saw a lot of folks announce raising their minimum wage to \$15 an hour. The entry wage here at Santander Consumer was already higher than \$15 an hour, even at the call centers, and so we don't feel like we need to do that. Certainly we'll be thinking about ways to invest in our business and also, again, we expect competitors to be somewhat more aggressive, probably, in the marketplace, so we have to be thoughtful about that, but the majority of it we expect to hit the bottom line.

Juan Carlos Alvarez:

Maybe to add to that, regarding the capital actions, you know what we're going to do in Q1. We just announced the increases in the dividend. Coming out of CCAR, we also highlighted what the expected capital actions were for Q2, and the CCAR submission that we have to go through is coming up very quickly, in April, and the difference, as we all know now, is that system around we're in a normal capital planning cycle so all the options are available to us in that regard but we still have to go through the process.

Mark DeVries:

Thanks. Can you just discuss for us the implications on returns as you kind of shift towards—given your current origination rate was more of a leasing focus than the focus on your installment contracts. I know you're making an effort to grow that part of the business again, but could you just talk about the relative returns on leasing versus your loans?

Juan Carlos Alvarez:

Leasing provides healthy—I think we've talked about target ROAs in the past for lease. It offers a good return. It's a business that we feel comfortable with. We also talked about the improved funding platform that we have for it, that's also going to help or has helped. Certainly we've been successful in terms of year-over-year originations. We expect to continue to make good progress in there. That's supported by let's not forget by the residual risk sharing agreement with FCA. But, more progress there but it's not as if we're turning just to lease and turning away from our core non-prime and originations, right? When you look at that originations table, that's where you see the significant drop and that's what the initiatives that Scott talked about, that's what it's intended to correct mostly.

Scott Powell:

The real focus there is on core non-prime because that's where the biggest decline happened in originations, but to Juan Carlos's point, we'll be looking to increase loan originations for Chrysler and core non-prime, and then as Juan Carlos said, we're very comfortable with leasing so we would expect that to grow in the future as well.

Mark DeVries:

Got it. Thank you.

Operator:

We'll go next to David Scharf with JMP Securities.

David Scharf:

Hi, good morning. Thanks for taking my questions. First off, I think you sort of partially responded to this for the prior question relating to competition, but I'm wondering during the fourth quarter, and I realize it's a seasonally kind of low volume quarter, maybe it doesn't give you the best read, but were there any noticeable changes in your capture rate, particularly for your lowest sub-prime bands that would give you a sense for how we ought to be thinking about first half volumes and mix?

Juan Carlos Alvarez:

What I would say is nothing in the early part of the quarter but as we get closer to the end of the quarter, some of the initiatives that Scott talked about started having an impact and improved capture rates in the channels where those were deployed. We also talked about how those trends have continued in the first few weeks of the year and that's what's encouraging about coming months. Those initiatives certainly are starting to have an impact and we expect there is more to do and expect more of it.

David Scharf:

Got it. That's helpful. Then as a follow-up, zeroing in on perhaps some of the inputs into your provision expense guidance for Q1, about \$20 million sequentially down, is it safe to assume that based on the expectation that TDR balances may have or imminently about to peak and your other commentary about how the 2016 vintage is performing and ageing that the ALLL inherent in that provision expense is flattish from Q4 levels?

Juan Carlos Alvarez:

Just to be clear, we expect provision expense to be either down \$20 million to up \$20 million, so on both sides of flat. The factors that you mentioned do go into it, right? The TDR, our expectation, the TDR will level off, we're going into that expectation, absolutely.

David Scharf:

Got it. Thank you.

Operator:

We'll go next to Arren Cyganovich with Citi. Please go ahead.

Arren Cyganovich:

Thanks. I was wondering if you could touch about the penetration rate; it was down quarter over quarter. Is that seasonal or is there something in the mix that drove that difference between the third quarter?

Juan Carlos Alvarez:

No, nothing. Well, there's seasonality certainly off the interaction or the originations, in that sense, but as it pertains to the penetration rate, during Q3 we talked about how it had been let's say relatively volatile. It got as high as low-20s with some of the summer initiatives, then came back down to end the quarter at 18% in September. For the fourth quarter, that penetration rate has remained very stable around 18%. Again, as we make further progress on the initiatives that we've discussed, we do expect to make good progress on that penetration rate.

Scott Powell:

Arren, I would add two things, too. If you look at the originations volume for Chrysler from the third quarter to—from the fourth quarter of last year to the fourth quarter this year, there is growth there, and certainly the number of initiatives that we have around dealers especially and making it easier for Chrysler dealers to do business with us is also a reason we're optimistic about the penetration rate improving in the future.

Arren Cyganovich:

Great. Thank you.

Operator:

We'll go next to Jack Micenko with SIG. Please go ahead.

Jack Micenko:

Hi, good morning. I wanted to talk first about your go-forward asset yields. They've been coming down. You've been I think increasing FICO a bit. You said competition is stable. The curve here is maybe beginning to steepen some, and then you talked about some new initiatives to drive more volume. How do we, on a big picture basis if sort of things kind of stay the way they are competitively, how do we think about new money yields in '18 for the portfolio?

Juan Carlos Alvarez:

The picture that you're looking at in '17 is impacted by having originated on a relative basis less core non-prime and having held on balance sheet prime loans, more prime loans that are later going to be sold to Santander through the flow agreement. That in itself puts pressure on the yield number. As we look ahead, with the success that we expect in terms of our originations, the progress we expect in terms of core non-prime originations, that should help us increase that top number, the yield, and then obviously as the amount of prime loans that we originate for the flow agreement are also going to have an impact, but the mix should go back to more what had been in the past and help that line.

Jack Micenko:

Okay, so better. Then I guess, Scott-

Juan Carlos Alvarez:

One more, Jack, if I may.

Jack Micenko:

Yeah.

Juan Carlos Alvarez:

At the top line the one thing to keep in mind and it's very evident from the results is that the cost of funding, right, has gone up significantly over 2017 even though funding spreads have tightened. That headwind in the base rates is significant for us, and if we expect rates to go higher, as we do, that's something that we are also going to have to continue to manage through because it will remain a headwind for NIM in general. Okay?

Jack Micenko:

Got it. So the top line yields maybe don't translate into NIM.

Juan Carlos Alvarez:

Correct.

Jack Micenko:

Okay. Then, Scott, the Company has built about 300 basis points of capital last year, '17, and on some reasonable math that number maybe even goes higher all else equal. When you talk about a target and you're above that, what is the right—you've worked through some of the regulatory things. What's the right level of capital you think to run the Company? How long does it take to get to that right level with the things you're thinking about in terms of growth and dividend and other things?

Scott Powell:

I think we said before is a CET1 of 12.5% is the right level to run the Company at. Then, you know, in terms of I guess you're really asking about how long is it going to take to get there, and that's a more complicated question. It's hard to really say. We have—the good news is we're in a much better position as we enter the CCAR cycle with the Federal Reserve, and we are in the process of thinking about what we might propose. We haven't reached a conclusion. It has to be a really thoughtful proposal in terms of how we do this, so I don't think I can give you much more guidance than that, except to say as Juan Carlos said, which is all the options are on the table now. We just have to be thoughtful about how we progress through the process.

Does that help? I hope.

Jack Micenko:

Yeah, it's fair enough. I know it's kind of a multifaceted questions. Thanks for taking the questions, guys.

Operator:

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

Scott Powell:

Hey Betsy.

Betsy Graseck:

Hi, good morning. A couple of follow ups. On the growth question, obviously number one use of the capital generated here, the question is how are you going to be thinking about getting that growth? Is it just a function of you've got more sheet? Same pricing, same risk metrics, just waving more in? Do you expect that you would be going a little bit more down market? Are you going to be more competitive on spreads? Just wanted to understand what you're going to flex in order to generate that growth.

Scott Powell:

One of the things I really love about this business is the power of analytics and how this business works. I mentioned that we are very focused on optimizing our risk and pricing model. We want to make sure that we are getting paid for the expected credit losses, primarily, that we'll experience in these different segments, and so getting the analytics right and pricing each sell in each segment the right way can create opportunities for it. It can also create problems if you do it wrong, but so we have been spending a lot of time with analytics and optimizing our pricing in the market for the expected losses. So, yeah, there's no shift to deeper credit happening here. We expect to increase our penetration rate in our traditional bread and butter market, which is really core non-prime, which is near-prime and sub-prime, and those opportunities exist with Chrysler dealers as well.

Then the other thing that we think will help us with creating more originations is that whole focus on dealer service that I mentioned, which is, like it or not, there is a perception, and J.D. Power results are public, so if you look at J.D. Power results, you'll see that we are towards the bottom with how dealers feel about us. We need to make it easier to deal with us. We need to be much more dealer friendly. We need to be much more responsive, and we're working on that. As dealers feel that, we believe that will help with our capture rate across the board.

Betsy Graseck:

Okay. So on the first point—I get the dealer point. That's very clear, but on the first point, the analytics are not—you're leveraging the analytics to drive more business at the current rate than you did in the past and it really boils down to you're going to wave more business in. Basically what you're saying is you could have waved more business in in the past but you didn't?

Scott Powell:

Yes, it's really—it's not quite that black and white. It's really about optimizing the trade-off between risk and pricing and finding the places where we feel like we've got an opportunity to capture more volume. Typically to do that, you have to go in with a lower price or more attractive structure to get that, but we think there are places where we can do that and our early returns from that work is good. That's why we believe we are driving originations.

Betsy Graseck:

Got it. I'm just wondering why now. Is it because the tax rate has changed and so that gives you more opportunity to wave more business in? If you're not taking more risk and you're not changing spreads then is it the tax rate that enables you to do that?

Scott Powell:

No. Not the tax rate change. I would say we've made a lot of management changes going back to when I arrived here, and I feel like we've got a different approach when it comes to thinking about pricing for this risk. We've also brought in other folks into the organization that know how to do it and have done it before. I think that's part of it.

Betsy Graseck:

Then just lastly on the analytics piece, I know you had the conversation earlier about tax rate change could change how your borrowers behave. How quickly do you think you'll be able to see that in the analytics and then how long do you have to see it in the analytics before you take action on it?

Scott Powell:

That's a hard one. I don't think we'll see it quickly. I think we'll see it over time. It's too soon. People have got to see the less withholding in their paychecks. I think we'll see it, it's just going to take time to emerge. There's things that people will do to react to that. I know that's a vague answer but it'll show up, it's just hard to tell how quickly.

Juan Carlos Alvarez:

Too soon.

Betsy Graseck:

Yeah, and I'm just wondering once you start seeing it do you have to see it for six months before you take action or could you be quicker than that?

Scott Powell:

If we see a significant improvement in risk, we would respond to that very quickly, provided we're convinced we understand it and what's causing it because then we can price more effectively.

Betsy Graseck:

All right. Thanks a lot.

Scott Powell:

Thanks. Thanks for those hard questions.

Operator:

We'll go next to Rick Shane with JPMorgan.

Rick Shane:

Hey guys, a couple of questions here. First of all, with the debate of the quarter's really going to be the performance adjustment of \$90 million, why should we not see that as a one-time item? Can you give us a lot more specifics on what drives that \$90 million change?

Juan Carlos Alvarez:

Sorry. On the \$90 million, you're talking about the \$90 million adjustment in legal reserves?

Rick Shane:

No. I'm looking at the ALLL. I'm sorry. Yeah, the performance adjustment.

Juan Carlos Alvarez:

The ALLL. That's just a reflection of credit performance during the quarter and if you go back and look at earlier quarters, you'll see that that is the most positive number that we presented for quite a long time, and I think it speaks to the trends that we've discussed earlier in the call.

Rick Shane:

Okay. Again, given that should be nonrecurring, why should we not break that out from our one-time adjustment?

Scott Powell:

I wouldn't say it should be—it could be recurring, right?

Juan Carlos Alvarez:

Yeah.

Scott Powell:

That's just the part of the allowance which reflects the improved performance of the different segments of the portfolio. So if our outlook continues to improve, we would continue to see that reduction.

Juan Carlos Alvarez:

Yeah. I'm missing why we talk about it as a significant nonrecurring. Rick, is that a ...?

Rick Shane:

The reason we would talk about it as a nonrecurring is that if credit outlook is to—your credit performance is to remain consistent with your expectations, we wouldn't see that again. That's why I'm trying to understand whether or not we should include it or not.

Juan Carlos Alvarez:

I think if our coverage ratios have come down a little bit over the quarter, a lot of things go—a lot of factors as we discussed earlier go into our ALLL, but it's not a nonrecurring item. Last quarter it was already positive, a smaller number. Earlier quarters had a negative, so that number will continue to do both. If credit and credit outlook continues to improve that number should continue to be there.

Rick Shane:

Got it. Next question, I'd love to talk a little bit about Bluestem. Frankly, it's been for sale for so long that no one even talks about it any more. You guys break it out in terms of your numbers and show a pretty substantial drag. If there is no resolution in terms of selling it, does it make sense to try to either buy out the contracts, or is there something within the existing framework that you guys can do to mitigate the impact on your earnings?

Juan Carlos Alvarez:

No, we are still—our intent is to sell it, and thus, we continue to account for it the way we do. It's a held-for-sale portfolio and we continue to work at it. That's really the answer. That's the option that we're looking at.

The profitability you're talking about, Q4 was a drag but it is in line with the expectation that we had for the quarter, the seasonality and customer activity is very much in line with what we anticipated in that regard.

Rick Shane:

Understood, and again, we understand the seasonality there, but if you look at you guys present the numbers on annual basis and it's still, it's a substantial drag, at least the way that you guys are presenting it, so that really drives that question.

Juan Carlos Alvarez:

We're going to continue to work on finding the right solution for that portfolio, and our intent is to sell it.

Rick Shane:

Thank you.

Scott Powell:

We're still working on it is the short answer. We're looking, exploring all options with this one.

Rick Shane:

Thank you.

Scott Powell:

You bet.

Operator:

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

Evan Black:

Moshe?

Scott Powell:

Good morning.

Moshe Orenbuch:

Can you hear me?

Scott Powell:

Yes.

Moshe Orenbuch:

Most of the questions I had, actually have been asked and answered, but I wanted to ask quickly about the lease securitization. Does that open up the balance sheet capacity for other things? Either your lines

with your parent or elsewhere? Should we think about that as one way to kind of help grow the more prime assets and your penetration with Chrysler?

Juan Carlos Alvarez:

That is correct. It's incremental funding and incremental lower cost money, so you're right in that regard. We were using funding from other facilities that are now freed up by the amounts that we do in SRT.

Moshe Orenbuch:

Got it. I'm also kind of struck by the amount of time that the Bluestem marketing process has taken, and I don't know if there is anything you can kind of add to what the sticking points are to find someone to stand in your shoes there because—maybe if you could just talk about that a little bit?

Juan Carlos Alvarez:

Yeah. The hard part here is that we're not selling a portfolio, right? We're selling a partnership. It's a business, and you have to find the right partner that is not just looking to put on a equivalent of a securitized position in their books. They need to partner up for a true business and it has to work for both parts. That's what makes this particularly tricky and that's why it's taking so long. But as Scott said, we continue to work at it and explore many options here.

Moshe Orenbuch:

Okay. Thank you.

Operator:

We will take our last question from Geoffrey Elliott with Autonomous Research. Please go ahead.

Geoffrey Elliott:

Hello. Thanks for taking the question. On the hurricane impact, you mentioned that kind of flips to a negative for the 1Q. Could you help quantify that a little bit? Where do we see that? Do we see that in the provision expense line and how big is the impact going to be there?

Juan Carlos Alvarez:

You shouldn't see it in the provision—it should be neutral to provisions. The way we talked about it last quarter, I think it was on follow-up question, there was a little bit in the net charge-off ratio. There was a small benefit to Q3. The bulk of that benefit remains there during Q4, the benefit to the ratio. Then that should be reversed in the early part of 2018. I think we quantified it last quarter the way we talked about it in saying that it would have been flat, it was in the range of call it 20 to 30 basis points on the charge-offs.

Geoffrey Elliott:

Great. Then just following up on credit, the TDR portfolio stable pretty much this quarter. You've talked about that kind of peaking and starting to decline into 2018. Can you give us a sense of how much you think that could come off and what you think that could free up in terms of reserves?

Juan Carlos Alvarez:

To clarify, we are not expecting it to peak; we're expecting it to level off. We're always going to have, and we certainly don't expect it to come down. We're always going to have TDR flow but after the very rapid

growth we've had when we changed our methodology, we're starting to see the leveling off that we anticipated and as we go forward this should just be moving in line with our portfolio growth and the mix of our portfolio. It's not a peak and a come down, it's a leveling off.

Geoffrey Elliott:

Great. Thanks very much.

Juan Carlos Alvarez:

Yes.

Scott Powell:

You bet.

Thank you everyone for joining the call. Thanks for your interest in our company. Certainly you can reach out to Evan and our Investor team if you have any questions, and I'll look forward to chatting with you at the next quarter end. Thanks. Bye bye.

Juan Carlos Alvarez:

Thank you.

Operator:

That does conclude today's call. We thank you for your participation. You may now disconnect.