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Weekly Credit Brief Nov 01 - Nov 07

# Has Santander Consumer USA stabilized after a bumpy 2016?

by Benjamin Lye

Santander Consumer USA (SC) posted a rather satisfying financial result during the second quarter, coinciding with an improving credit profile. However, being an auto loan lender to subprime borrowers, the company is often criticized by regulators for its auto lending practices. Despite a stable credit outlook, a severe economic crisis could wreak havoc on the auto lender's bottom line as more subprime borrowers default on their loan obligations.

Santander Consumer USA Holdings Inc. (SC) is a specialized consumer finance company, providing vehicle finance and third-party servicing in the US. Its range of products and services include retail installment contracts, vehicle leases and dealer loans. The main revenue contribution includes financial receivables and loans (77.4%), vehicles leased (22.4%) and others (0.2%). 70% of the firm's retail installment contracts (a majority constituent of financial interest receivables and loans) is with subprime borrowers (see Figure 1). Bloomberg Intelligence showed net charge-offs and delinquency rates for SC were way above the other auto loan lenders, stemmed from its large subprime customer base.

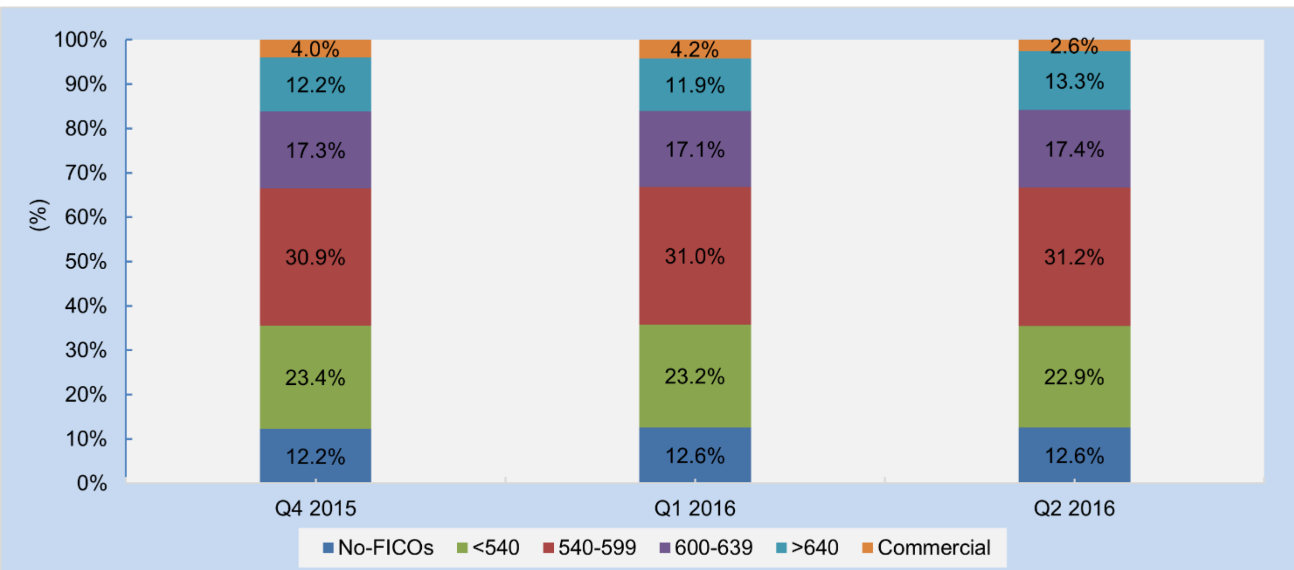


Figure 1: Fair Isaac Corporation's credit score (FICO score) distribution for Santander Consumer USA. The FICO score measures the credit score of borrowers based on payment history (35% weightage), current level of indebtedness (30%), types of credit used (10%), length of credit history (15%) and new credit accounts (10%). Subprime borrowers are borrowers with a FICO score less than 640 and characterized as below-average credit history borrowers and subject to high interest rates. *Source: Company's filing*

Santander Consumer USA has often been faulted by authorities for violating fair-lending laws. Early this year, the US Stock Exchange Commission questioned SC about a lack of regulatory compliance resulting in a delay in its 2015 annual report filing. During the press conference, the CEO and CFO admitted weaknesses in their disclosure controls and procedures and methods of provision for loan losses estimation. The company also delayed its filing for its second quarter report for 2016 due to issues relating to discount accretion and credit loss allowance methodologies.

In June 2016, Santander Holdings USA Inc. (SHUSA), the holding company of SC (59% ownership), failed the Fed's stress test for the third consecutive year. The Fed claimed SHUSA did not use “reasonable or appropriate” assumptions and analysis in capital planning despite an “improvement in its approach to loss and revenue projection”. During the stress test, the Fed projected a USD 4.4bn loan loss and a 16.5% portfolio loss rate in a severely adverse scenario between Q1 2016 to Q1 2018. On a brighter note, SC announced that it will restate its financial reports from as early as 2013 to Q1 2016 and adjust Q1 2016 total equity upwards. This news lifted the company’s market capitalization from USD 3.89bn to USD 4.27bn, up by 9.8% in just one day on 23 September 2016.

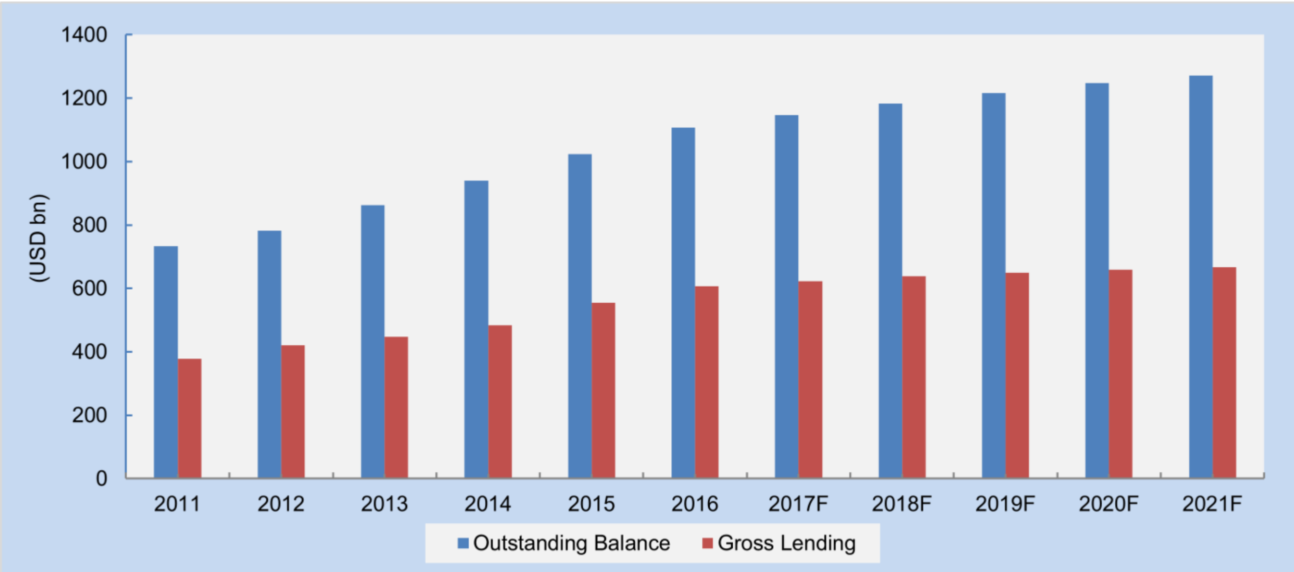


Figure 2: Euromonitor’s outlook on auto lending industry. F denotes forecasted values by Euromonitor. *Sources: Euromonitor*

According to Euromonitor, the auto loan industry’s gross lending is expected to grow moderately at an annualized rate of 2.8% and 1.9% from 2016 to 2021, respectively. This stands in contrast to the achieved CAGR of 8.6% and 9.9% from 2011 to 2016 as people bought used cars due to more competitive pricing. The outstanding balance and gross lending for auto lending are expected to reach USD 1.27tn and USD 660.9bn in 2021 (see Figure 2). In addition, both US new auto light vehicle sales (see Figure 3) and the Manheim Used Vehicle Index (see Figure 4) have been increasing since 2009, which suggest a positive outlook for the auto lending sector.

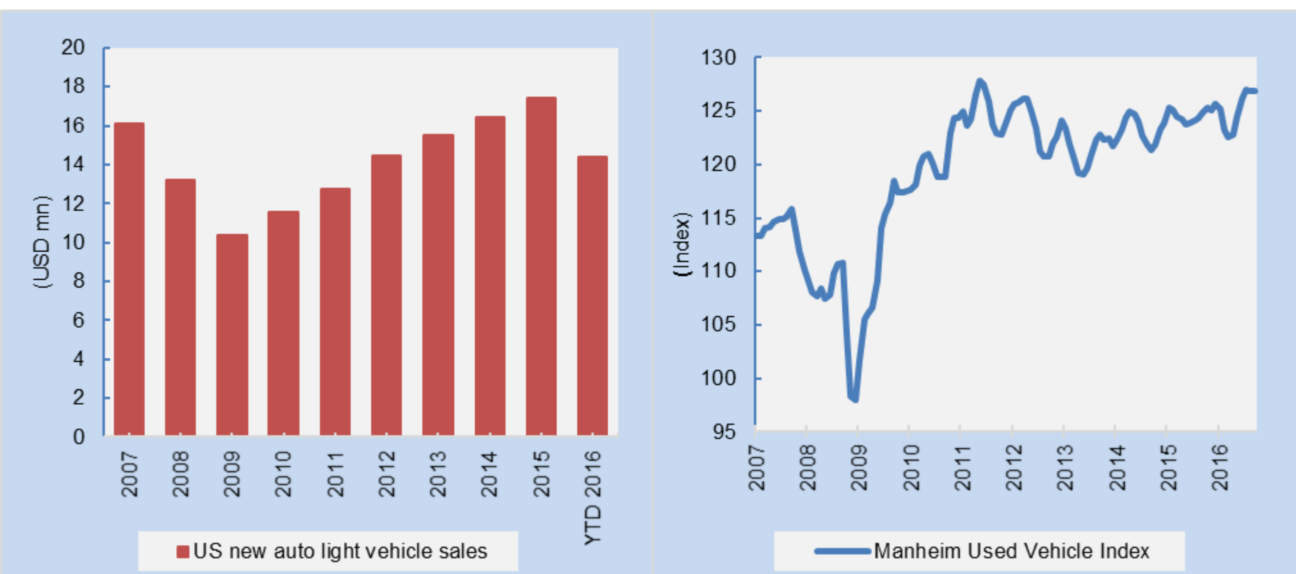


Figure 3: US new auto light vehicle sales (USD, mn); Figure 4: Manheim used vehicle value index. *Sources: Bureau of Economic Analysis, manheim.com*

As shown in Figure 5, the RMI-CRI 1-year Probability of Default (PD) for SC has dropped from its peak, 329bps in March 2016 to 127.75bps on Nov 4. At the same time, the company's market cap has resumed an upward trend after March after falling 66.5% from its peak in June 2015. The US unemployment rate is often quoted as an economic proxy for the firm's performance during company presentations. Using this macro variable as an input to the CRI scenario analysis toolbox, future macroeconomic conditions are simulated using the CRI credit cycle indices, which measure the credit market conditions on a global and industrial level, and predicts the movement of RMI-CRI 1-year PDs. Our forecast shows that the 1-year PD for SC will rise to 360bps in the event that US unemployment rate reaches 10% by November 2017.

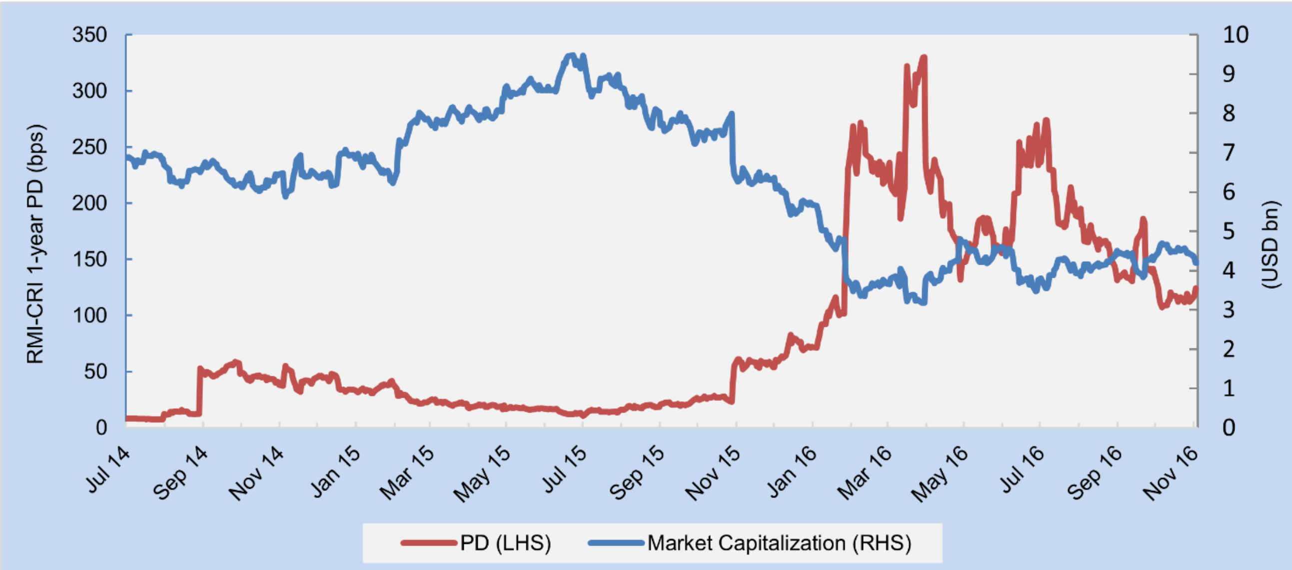


Figure 5: The RMI-CRI 1-year PD for Santander Consumer USA Holdings Inc. *Source: RMI-CRI, Bloomberg*

| | Q1 2015 | Q2 2015 | Q3 2015 | Q4 2015 | Q1 2016 | Q2 2016 |
|---|---|---|---|---|---|---|
| **Net Income** | 246.3 | 364.7 | 223.9 | 28.7 | 200.7 | 283.3 |
| **Return on Assets (%)** | 2.5 | 3.5 | 4.1 | 2.5 | 2.2 | 3 |
| **CAPEX** | -1140.0 | -1434.8 | -1579.6 | -1013.9 | -1636.7 | -1704.9 |
| **Free Cash Flow** | 103.2 | -831.0 | -697.8 | 161.8 | -982.3 | -1050.9 |
| **Net Charge-Offs** | 474.8 | 367.4 | 1105.8 | 681.7 | 584.7 | 413.9 |
| **Debt to Equity (x)** | 7.7 | 6.9 | 6.9 | 6.9 | 6.9 | 6.5 |

Table 1: Financial metrics for Santander Consumer USA. Figures in USD mn, unless indicated otherwise. *Sources: Bloomberg*

SC's net earnings has improved in the last two quarters although its free cash flow position had worsened to negative USD 1bn in Q2 2016, due to significant capital expenditures, particularly on vehicles for leasing purposes. Net charge-offs and leverage declined in 2016, but the absolute level of leverage for SC continues to be high with total debt to equity at more than 6.5X.

In short, despite recent improvement in its performance and, Santander Consumer continues to be a risky firm as subprime borrowers contribute significantly to its revenues. This is worrisome as these are borrowers with poor credit scores and limited repaying ability. Although there is a good chance of sound earning performance during periods of economic boom, the consequence of an economic recession on subprime borrowers and Santander Consumer could be devastating as indicated in the results of the Fed's stress test.

**Credit News**

**Australia may lose AAA rating as soon as next month, says Blackrock**

**Nov 7.** Australia could lose its AAA rating by S&P Global Ratings as soon as next month if the government's interim budget review shows further deterioration. The Australian government has struggled to keep its budget deficit in check as lower commodities price have reduced tax revenues. In July, S&P said that there was a one-in-three chance that it would downgrade Australia's credit rating if lawmakers failed to agree to balance the budget by early 2020s. A rebound in commodity prices, however, could help to allay the downgrade concern. (Straits Times)

**First S4A debt recast gets approval, more may follow**

**Nov 5.** The high level-panel set up under the Reserve bank of India's (RBI) new scheme for sustainable Structuring of Stressed Assets (S4A) has approved the first debt recast. According to banking sources, the RBI-mandated Overseeing Committee (OC) has approved the scheme, which was passed by an ICICI Bank-led joint lender forum in September. Construction major HCC became the first case to obtain approval and under the recast, 52% of HCC's INR 5000 crore debt was found to be sustainable and would be served as per the original terms and conditions. INR 1000 crore of the remaining 48% of debt would be converted into equity for the banks, eventually giving them a 25% stake in the company's post-scheme equity capital. (Money Control)

**Moody's warns of UK credit rating downgrade**

**Nov 2.** Moody's warned that it would downgrade the UK's credit rating once again if the government fails to retain access to the single market in the Brexit negotiation. The loss of access, warned Moody's, could lead to a slower growth in the UK over the medium-run and drag on the public finance. Currently, Moody's rates the UK at AA1, one notch below the AAA rating. The credit rating agency also highlighted that its negative outlook on the UK banking system reflected "Brexit-induced uncertainties" that had put pressure on banking revenues, asset quality, and profitability. (The Guardian)

**China conducts first batch of credit default swap transactions**

**Nov 1.** China's first batch of credit default swaps was launched, in an attempt to address the company's rising debt risks. According to a Chinese bond supervisory body, ten financial institutions conducted 15 credit default swaps (CDS) transactions on Oct 31, the first transactions in China's interbank market. In a statement released by the National Association of Financial Market Institutional Investors (NAFMI), the 15 transactions totaled CNY 300mn in nominal principal. Hong Kong-based CEO of ASIFMA Mark Austen mentioned that "tools like CDS and IRS (Interest rate swaps) are important to development of capital markets in general and fixed income in particular. It is critical to driving bond market liquidity and it's a welcome development." (Reuters)

**Singapore banks remain strong despite hit from oil & gas sector**

**Nov 1.** Credit rating agency (CRA) Fitch maintained a stable outlook for Singapore banks despite a modest decline in asset quality due to exposure to the troubled oil and gas sector. Fitch said that the lenders were well capitalized with high liquidity ratios. The banks' combined exposure to the oil and gas sector stood at 50% of overall core equity Tier 1 capital in Q3 2016 and majority of the underlying loans were collateralized. The CRA's stress tests showed that the banks' capital buffers should enable them to weather a significant deterioration in credit quality. (TODAY)

**Corporate bond market set for record year of debt issuance** (FT)

**Monte dei Paschi's senior debt hit by conversion risk** (Reuters)

**China takes welcome step with debt-for-equity swaps** (FT)

**Regulatory Updates**

**EBA issues recommendations on the implementation of new counterparty and market risk frameworks**

**Nov 3.** The European Banking Authority (EBA) has published a report to assist the European Commission to adopt the two new frameworks proposed by Basel Committee: the new-standardized framework for counterparty risk (SA-CCR) and the new market risk (MKR) framework. The report assesses the impact of the implementation of two frameworks on institutions and highlights a number of issues that might need to be addressed before implementation. The report also includes a series of recommendations which are addressed to the European Union. (EBA)

**ECB reviews its risk control framework for collateral assets**

**Nov 3.** The European Central Bank (ECB) adjusted its collateral eligibility rules and risk control measures applied when accepting collateral in Eurosystem monetary policy operation. The governing council of the ECB decided on a number of measures to improve the overall consistency of the framework. With effect from 1st January 2017, the haircuts schedule for marketable and non-marketable assets will be updated, graduated haircuts for eligible asset-backed securities (ABS) based on its Weighted Average Life (WAL) as calculated from expected flows will be introduced. Furthermore, the Governing Council decided to introduce graduated haircuts depending on remaining maturity also for floating-rate assets, which are currently assigned a flat haircut irrespective of their maturities and adjust the risk control measures for retained covered bonds with extendible maturities (e.g. soft bullet and conditional pass-through covered bonds). (ECB)

**EU reconsiders financial market access rules** (FT)

**Bank of England may tighten bank capital rules after Brexit relief** (Reuters)

**German financial watchdog says Basel IV draft bank rules unacceptable for Germany** (CNA)

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