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Second Party Opinion

Shriram Finance Ltd.'s Social Finance Framework

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Location: India	**Sector:** Non-Banking Financial Institutions

Alignment With Principles

Aligned = ✔ Conceptually aligned = ○ Not aligned = ✖

✔ Social Bond Principles, ICMA, 2023

✔ Social Loan Principles, LMA/LSTA/APLMA, 2023

See Alignment Assessment for more detail.

Strengths

Shriram Finance Ltd. (SFL) supports financial inclusion and economic empowerment in India. It does so by providing loans to underserved populations, including small road transport operators who would like to increase their income streams, through its established nationwide network (2,975 branches and 708 rural centers) as well as supporting over 70,000 employees.

SFL focuses on financing payment of newer vehicles, demonstrating its environmental commitments. Given the nature of the company's business, indirect scope 3 greenhouse gas emissions are significant. SFL does not finance vehicles older than 10 years. It also has differentiated loan-to-value and margin practices to incentivize customers to purchase newer vehicles, and is studying the potential to finance electric vehicles (EVs).

Weaknesses

The social impact indicators SFL will disclose are output rather than outcome. This means the company will disclose the number of beneficiaries of its services and not the related social impact, such as increased income or savings of beneficiaries. The latter would be more informative than the former. However, such reporting practices and choice of indicators are not unusual for labelled social instruments due to the nature of the social indicators (e.g., more complex to measure).

Areas to watch

The social benefits of personal and gold loans is limited, compared with those of other social eligible projects. They account for a small portion of assets under management (6% as of the end of September 2023). They are typically add-ons available to existing borrowers with loans financing income generating assets. They can often be used for open-ended purposes (e.g., working capital for their businesses).

Issuer Sustainability Context

This section provides an analysis of the issuer's sustainability management and the embeddedness of the financing framework within its overall strategy.

Company Description

Shriram Finance Ltd. (formerly known as Shriram Transport Finance Co. Ltd.) is a nonbanking financial institution (NBFI) based in Mumbai, India. As of Sept. 30, 2023, the company has assets under management amounting to Indian Rupee (INR) 2,026 billion (US$24 billion) across commercial vehicles (49%); passenger vehicles (20%); micro, small, and medium enterprises (MSMEs) (11%); construction and farm equipment (9%); two wheelers (5%); and personal and gold loans (6%). The company has over 7.7 million customers, and 71,373 employees. It has a network of 2,975 branch offices and 708 rural centers. SFL is among the largest finance companies in the country in terms of total assets and a leading player in the pre-owned commercial vehicle market.

Material Sustainability Factors

Access and Affordability

NBFIs enable access to financial services for individuals and businesses. While banks may offer financial services as a package deal, NBFIs usually unbundle these services, tailoring their offerings to particular groups with a specific purpose. The subprime sector offers these individuals alternative financing options, yet challenges such as asymmetric information and limited financial literacy may result in costly expenses for borrowers. Advancements in technology should help NBFI lenders improve their cost efficiencies and provide innovative product solutions for their customers. In India, formal credit use is low. The share of women borrowers is only 10%, as compared to 15% of men (source: World Bank). Likewise, the penetration of bank accounts is about 78% (source: McKinsey), which suggests NBFI have an important role to play in supporting financial inclusion. India has a 19% poverty rate in rural areas and 5% in urban areas in 2019 to 2021 (source: National Multidimensional Poverty Index by the United Nations Development Program (UNDP) and Oxford Poverty and Human Development Initiative), as well as high income inequality with Gini coefficient of 34.2 (source World Bank).

Impact on Communities

NBFIs have the capacity to impact a wide range of community issues by providing access to essential services for economically vulnerable groups. Providing access to essential services for economically vulnerable groups not only has the potential to alleviate income inequality but also fosters upward social mobility. The realization of this objective hinges on the responsible lending practices of NBFIs, which include transparent contractual terms, financial education programs, and support for borrowers encountering unexpected financial hardships. In contrast, when loan terms are obscured or predatory lending practices persist, these issues can exacerbate existing socioeconomic disparities in the customer base. By actively addressing these concerns, NBFIs can access new markets, achieve better financial performance, attract top talent, and mitigate their reputational and regulatory risk. For instance, more than 60 million women hold small, collateral-free loans, impacting as many as 300 million families in India, according to the Microfinance Institution Network.

Responsible Labeling and Marketing

The financial services sector depends greatly on customer satisfaction and trust, yet opaque pricing and misleading sales have challenged customer trust for some NBFIs. While regulators are closely watching certain subsectors such as subprime lending, student loans, and residential mortgage origination/servicing, the industry's regulation and supervision is typically less strict than for banks and this can sometimes result in more aggressive underwriting or collection practices, or more opaque pricing considerations. Additionally, investors, regulators, and the broader public are exercising greater scrutiny on NBFIs' sustainable products, with much of the skepticism based on concerns that firms may use disclosures and sustainability-related labels on products and services as a marketing tool to appear more proactive on those issues than they truly are. These ethical challenges, if not properly managed with responsible marketing practices and customer engagement considerations, could pose material social risks to issuers. Regulation and consumer protection mechanisms have evolved over the past decade and should continue to help limit these risks in the financial services sector. For example, the Reserve Bank of India (RBI) has issued the Fair Practices Code to guide NBFI-MFIs (Microfinance Institutions) on responsible lending.

Climate Transition Risk

NBFIs are highly exposed to climate transition risk through their financing of economic activities that affect the environment. For examples, the number, scope, and ambition of regulatory requirements regarding greenhouse gas emissions will increase significantly for the automotive sector. There are rising risks related to bans on the sale of new internal combustion engine vehicles and their use in urban areas, the imposition of stricter vehicle fuel efficiency standards, and regulations applying to emissions that will be felt across the value-chain. Therefore, climate transition risk management is at the forefront of automotive industry participants' strategies and is transforming their value chains. While electric vehicles are unlikely to grow meaningfully in the company's portfolio in the near term, SFL's focus on newer vehicles limits transition risks. This is one of SFL's identified materiality topics, which its board-level ESG committee, chaired by an independent director, endeavors to address. In addition, India aims to achieve net zero by 2070 (see Ministry of Environment, Forest and Climate Change), a comparatively longer timeline.

Issuer And Context Analysis

Eligible categories should contribute to better access and affordability of formal credit for unbanked groups and to positive impact on communities through socioeconomic advancement and empowerment. Both are material social sustainability factors, especially for NBFIs operating in emerging economies, and given the nature of SFL's target customers, i.e., segments of the population in India with limited to no access to banking credit. Given its broad network of branches, understanding of these clients' needs, expertise to value vehicles and digital capabilities, SFL can offer transparency and lower interest rates compared to informal lending.

SFL's vision is to empower the underserved individuals and entrepreneurs through provision of various types of loans with one- to five-year tenors. Given its focus on financial inclusion and community development, SFL focuses the bulk of its funding on assets with direct or indirect income generating capabilities, i.e., transportation. Likewise, the company supports various MSMEs with unestablished financial credentials. SFL's above average nonperforming loans and credit costs reflects the social nature of its business positioning, with operations in high-risk and high-return business lines that target low-income, underbanked customers in semi-urban and rural areas of India.

SFL's customer interactions and policies suggest more responsible marketing and labelling practices compared to alternative funding options available to their target groups. Its website offers several loan simulators, a free credit score, and education through several articles around financial planning and the variables driving the cost of loans. Customers have also the option to report complaints. In addition, SFL endeavors to strengthen customers' experiences through means such as a centralized contact hub with smart interactive voice response.

SFL offers affordable and flexible lending terms and enjoys a high number of repeat customers. SFL's customers are in general not able to access traditional commercial banking services due to lack of credit history. Given the often low credit quality of its clients base, SFL offers relatively higher lending rates compared with those from the banks. For example, loan simulators available on SFL's and conventional banks' website suggest SFL would typically charge 400 bps more than banks for comparable loans. However, given banks' less flexible lending operations and limited appetite for used commercial vehicles for instance, they may not make credit available for SFL's target customers. This means the most immediate alternative to SFL's services are money lenders, who charge interest rate between 30% and 40% for loans usually not exceeding one year. SFL has higher profitability than the banking sector average in India, but it is not significantly higher than that of private sector banks. SFL's return on equity, for example, is 15% on average, compared with 12.5% for the India banking sector and 17% for one of SFL's peers. This reflects higher operating expenses and credit costs involved in servicing its niche customer base.

Climate risk is a growing sustainability issue for SFL, which aims to contain transition risk in its financed portfolio through its lending policy. The framework's do no significant harm (DNSH) policy restricts financing to vehicles below 10 years. Likewise, SFL aims to finance fuel-efficient vehicles such as those using liquified petroleum gas. However, the company has significant exposure to scope 3 emissions and has just started to monitor scope 1 and 2 emissions at its operational sites across India. Likewise, it is yet to set carbon reduction targets, an area to further strengthen SFL's existing commitment to mitigating climate risks.

Alignment Assessment

This section provides an analysis of the framework's alignment to Social Bond/Loan principles.

Alignment With Principles

Aligned = ✔ Conceptually aligned = ○ Not aligned = ✘

✔ Social Bond Principles, ICMA, 2023

✔ Social Loan Principles, LMA/LSTA/APLMA, 2023

✔ Use of proceeds

All the social project categories are considered aligned, and the issuer commits to allocate the net proceeds issued under the framework exclusively to eligible social projects around the themes of Access to Essential Services (in the form of financial inclusion) and Socioeconomic Advancement and Empowerment. The maximum look-back period for refinanced projects is three years after issuance, in line with market practice. Please refer to the Analysis of Eligible Projects section for more information on our analysis of the social benefits of the expected use of proceeds."

✔ Process for project evaluation and selection

SFL has established a Social Financing Working Group ("SFWG"), chaired by SFL's Treasury, comprising of representatives from the treasury department, corporate social responsibility department, transport planning department, and business operation department. The SFWG will meet at least annually and oversee projects screening. It will select, review, and approve the projects. There is a process to identify and manage the social and environmental risks associated with financed projects. In addition, the SFWG will validate the reporting for investors/lenders, and lead any update to the Social Finance Framework to reflect any changes in market practices or with regards to SFL's sustainability strategies and initiatives.

✔ Management of proceeds

SFL will allocate the proceeds from social instruments to eligible social portfolios, within 36 months of issuance. The written timeline is longer than current market practices, but it typically allocates less than 12 months. SFL will establish internal monitoring systems to track and record the allocation of the net proceeds. The company will ensure that the level of allocation in eligible social portfolios matches or exceeds the balance of net proceeds from its outstanding social financing. If eligible projects cease to fulfil the eligibility criteria, SFL will replace them. Unallocated proceeds will be temporarily invested in cash or cash equivalent instruments, in accordance with SFL's investments and treasury policy.

✔ Reporting

SFL will report annually on the allocation of proceeds and actual impacts of financed projects, until full allocation of the social instruments, and in case of significant changes. The information will be available on the company's website, as a standalone Social Financing report or as part of the annual report. Allocation reporting will include the amounts allocated and unallocated, and a description of eligible social projects with associated target populations. SFL will provide information on the social impact of financed projects, such as the number of financial products and services serving low-income groups or number of enterprises benefiting from MSME financing and total of MSME financing provided.

Analysis Of Eligible Projects

This section provides details of our analysis of eligible projects considered to have clear social benefits and to address or mitigate a key social issue.

Over the three years following issuance of the financing, the portfolio of SFL should not shift drastically, meaning that more than two-thirds of net proceeds are likely to fund four-wheelers.

The issuer expects a minority of proceeds to be allocated to refinancing projects, while the bulk of funds will be directed to finance new projects.

Social project categories

Access to Essential Services

SFL's financial instruments and services provided are:

- Financing to small road transport operators (SRTOs) and first-time borrowers (FTBs) at favorable interest rates, where SRTOs and FTBs are from underserved communities across India;
- Suitable financial instruments and services for micro, small and medium enterprises (MSMEs), whose current asset base does not allow access to mainstream bank credits or without proof of income to qualify for traditional loans; and
- Affordable financing instruments (i.e., personal loans, gold loans) to individuals (i.e., unbanked and/or underserved individuals, including women as a target population).

Analytical considerations

- SFL describes the target populations, particularly important for social financing, as: i) SRTOs and FTBs from underserved communities across India, ii) MSMEs whose current asset base does not allow access to mainstream bank credits, or without proof of income to qualify for traditional loans, and iii) Unbanked and/or underserved individuals including women.
- SFL's financial services under the eligible category should address key social issues such as unequal distribution of resources, financial inclusivity, and gender inequality. India's Gini coefficient, an wealth inequality indicator, is still comparatively high. However, it improved to 34.2 in 2021 from 34.8 a year before (World Bank). Likewise, India's Gender Inequality Index is 0.49 in 2023, ranked 122nd out of 191 countries (see 2023 gender social norms index by UNDP).
- The projects under the category are addressing the acute need for financial inclusion in rural and semi-rural India, helping remote populations get access to credit to fund income-generating assets. In addition, SFL has also established training programs for underserved individuals, such as women and youths. For example, SFL's driving trainings helps the underprivileged youths learn professional driving skills, ethical driving manners, and safety awareness, all of which should provide them employment opportunities as drivers.
- SFL does not finance vehicles older than 10 years, has differentiated loan-to-value and margin practices to incentivize customers to operate newer vehicles, and is studying the potential to finance electric vehicles (EVs). Given the nature of the company's business, indirect scope 3 greenhouse gas emissions are significant.
- Indicative indicators to measure impact include, for example, the number of financial products and services serving low-income groups, number of women borrowers/co-borrowers, and number of enterprises benefitting from MSME financing and total of MSME financing provided. However, the social impact indicators focus typically on the count of beneficiaries, providing limited insight on the effectiveness of projects, compared with those for environmental impact indicators (e.g. greenhouse gas emissions avoided).

Socioeconomic Advancement and Empowerment

SFL's financial instruments and services provided are:

- Loans to help communities alleviate income through promoting entrepreneurship, with target population of unbanked and/or underserved individuals and MSMEs from low-income states as defined by the World Bank

Analytical considerations

- SFL endeavors to address social issues such as income and wealth inequality and MSMEs' business growth. The company set clearly target populations i) unbanked and/or underserved individuals, and ii) MSMEs, defined in accordance with India's Micro, Small and Medium Enterprises Development Act (2006), in the local income-states of the country as per the World Bank's classification.
- According to a study from the International Finance Corp. (IFC), MSMEs' potential debt demand in the country is INR69.3 trillion (US$1.1 trillion), INR10.9 trillion of which is served by formal financial sources including commercial banks and NBFIs (the remainder is debt from the informal sector). Still, there is a huge potential addressable credit gap of INR25.8 trillion (US$397 billion) in the India's MSMEs sector. MSMEs in the low-income states represent INR5.9 trillion (US$90.6 million) or 23% of total addressable credit gaps in the country. SFL's financing loans should empower MSMEs in low-income states, where one of its target populations resides.
- The RBI considers MSMEs a priority lending category as they represent 31% of India's GDP and 45% of India's exports. SFL offers to MSMEs up to INR3 million business loans with tenors ranging from 12 to 60 months as well as around 15% p.a. interest rates. These terms are much more favorable (and relatively stricter) than those of informal money lenders (and some traditional banks). These should support entrepreneurship in the country.
- Indicative indicators to measure the eligible projects' impacts include the number of enterprises benefitting from MSME financing and total amount of MSMEs financing provided. Social impact indicators, however, focus typically on the count of beneficiaries, providing limited insight on project impacts.

Mapping To The U.N.'s Sustainable Development Goals

Where the Financing documentation references the Sustainable Development Goals (SDGs), we consider which SDGs it contributes to. We compare the activities funded by the Financing to the International Capital Markets Association (ICMA) SDG mapping and outline the intended linkages within our SPO analysis. Our assessment of SDG mapping does not impact our alignment opinion.

This framework intends to contribute to the following SDGs:

Use of proceeds	SDGs			
Access to Essential Services	*1. No poverty	*8. Decent work and economic growth	*9. Industry, innovation and infrastructure	*10. Reduced inequalities
Socioeconomic Advancement and Empowerment	*1. No poverty	*8. Decent work and economic growth	9. Industry, innovation and infrastructure	*10. Reduced inequalities

*The eligible project categories link to these SDGs in the ICMA mapping.

Related Research

- Analytical Approach: Second Party Opinions: Use of Proceeds, July 27, 2023
- FAQ: Applying Our Integrated Analytical Approach for Use-of-Proceeds Second Party Opinions, July 27, 2023
- Analytical Approach: Shades of Green Assessments, July 27, 2023
- S&P Global Ratings ESG Materiality Maps, July 20, 2022

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