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# Drop in residual values

## **Automotive banks in a pinch**

Automotive banks are attractive to customers during the global recession because they offer affordable financing conditions. Despite this advantage, automotive banks are no longer the reliable sources of income they used to be for their owners. Worsening refinancing conditions and the need for massive provisions to cover residual-value risks in the leasing segment have hurt automotive banks. To resume making good profits, automotive banks need these things: alternative refinancing sources; intensified industrialization of processes; more professional risk and used-car management; and increased sales performance.

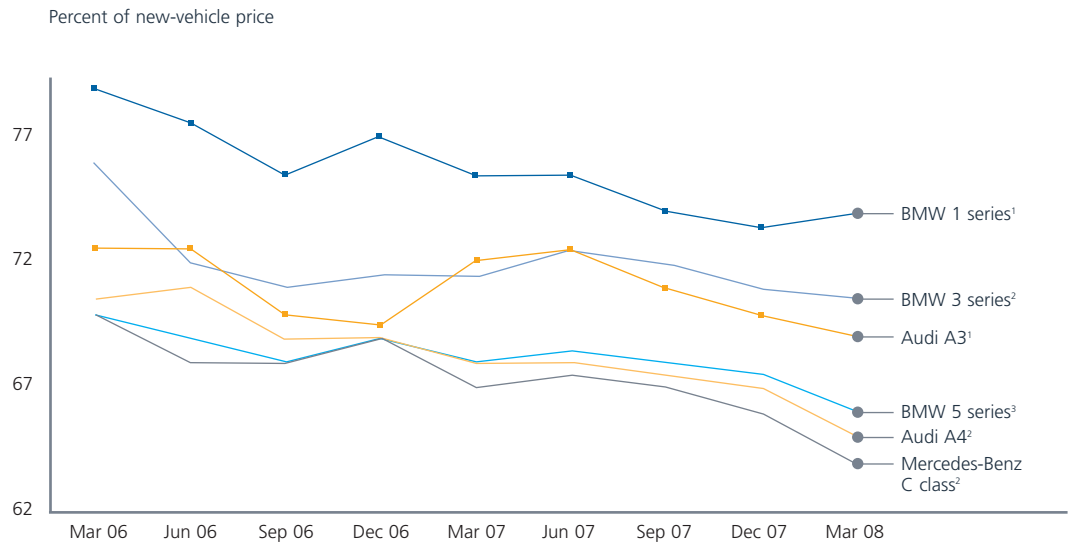
Matthias Bentele,  
Roland Bubik

During 2008, Europe's passenger-car sales fell by about eight percent. This amounted to a decrease of about 1.3 million vehicles and marked the lowest level in 15 years. In Germany last year, the number of newly registered vehicles fell 1.8 percent to 3.09 million compared with 2007. At the same time, automakers endured a shift from high-margin vehicles to less-profitable small cars. While sales volume dropped 19 percent for luxury vehicles, the mini segment rose 18 percent. Making matters worse for premium manufacturers was that their ensuing earnings de-

cline was magnified by the need to establish multi-billion-euro reserves for residual-value-risk and credit-default provisions. These provisions have a major negative effect on liquidity and are massively restricting the financing leeway of the companies' own financial service providers. At the same time, capital market observers have grown increasingly worried about the OEMs' liquidity and earnings outlooks. Rating downgrades have caused interest rates on debt capital to rise by up to 300 basis points for many manufacturers.

## Residual-value trends for selected vehicle models

The drop in residual values is hurting automotive banks



<sup>1</sup> Lower mid-sized vehicles: 2 years, 40,000 km

<sup>2</sup> Mid-sized vehicles: 2 years, 50,000 km

<sup>3</sup> Upper mid-sized vehicles: 3 years, 68,000 km

Source: Schwacke Dialog 2008

### Refinancing becomes complicated

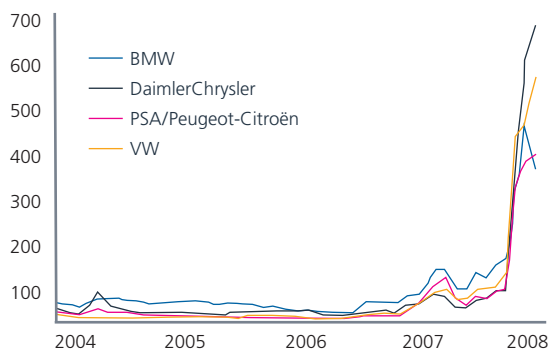
Refinancing conditions for automotive banks are also worsening as a result of their legal attachments to their automakers. Their ability to tap the capital markets has been significantly curtailed by the illiquidity of the interbank market and a noticeable lack of investors. The automotive banks, the so-called »captives,« now face the challenge of tapping new sources of financing in an extremely difficult business environment. Because purely internal financing appears to be difficult to get, some automotive banks are considering obtaining guarantees from Germany's Special Fund for Financial Market Stability.

### Financial crisis exposes weaknesses

The increased refinancing costs are creating a dilemma for the automotive banks. Given the collapse of sales volume for passenger vehicles seen around the world, automotive banks, more than ever before, are providing their owners with attractive sales financing conditions. This is happening even though the banks actually should be tightening these conditions. The interest margin decrease of up to 100 basis points hits the automotive banks that much harder because the strong growth of past years kept a veil over less-efficient processes and a higher cost basis in comparison with independent competitors. While this enabled the automotive banks to defend their 64 percent market share and expand their leasing business with private customers, many could not foresee the plunge in residual value resulting from the economic crisis.

### Risk-premium trends

In basis points



Sources: Oliver Wyman, Moody's

### Large burden from leasing business

It is precisely this drop that is requiring write-downs of up to ten percent on the residual value of lease returns. The write-downs have significantly lowered earnings at automotive banks. Overall, leasing rates would have to rise up to 30 percent to offset this effect. That is too much for the market to accept. At the moment, 28 percent of auto dealers have reported a worsening of commercial receivables; 93 percent are even expecting an increase in bankruptcies in their sector.

## Six areas of action in the crisis

Automotive banks are in a difficult situation. High refinancing and risk costs are squeezing margins. At the same time, they have to support sales by providing attractive offers. Automotive banks have to find ways to sustainably improve their earnings. Here are six areas of action to consider.

### 1. More refinancing options

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By turning their business into a full-service bank, automotive banks can gain additional distance from the financial market. In addition, the formation of a consortium with other banks, that is, a syndication or securitization of highly rated receivables, will result in a decoupling from the refinancing conditions of the parent company. Furthermore, receivables can be sold or assigned in order to lower capital needs and, as a result, to take pressure off the liquidity of individual OEMs.

### 2. More efficient processes

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As a result of the segment shift, automotive banks are required to design their processes in a more efficient manner and to increasingly industrialize them. Furthermore, they must strive to have a competitive level of overhead costs. Through consistent monitoring, a benchmarking of performance indicators and a best-practice comparison can yield information about optimization.

### 3. Refined risk management

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The banks must examine the current portfolio for hidden risks and further refine their early-warning systems. The gross margin can be improved by using differentiated, risk-adjusted pricing. A restrictive issuance of loans in the dealer business should be carried out with a sense of proportion to prevent this customer segment from being acquired by independent competitors. Furthermore, automotive banks must optimize residual-value management and stabilize new-car prices in this regard, improve forecast quality, avoid surplus supplies and manage maturities.

### 4. Higher sales performance

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Targeted incentives such as commissions and non-monetary rewards as well as more responsibility for sales representatives will raise the penetration rate of financial services products. Critical key performance indicators will make the sales management transparent. By using financial-service sales representatives, larger dealers can provide additional stimulus to sales.

### 5. Optimized remarketing

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The solution for improved remarketing is a combination of multichannel sales, differentiated sales formats based on used-car segment and type, specific downstream offers and management of performance indicators such as holding times.

### 6. Ventures into new growth fields

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Automotive banks should specifically focus on individual countries and customer segments as well as expand insurance offerings and increasingly integrate them. In addition, they must intensify cross-selling and tap new markets such as Brazil, Russia, India and China.

A systematic approach to these areas of action will not only strengthen the earnings position of automotive banks and their OEM owners. It also will create an opportunity to expand market positions against independent financing and leasing providers. After all, independent financing and leasing providers lack full-service bank status and frequently have weak brands. Therefore, they suffer even more intensely from restricted refinancing options because they are unable to generate comparable demand in such areas as the deposit business. Freeing themselves from the current squeeze, automotive banks could strengthen their market position even more.