

# Sustainable Investment Framework

Municipality Finance Plc

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# 1 Introduction

MuniFin is one of the largest financial institutions in Finland with a mission to build a better and more sustainable future together with its customers. MuniFin's customers include Finnish municipalities, joint municipal authorities, municipally controlled entities and non-profit housing organisations. In general, MuniFin grants financing for environmentally and socially responsible investments, such as public transportation, sustainable buildings, hospitals and healthcare centres, schools and daycare centres, and housing for people with special needs.

MuniFin was established to develop the Finnish welfare state and sustainability is involved in all of MuniFin's decisions and actions. This is in the interest of MuniFin, its customers, shareholders, investors, and the Finnish society. MuniFin is committed to support the UN Sustainable Development Goals in its everyday work, and to measure and disclose the greenhouse gas emissions associated with its own financing.

MuniFin has defined its key principles and goals of corporate responsibility already in 2017. These are disclosed in the Sustainability Policy, which is approved by the Board of Directors (BoD). As part of MuniFin's sustainability governance model, multiple sustainability virtual teams work across business units and coordinate and promote sustainability practices proactively within the organisation.

MuniFin Treasury has reviewed and monitored issuers' ESG performance as part of liquidity portfolio management since 2016. Portfolio ESG score is compared against a fixed income market benchmark and this metric has been determined as a material risk indicator in MuniFin's Risk Appetite Framework (governed by the BoD). Sustainability of investments is linked to the annual compensation of employees responsible of liquidity portfolio management at MuniFin.

## 2 Overview of investments

MuniFin is a systemically important financial institution (O-SII) and directly supervised by the European Central Bank (ECB). MuniFin is by regulation obliged to hold an adequate liquidity buffer to secure efficient business operations in possible stress scenarios. This buffer includes cash and fixed income security investments, and it is subject to active portfolio management by the Treasury.

Primary objective in liquidity portfolio management is to preserve liquidity and invested capital, while generating sufficient income from Net Interest Income (“NII”) perspective. In order to achieve this, the asset portfolio is constructed of fixed income securities issued by Financial Institutions, Sovereigns and Sovereign Agencies and Supranationals. There are no investments in corporate issuers or equities.

MuniFin has chosen to invest only in issuers domiciled in OECD countries, and this rule also applies to the issuer’s ultimate parent. This principle defines the base standards for social, economic, and environmental matters in liquidity investments, and significantly reduces sustainability risks in the portfolio.

MuniFin has a long-standing commitment to sustainable thematic investing, which is related to the company’s tradition of being an active issuer of green and social bonds already since 2016. Equally, MuniFin has actively invested in green, social and sustainability bonds as part of liquidity portfolio management.

## 3 Approach to sustainable investing

MuniFin’s investment policy allows only fixed income investments that are principally issued by financial institutions, sovereigns and sovereign agencies from OECD countries. This, in our opinion, reduces major sustainability risks in the portfolio, as OECD supports the United Nations’ 2030 Agenda for Sustainable Development. MuniFin is committed to support the Paris Agreement goals and seeks to mitigate environmental risks by holding a growing amount of sustainable bonds that provide environmental benefits in the thematic sustainable asset portfolio.




Since MuniFin’s ultimate objective is to embed sustainability across its whole business, Treasury has set specific sustainability targets for liquidity portfolio management. The approach is two-fold. First, MuniFin aims to encourage issuers and market participants to engage in more sustainable practices. Second, in-depth fundamental analysis and active mitigation of Environmental, Social and Governance (“ESG”) risks are believed to improve risk-adjusted portfolio performance in the long run, creating value also from a traditional economic perspective.

MuniFin has been a member of Finland’s Sustainable Investment Forum (Finsif) since 2016, which promotes sustainable investing among Finnish institutions.

**Figure 1: MuniFin’s approach to sustainable investments**



MuniFin promotes its objectives in sustainable investing by applying the following three operational principles:

-  1 Investment and issuer selection, exclusion and controversy monitoring.
-  2 Applying issuer-level ESG management to the portfolio management process covering the entire portfolio.
-  3 Thematic investing in sustainable assets that generate direct environmental and social impact globally.

Munifin believes that each of these principles adds value and the combination of them constitutes a holistic approach, which helps us to meet our sustainability goals.

### 3.1 Exclusions and controversy monitoring

Essential part of sustainability management in investments is the exclusion of any issuers/investments that violate MuniFin's ethical standards, or operate in controversial fields of business. MuniFin limits its investments solely to OECD countries in order to reduce major sustainability and economic risks. To fully assure that all portfolio assets are aligned with the sustainability objectives, negative screening criteria have been set for the liquidity portfolio. Misaligned issuers are subject to internal review and possible exclusion from the portfolio.

**Figure 2: Pre-defined exclusion criteria for all issuers in the portfolio**

<b>Controversial business practices</b>	
▪ Violation of UN Global Compact principles	✓
▪ Violation of UN Guiding Principles on Business and Human Rights	✓
▪ Violation of ILO labor standards, including child labor and forced labor	✓
<b>Controversial fields of business</b>	
▪ Oil & gas	✓
▪ Thermal coal	✓
▪ Controversial weapons (e.g., cluster munitions, landmines, WMDs)	✓
▪ Conventional weapons (including civilian firearms)	✓
▪ Tobacco	✓
▪ Gambling	✓
▪ Alcohol	✓
▪ Animal testing	✓
▪ Genetic engineering	✓
<b>Countries</b>	
▪ Illiberal states (based on Freedom House status)	✓
▪ High level of corruption	✓
▪ Non-OECD countries (applies to all issuers by their domicile)	✓

Treasury is responsible for screening issuers against the exclusion criteria when applying for a new investment credit line, and at the time of investing. Whenever a new credit line is requested, Risk Management analyses the counterparty from ESG perspective and conducts the aforementioned screening.

Liquidity portfolio is screened quarterly to ensure that investments are constantly aligned with MuniFin's values. Misaligned issuers are reviewed by Risk Management & Compliance, who can decide to address these investments in the Capital Markets and Sustainability Management Team, if they see that the misalignments are considered material for the issuer. These issuers can be rejected from future investments (soft exclusion) or removed from the portfolio (hard exclusion).

## 3.2 ESG management and methodology

MuniFin's Sustainability Policy states that Environmental, Social and Governance factors ("ESG") must be integrated in the investment process. This policy is adopted by using a benchmark approach, where the ESG score of each issuer is compared against a benchmark index ("sustainability benchmark"). Sustainability benchmark is constructed from relevant fixed income indices replicating the actual portfolio weights in each of MuniFin's three internal asset classes (covered bonds, senior financials, SSAs).

Portfolio ESG score is constantly managed at aggregate level vs. the benchmark, with the objective to outperform it. Average ESG score of the portfolio has been established as a material risk indicator in MuniFin's Risk Appetite Framework (RAF). The RAF indicator suggests that the average ESG score of the portfolio should be above the sustainability benchmark at all times. This reinforces investing in instruments with an ESG score higher than the benchmark, and ultimately drives towards a best-in-class ESG portfolio.

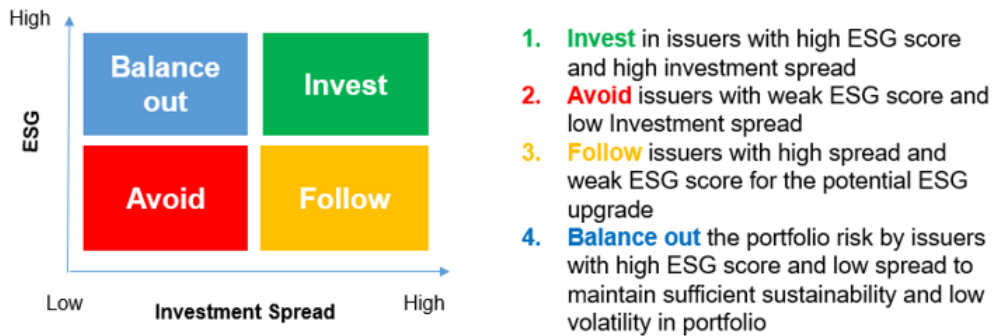


Portfolio ESG is a material risk measure (RAF) with the following condition:  
Portfolio ESG score  $\geq$  Sustainability Benchmark

Treasury is responsible for assessing the issuer ESG score when applying for a new credit line and at the time of investing. ESG management is part of the overall risk management process of the portfolio, as it is acknowledged that potential for an upgrade in the ESG score creates more investment value in the future. Share of non-rated issuers in the security portfolio is capped to 25 % (nominal-weighted).



**Figure 3: ESG dimension in asset allocation**

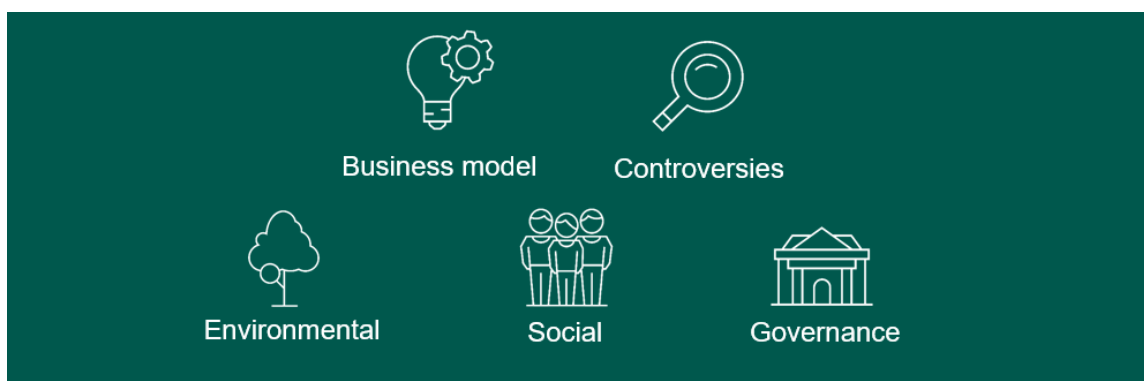


The second line of defence (Risk Management) is in charge of overseeing the sustainability benchmark and reporting portfolio ESG performance vs. benchmark. The results are published quarterly on MuniFin's website.

MuniFin receives ESG data for each issuer from an external service provider, who has long-standing market expertise in sustainable investing. This enables more comprehensive analysis and more reliable results than what would be achieved internally. ESG Scores used in MuniFin measure sustainability holistically from various perspectives:

- ESG management quality: How well are E,S & G aspects managed in companies
- Business Model: To what extent are business areas sustainable in terms of supplying product solutions that foster sustainability
- Controversies: To what extent are companies involved in significant controversies
- Consideration of financial materiality by means of putting a stronger weight on those ESG aspects that have a material impact on corporate financial performance

**Figure 4: Sustainability dimensions in ESG score calculation**



### 3.3 Sustainable asset portfolio

MuniFin wants to promote and support Green and Social projects across the whole balance sheet, including liquidity investments. Hence, MuniFin has linked the target amount of sustainable assets in the liquidity portfolio to the amount of MuniFin's own eligible funding. At all times, the nominal amount of sustainable thematic assets in the portfolio should be at least 10 % of the total outstanding amount of MuniFin's own green and social bond funding.

Furthermore, MuniFin has set a goal for the share of sustainable investments in the portfolio against a market benchmark. The share (%) of eligible sustainable assets in the liquidity portfolio shall be significantly higher than in the benchmark, which is a weighted composition of relevant fixed income market indices.

Eligible assets may include green bonds, social bonds, or other bonds that provide environmental and social benefits. Due diligence is conducted for potential sustainable investments to ensure that internal eligibility criteria is met. The basic requirement is that eligible assets must be issued in accordance with the respective International Capital Market Association ("ICMA") principles. Also, the underlying framework preferably carries a second opinion (some institutions with explicit mandates can qualify without it). The internal criteria for sustainable thematic assets is subject to constant evolution in accordance with changes in market standards and regulation.

The development of sustainable thematic assets in the portfolio vs. benchmark is published quarterly on MuniFin's website.

### 3.4 Engagement

MuniFin is committed to promote sustainability through active dialogue with potential issuers. Issuers are met regularly and this offers MuniFin an opportunity as an investor to encourage issuers to engage in better ESG practices on corporate level. An essential part of engagement is communicating to issuers that ESG performance affects MuniFin's desire to engage in transactions with them.

In addition to company-level ESG performance, MuniFin actively communicates its preference for thematic sustainable securities over traditional securities, encouraging investors to improve their ESG frameworks and the underlying business factors. MuniFin also communicates to its intermediary dealers that sustainable practices are valued and good ESG conduct is a major interest when new investments are made, which is seen as an indirect way of engaging and communicating with the issuer base.

# 4 Governance, roles and responsibilities

Key governing documents for sustainable investing include MuniFin’s Sustainability Policy and the Sustainable Investment Framework. These two documents contain the principles and practices behind MuniFin’s sustainable investments.

Treasury is responsible for liquidity portfolio management in the first-line of defense, including sustainability analysis. When investment decisions are made, ESG factors are considered in the same way as other traditional variables, such as credit or market risk factors. Risk Management & Compliance is responsible for monitoring and reporting the liquidity portfolio’s ESG score and the portfolio exclusion factors, as the second-line of defense. Risk Management & Compliance also ensures that sustainable investment practices comply with regulations and internal requirements. When setting internal guidelines and defining roles and responsibilities, MuniFin pays close attention to the relevant, continuously changing regulation.

**Figure 5: Sustainable investments governance model in MuniFin**

	Purpose and key contents	Approval
<b>Sustainability Policy</b>	<ul style="list-style-type: none"> <li>• Defines and governs sustainability throughout the whole company</li> <li>• Sets out requirements for ESG considerations in investments and sustainable assets</li> <li>• Sets first-level criteria for approved counterparties</li> </ul>	Board of Directors
<b>Sustainable Investment Framework</b>	<ul style="list-style-type: none"> <li>• Sets out the responsibility and sustainability practices for liquidity investments</li> </ul>	Capital Markets and Sustainability Management Team
<b>Sustainability Teams across business units</b> <ul style="list-style-type: none"> <li>• Coordinate and guide sustainability development proactively</li> <li>• Comment on sustainability issues</li> </ul>	<b>Treasury</b> <ul style="list-style-type: none"> <li>• Responsible for the strategy and operational execution of portfolio management according to the governing policies and guidelines</li> <li>• Responsible for operating according to the Sustainable Investment Framework</li> </ul>	
	<b>Risk Management &amp; Compliance</b> <ul style="list-style-type: none"> <li>• Responsible for monitoring portfolio ESG and the sustainability benchmark for investments</li> <li>• Exclusion screening</li> <li>• Compliance monitoring for tasks &amp; processes</li> </ul>	

To ensure that supervisory expectations are met, ESG risks are incorporated in the existing portfolio- and risk management processes. Furthermore, portfolio ESG risk has been established as a material risk indicator in the Risk Appetite Framework (governed by the BoD).

**Figure 6: Sustainability as part of portfolio management**

