FINANCIAL RISK MANAGEMENT AS STRATEGIC TOOL

Techniques developed in automakers' finance arms can aid their other businesses

The auto industry faces an ever-expanding range of risks: New mobility services, self-driving systems, and other technological advances are changing the ways cars are used, as well as customer expectations. Digital tools are taking on new roles, such as customer targeting and market-trend identification. At the same time, regulations and compliance standards are constantly being tightened.

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COST FOR INTRODUCTION OF IFRS 9 CAN EASILY REACH

$50 MM

SO FIRMS WOULD BE BETTER OFF MAKING USE OF CORRESPONDING METHODOLOGIES

These challenges are elevating the role of automakers' finance departments. Long relegated to the position of assisting in the financing of customer purchases and managing sales units, the compliance requirements of the role dictated that the finance function develop advanced risk-management systems and methods. These tools and processes included, among other things, early warning frameworks, customer risk assessments, and financial planning. (See Exhibit 1.) And now, given stricter financial regulations, finance departments are upgrading and improving their risk-management techniques.

First movers have already grasped the importance of such expertise in automakers' wider businesses. Digital disruption means the car industry needs to improve its strategic and forward-looking management. That involves new ways to monitor global markets – the impact of political events, economic downturns, and changes in customer demands – and to identify and be able to react to adverse market developments. Such capabilities are also being demanded by authorities as part of increasingly stringent compliance and risk requirements for the overall auto business. These tasks are making finance's methodologies more relevant, as they have already been used to develop related tools.

One example is compliance with IFRS 9, the International Financial Reporting Standard that goes into effect in 2018. The standard requires significant credit-risk modeling capabilities to determine the impairment allowances for financial instruments, such as customer financing and lease receivables. Compliance with IFRS 9 thus requires robust stress-testing and loss-forecasting methodologies, as an inadequate approach could have an impact on profits, making them more volatile. Once fully developed, the models and methods can be leveraged to manage an automaker's wider business and strategy development. In particular, the core methodologies developed for IFRS 9 compliance are applicable to strategic planning and scenario analysis. (See Exhibit 2.)

NEW TOOLS FOR NEW DATA

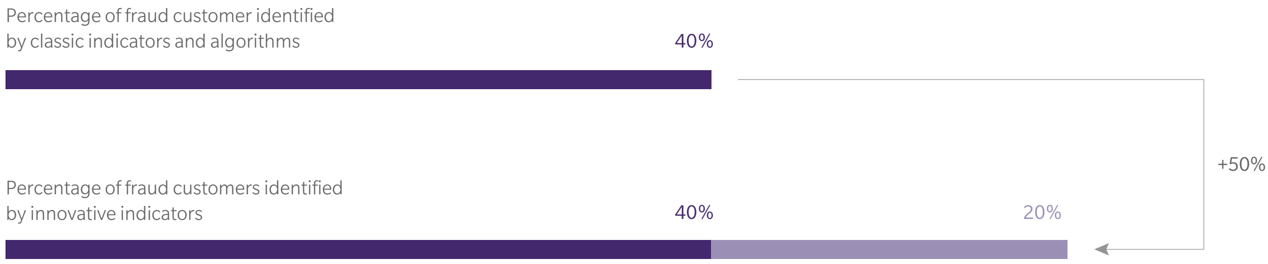
Finance's processing capabilities are becoming increasingly important to automakers, given the ever-growing quantity of data from new sources, social media, and connected cars. The data provides vital information on consumer preferences, enabling automakers to better manage customer relations. To take advantage of the information, however, requires innovative leveraging of input data, sophisticated algorithms, and advanced machine learning – techniques developed for financial and risk management. Combining the new data with traditional indicators can, for example, boost the power to predict potential fraud cases by more than a half.

Consumer demands and market trends can be anticipated, using early-warning and monitoring frameworks developed from finance's methodologies. Other such tools include scenario-based portfolio and residual-value modeling, which are now being used frequently in strategy development and performance management.

As the automobile industry faces disruptive change, manufacturers are struggling with the new ways in which cars are being used, driven, and bought. The good news is that they need not look far for a solution: A peek at their finance and compliance operations will reveal sophisticated techniques that can add value and help automakers manage the new and increasingly complex risks they face in a digitized and connected world.

EXHIBIT 1: SUCCESS RATES OF FRAUD IDENTIFICATION ALGORITHMS

Classic vs. innovative indicators

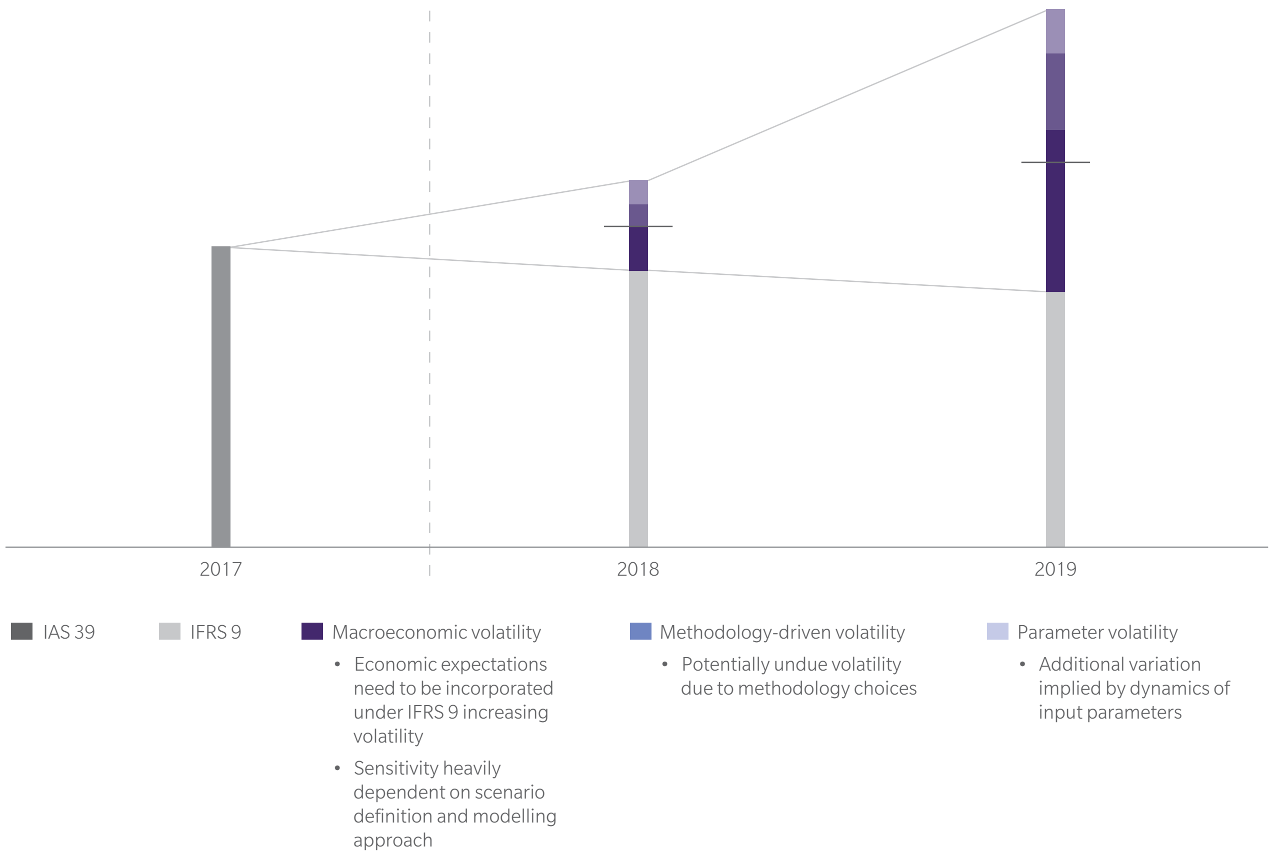


Source: Oliver Wyman

EXHIBIT 2: DRIVERS OF VOLATILITY OF IFRS 9 ALLOWANCES

Methodology and parameter choices can have significant impact on IFRS 9 provisioning results – thus they need to be sufficiently robust to avoid undue adverse implications

ILLUSTRATIVE, ASSUMING CONSTANT BALANCE SHEET



Explanatory note: illustrative base prognosis for the IFRS 9 allowance balance in 2018 and 2019

Source: Oliver Wyman