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Second Party Opinion

Tricolor Auto Acceptance Social ABS Framework 2023

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Alignment With Principles

Aligned = Conceptually aligned = Not aligned =

Social Bond Principles, ICMA, 2023

See Alignment Assessment for more detail.

Strengths

Tricolor offers lower-interest-rate loans to its low-income or credit invisible borrowers than most of its subprime auto lending peers. The company also maintains a longer expected loan life term, net of losses, than most peers, partially due to its lower interest rates and complementary financial literacy programs.

The company was certified as a community development financial institution (CDFI) by the U.S. Department of the Treasury CDFI Fund (CDFI Fund) in 2019 and is the only asset-backed securities (ABS) subprime issuer to attain this designation. The CDFI Fund awards this designation to entities it deems mission-driven in their commitment to support economically disadvantaged communities.

Weaknesses

Tricolor's high rate of vehicle repossession is on par with that of its industry peers, which dilutes the effectiveness of its social mission and may illustrate a lack of safeguards to mitigate its borrowers' exposure to financial risk. While the company partially achieves the framework's goals of access to mobility options and financial inclusion through its relatively affordable financing terms and establishment of credit scores for some customers, its repossession metric raises some concerns regarding the projects' overall contribution to social outcomes.

Areas to watch

Tricolor's capture and analysis of historical and prospective borrowers' non-traditional customer data, through its proprietary artificial intelligence (AI) technology, exposes it to client data privacy risks. While supportive of its relatively lower interest rates, the company's use of these patented tools to derive lending insights may increase its exposure to the risk of cybersecurity breaches.

The financing of used vehicles by subprime auto lenders is subject to growing climate transition risk. The industry faces increased regulatory pressure, including in the state of California—one of Tricolor's largest markets—to comply with the ambitious environmental standards in the automotive industry. As the manufacture of internal combustion engine (ICE) vehicles is banned and/or becomes more expensive, the subprime auto lending segment may face operational cost challenges.

Broadly, the subprime auto lending sector is highly exposed to regulatory penalties and increased scrutiny of its lending practices. This heightened exposure stems from concerns surrounding the industry's potential predatory lending practices, non-compliance with consumer protection laws, and calls for greater transparency in the industry.

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

Tricolor Auto Acceptance (Tricolor) is an integrated retail automotive and consumer lending platform that offers financing, in the form of vehicle loans, to low-income borrowers and those with no or limited credit history. Established in 2007 and headquartered in Dallas, Tricolor and its affiliate Ganas Auto Group (Ganas) operate 50 retail dealerships across 20 markets in Texas, California, Nevada, and Arizona, with a shared services center in Guadalajara, Mexico. On a combined basis, Tricolor and Ganas have served over 90,000 customers and disbursed over \$2 billion in auto loans since 2007. In 2019, Tricolor became the only auto ABS issuer to be designated as a CDFI by the CDFI Fund.

Material Sustainability Factors

Access and Affordability

Non-banking financial institutions (NBFI) 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 auto lending segment in the financial services sector offers vehicle retail and loan financing to high-risk customers who are lower-income and underserved by banks, which rarely underwrite to this customer base. The subprime sector offers these individuals alternative financing options, yet challenges such as asymmetrical information and limited financial literacy may result in costly expenses for borrowers. We expect advancements in technology will help NBFI lenders address their cost efficiencies and provide innovative product solutions for their customers.

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.

Responsible Labeling and Marketing

The financial services sector depends greatly on customer satisfaction and trust, yet opaque pricing and mis-selling 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 for certain NBFIs. Additionally, investors, regulators, and the broader public are exercising greater scrutiny on NBFIs' sustainable products, with much of the skepticism founded 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 ethics 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.

Climate Transition Risk

NBFIs are highly exposed to climate transition risk through their financing of economic activities that affect the environment. Additionally, we expect the number, scope, and ambition of regulatory requirements regarding greenhouse gas (GHG) emissions will increase significantly for the automotive sector. There are rising risks related to bans on the sale of new ICE 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. For instance, California plans to prohibit the sale of new ICE vehicles by 2035. Therefore, climate transition risk management is at the forefront of automotive industry participants' strategies and is transforming their value chains. This shift may indirectly affect the subprime auto lending industry by increasing upfront costs for original equipment manufacturers (OEMs) and influencing vehicle resale values, thereby introducing affordability risk.

Issuer And Context Analysis

Through its retail sales of used vehicles and financing of subprime auto loans to low-income and credit invisible borrowers, Tricolor aims to address its most-material social issues, including access and affordability, impact on communities, and responsible labeling and marketing.

All vehicle loans financed through the framework will provide improved access and affordability for Tricolor's target customers, given the lower interest rate of the financings relative to those of its subprime lending peers and the firm's focus on helping borrowers build their credit history. Tricolor's intent, through its social bond framework and overarching business strategy, is to facilitate financially disadvantaged borrowers' inclusion in the economic mainstream by providing relatively affordable auto financing options for those who are low-income and/or who do not possess a credit history or social security number (SSN). The company relies on its patented AI technology that analyzes past and prospective customers' personal attributes to achieve advanced customer insights, which allow it to offer borrowers relatively lower average interest rates than its peers. The company pairs these lower interest rates with other benefits that help it stand out when compared with its subprime industry peers, such as the provision of 1.5-year warranties on fully reconditioned vehicles and complementary financial literacy programs. We note that this access to privately-owned transportation, particularly for credit-invisible U.S.-residing Hispanics with few other options (Tricolor's key target population), can be a positive force multiplier for socioeconomic advancement in these communities due to its potential to help customers build their credit history and improve their access to occupational and educational opportunities. Further, throughout the life of the loan, Tricolor reports its borrowers' credit scores to the major credit bureaus and tracks the percentage of borrowers who establish a credit score as a result of its financing. For its mission-driven purpose, the company was designated as a CDFI by the CDFI Fund in 2019 and has maintained this status since.

While Tricolor's above-mentioned efforts support eligible borrowers' access to essential services and socioeconomic advancement, its rate of loan defaults and vehicle repossessions will likely have a negative effect on the communities it aims to support. The company aims for its borrowers to successfully pay off their vehicle loans and build their credit scores without incurring costs associated with mechanical failure or expensive repairs. However, in practice, a sizeable proportion of Tricolor's customers default on their loans and have their vehicles repossessed, which is on par with the overall subprime auto industry. This can lead to long-term financial distress for these borrowers as they struggle to repay their outstanding loan balances and encounter years-long barriers to accessing credit due to their damaged credit scores. This aside, we acknowledge that Tricolor's explicit targeting of low-income and "credit-invisible" borrowers through this financing indicates a higher overall exposure to default risk. Further, the company estimates that roughly 40% of its total repossessions are "voluntary," wherein the vehicles are willingly surrendered to Tricolor, which may lead to lower overall costs charged to the borrower. Nonetheless, all vehicle repossessions are likely to result in outsized economic hardship to borrowers due to the accumulation of fees, considerable drops in their credit scores, and increased difficulty securing new financing for several years thereafter. In our

view, despite the company's relatively affordable loan interest financing and its proportion of voluntary surrenders, Tricolor's repossession rates illustrate a lack of requisite safeguards to mitigate borrowers' exposure to financial risk. We do not believe Tricolor has adequately responded to these material issues, which reduces its ability to achieve a positive social impact.

Tricolor's proactive customer engagement and compliance policies indicate sufficient responsible marketing and labeling practices. Illustrating its robust compliance and customer engagement programs, the company maintains a relatively high customer Net Promoter Score (NPS) and an exceptionally low Consumer Financial Protection Bureau (CFBP) complaint record. Due, in part, to its renewed emphasis on customer advocacy, the company was able to lower its total complaints received per active account by roughly 10x from 2019 (2.0%) to 2023 (0.2% per active account). It also organizes regular internal audits, staff trainings, and collaborations with external consultants to remain compliant with consumer protection regulations.

Climate transition risk is a growing sustainability issue for the NBF and automotive industries and their value chains, especially for operators in California, which is one of Tricolor's primary markets. The state has a proposed ban on the sale of new ICE vehicles by 2035, and other states in the U.S. are also expected to accelerate their investments in low-carbon technologies in the coming years. While such legislation affects subprime auto retailers less directly than the OEMs, as the manufacture of ICE vehicles is banned and/or becomes more expensive in certain jurisdictions, it may introduce operational cost challenges related to their sale. These risks are not addressed in Tricolor's current sustainability strategy.

Alignment Assessment

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

Alignment With Principles

Aligned = ✓ Conceptually aligned = ○ Not aligned = ✗

✓ Social Bond Principles, ICMA, 2023

✓ Use of proceeds

We consider the framework's social project category as aligned based on the issuer's commitment to allocate the net proceeds issued under the framework to eligible social projects. Please refer to the Analysis of Eligible Projects section for more information on our analysis of the expected use of proceeds.

✓ Process for project evaluation and selection

Tricolor's process for the evaluation and selection of eligible subprime auto loans is described in the framework. A subcommittee of the company's Credit Risk Committee, comprising its CEO, chief financial officer, chief credit officer, and other senior executives, ensures the financed loans are in line with its borrower eligibility criteria. This includes customers who do not have an SSN, lack a credit score, or whose net income falls at or below the 80% median county income level or 200% of the federal poverty threshold, which is a standard maintained by the Federal Housing Finance Agency (FHFA).

The framework also outlines Tricolor's environmental and social risk-management processes for providing loans to its target population. The issuer acknowledges that borrowers in its loan pool are more susceptible to defaulting on their loans due to a lack of financial preparation for emergencies, such as those caused by automotive mechanical failures. This is compounded by the frequency with which the vehicles sold in the subprime auto lending sector fall short on safety-, mechanical-, and emission-related tests. Tricolor manages these risks by providing its borrowers with inspected and reconditioned vehicles that have less accrued mileage--on average--than those of its peers, which also meet federal- and state-level regulations and emissions standards. Additionally, the company offers complementary financial literacy programs and 1.5-year warranty programs on fully

reconditioned vehicles to help reduce its borrowers' risk of mechanical emergencies and default. We note that Tricolor's efforts have yet to mitigate the high levels of defaults and repossessions among its borrower pool.

✓ Management of proceeds

Tricolor's process for managing and tracking the allocation of proceeds for financing newly originated eligible loans and refinancing previously originated eligible loans is outlined in the framework. No less than 75% of the proceeds will be immediately allocated to acquire previously originated loans from existing warehouse facilities that were defined as eligible during the 36-month look-back period. It will deposit the remaining proceeds in a third-party account that is held and managed by a designated indenture trustee before using them to purchase newly originated eligible loans during the three-month prefunding period. Tricolor's Credit Risk Committee will track and monitor all of the social bond issuances, which it will review on a quarterly basis.

✓ Reporting

Tricolor commits to publish annual and quarterly reporting on the allocation of proceeds and the expected and actual impact of its social bond proceeds until full allocation, respectively, on its website. An independent third-party auditor will verify the allocation reporting post issuance. The company's impact metrics include the percentage of borrowers who meet the eligibility criteria and who receive a free warranty, among others. Tricolor also commits to report the proportion of eligible borrowers who develop a credit score with a major credit bureau upon completion of the loan repayment period, which is a performance indicator intended to demonstrate the company's support of improving financial inclusion for its target population. Tricolor tracks these metrics through individual loan level data files and with updated credit scores that it receives from its partnership with a major credit bureau. We note that this type of measurement is difficult for many securitized bond issuers, making it a stronger feature of the framework.

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.

Tricolor expects to allocate 100% of the proceeds from the bonds issued under its framework to finance eligible subprime auto loans to its target population.

The eligible projects will include assets that Tricolor has placed in service prior to the applicable social financing.

Social project categories

Access to Essential Services

Tricolor commits to allocate the net proceeds of its 2023 ABS Social Bonds to acquire subprime auto loans originated to the target population set forth in its framework. The bonds will be issued by a special-purpose vehicle (SPV) as part of the company's securitization program. The loans will target borrowers with no SSN and/or FICO score or those that qualify as low income (income less than or equal to 80% of their median county income level or less than or equal to 200% of the federal poverty threshold). Tricolor's financing of these projects aims to promote its mission of financial inclusion and the advancement of social and economic mobility for credit-invisible and low-income borrowers with limited access to mainstream financial services. In particular, the framework outlines how the specific eligibility criteria aligns with Tricolor's overall social strategy to provide affordable auto loans to the U.S.-residing Hispanic population, which currently accounts for up to 92% of the company's total customer base.

We consider the framework's social project category to be aligned, given the issuer's commitment to allocate the underlying net proceeds toward improving mobility access for an economically disadvantaged target population. The social benefits of the projects are also highlighted by key identifying features, including their relatively low interest rates compared to those of its industry peers, complementary financial literacy programs, 1.5-year warranties, and the sale of reconditioned vehicles with 150-point inspections. However, we find that the framework's intention to facilitate borrowers' entry into the economic mainstream faces significant challenges when taking into account the issuer's corresponding levels of default and repossession.

Analytical considerations

- The project criteria specifies that only borrowers lacking an SSN and/or credit score or those classifying as low income, which is a population that is financially underserved, are eligible for the financing. Tricolor's intention through the framework is to support these borrowers' building of credit and follow-on entrance into the economic mainstream. In our view, this financing supports a net benefit by providing access to essential services for the target population it serves.
- Tricolor monitors and helps establish its customers' credit scores over the life of their loans, which supports its goal of providing improved access to essential services for the U.S.-residing Hispanic population. As of August 2023, the company reported that 41% of its borrowers established a credit history. In addition, it has committed to tracking this metric for the framework's eligible borrowers. We believe Tricolor's lower interest rates than those offered by its industry peers also extend the average term of its financings to three years, net of losses, which is longer than many other subprime auto loan options.
- We believe the company's offering of reconditioned vehicles paired with 18-month warranties lowers the likelihood its borrowers will experience mechanical failure or the need for unexpected repairs, which is a financial burden most in its target population cannot afford that would contribute to worse social outcomes. Further, providing access to privately-owned transportation, particularly for the largely credit-invisible U.S.-residing Hispanic community, can be a positive force multiplier for socioeconomic advancement due to the potential that it will help community members build their credit history and gain access to occupational and educational opportunities. This is especially true in areas of the U.S. where access to public transportation is underdeveloped. For this reason, we believe Tricolor's financing addresses an outsized need for its target population, in spite of the social hazards associated with the projects.
- A substantial portion of eligible borrowers will not successfully pay off their vehicle loans, on par with the average rate for the overall subprime auto lending industry, and will submit to the default and repossession of their vehicles. Of Tricolor's borrowers who default on their loans and have their cars repossessed, the company estimates that roughly 40% represent "voluntary repossessions," wherein customers return their vehicles due to their discovery of a more-affordable financing deal (after developing a credit score), because they emigrate back to their country of origin, or for other reasons specific to its clientele of financially disadvantaged and, in many cases, undocumented borrowers. Nonetheless, all vehicle repossessions may result in Tricolor's borrowers experiencing outsized economic hardship due to the accumulation of fees, the considerable drops in their credit scores, and the difficulty in securing new financing for several years thereafter. We note that the company does not provide targeted financial education to its customers regarding the negative effect of repossession on their financial health after voluntary repossession.
- Tricolor has gathered personal data from thousands of past customers, as well as auto loan applicants, and analyzes their behavioral attributes using a patented AI-based tool to derive insights for its lending decisions. While helpful in its facilitation of lower loan interest rates for the company's high-risk borrowers, such collection and follow-on monetization of customer data to third-parties will likely increase its risk of data breaches or leaks. To mitigate the risk associated with its proprietary AI technology, Tricolor has installed controls and established monitoring to fully comply with all updated Federal Trade Commission (FTC) requirements and continues to work to meet all applicable FTC Safeguard rules, California Act, Cyber Insurance, and Cyber best practices requirements.
- The framework's impact reporting, reported quarterly, omits the percentage of borrowers belonging to the U.S.-residing Hispanic community or the eligible borrowers' average interest and/or default rates over the life of the loans. Given Tricolor's focus on empowering this group to enter the financial mainstream at an affordable cost, we view the omission of these metrics in its impact reporting as indicative of weak stakeholder transparency. One material impact indicator included in its reporting is the percentage of borrowers who build a credit score with a major credit bureau, which we view as highly relevant to the project category. That said, we note that Tricolor estimates only 20% of its eligible borrowers will meet this benchmark through its financing.

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*	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
- [S&P Global Ratings ESG Materiality Maps](#), July 20, 2023

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