

Principles of ESG assessment in customer finance

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1 Introduction

MuniFin is supervised by the European Central Bank and fulfils the EU definition of a public development credit institution. MuniFin wishes to serve efficiently and profitably as the best financing expert in the field, providing its customers with solutions that are the best fit for their needs. MuniFin's customers are instrumental in carrying out socially significant projects, such as public transportation, sustainable construction, hospitals, healthcare centres, schools, day-care centres, affordable rental apartments and housing for people with special needs.

MuniFin's customer relationships are typically very long, making it particularly important to take sustainability broadly into consideration in all business operations. Sustainability is not only one of MuniFin's core values but also a key part of the company's strategy. Sustainability covers environmental, social and governance (ESG) factors. For MuniFin, sustainable business means operating in a way that is financially, socially and environmentally sustainable and takes stakeholder needs into consideration. All of MuniFin's operations reflect the company's values of customer centricity, transparency and sustainability. Through its business, MuniFin has the opportunity to help its customers and stakeholders in solving significant sustainability challenges. MuniFin's customers help create a more socially, economically and ecologically sustainable Finland.

In particular, MuniFin promotes the achievement of Finland's climate targets and widespread wellbeing in society. MuniFin encourages more sustainable investments by offering a margin discount for green and social projects that meet specific criteria, for example. MuniFin has offered its customers green finance for sustainable investments since 2016. In 2020, MuniFin expanded its sustainable finance offering by launching social finance, which is offered for projects that produce widespread social benefits. These products offer investors a pathway to financing positive change and are integral to MuniFin's funding strategy. Both products have their own frameworks, project portfolios and impact reports.

In addition to launching its sustainable products, MuniFin has been developing its environmental, social and governance (ESG) risk management and customer financing processes for several years and will continue the active development work in the coming years. MuniFin encourages its customers to make sustainable choices and investments by promoting information sharing, offering incentive pricing, conducting impact assessments and enhancing visibility. Moreover, MuniFin strives to identify and understand significant ESG risks that could indirectly affect its operations through its lending. MuniFin manages these risks by offering sustainable financing solutions, developing customer and project ESG assessment and fostering increased customer interaction.

As part of its stakeholder cooperation, MuniFin works actively in various expert organisations and networks. These include, for example, the EU Taxonomy working group of the Green Building Council Finland, the EU Taxonomy implementation steering

group of the Confederation of Finnish Construction Industries RT, the resource-wise leadership (REIJO) project of the Finnish Environment Institute, and the Finnish Business & Society (FIBS) corporate responsibility network. MuniFin also operates in international cooperation with sustainable finance experts. MuniFin is a signatory to the United Nations Global Compact and the Society's Commitment to Sustainable Development, entitled The Finland We Want by 2050, and is committed to using green and social finance to promote the development of a carbon-neutral society and increase environmentally and socially sustainable investments throughout Finland.

MuniFin's risk management principles are set out in the company's Risk and Governance Framework. MuniFin's risk management is built upon three lines of defence, which ensure a clear division of responsibilities, appropriate reporting and actions, and a robust escalation process. MuniFin's Risk Appetite Framework outlines the risk appetite and indicators, serving as a tool to ensure adherence to defined risk limits. MuniFin incorporates climate and other ESG risks into its traditional risk management categories. MuniFin's risk management is discussed in more detail in the half-yearly Pillar III Disclosure Report¹, compiled in accordance with the Capital Requirements Directive.

This document describes the consideration of ESG factors in MuniFin's customer financing at both customer level and project level. It serves to complement other policies and guidelines that steer lending, risk management and sustainability at MuniFin.

¹ <https://www.kuntarahoitus.fi/app/uploads/2023/03/2022-Pillar-III-MuniFin.pdf>

2 How MuniFin's customers and operating environment affect its ESG assessment

MuniFin's customers include municipalities, joint municipal authorities, wellbeing services counties, joint county authorities and corporate entities under their control, and non-profit organisations nominated by the Housing Finance and Development Centre of Finland (ARA). The Act on the Municipal Guarantee Board defines the kinds of customers and projects that MuniFin can finance. MuniFin's core mandate is to ensure that its customers have access to affordable funding regardless of the market and social situation. MuniFin does not finance operations in competitive markets, and all its financed projects and customers are located in Finland. MuniFin sources funding for its lending operations from the international capital markets, where it is recognised as a reliable and highly responsive market participant. MuniFin's funding is guaranteed by the Municipal Guarantee Board (MGB), a public law institution whose members consists of all the municipalities in mainland Finland.

The special characteristics of MuniFin's operating environment and customer base inherently limit its business operations and customer finance. Geographical and sectoral restrictions on MuniFin's customer finance significantly limits the types of ESG risks to which its customers are exposed. A deep understanding and analysis of the operating environment guides the development of MuniFin's ESG assessment, ESG processes, products and services, as well as its management of climate and environmental risks.

According to the European Central Bank's (ECB) economy-wide climate stress test², companies operating in Finland bear relatively small physical and transition risks related to climate change by European comparison. MuniFin's counterparties do not include the world's most emission-intensive companies, or, according to MuniFin's assessment, companies that are excluded from the EU Paris-aligned benchmarks.³

MuniFin's ESG risk management prioritises the identification and management of climate and environmental risks. Transition risks emerge when economic entities need to make their operations less carbon-intensive by reducing their emissions. Such risks can be associated with operating conditions changing due to new regulation, technology or consumer demands. Physical risks arise from environmental disasters caused by climate change, such as floods, droughts or storms. Extreme weather phenomena and

² <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op281-05a7735b1c.en.pdf>

³ MuniFin's Pillar III Disclosure Report 2022, p. 188

<https://www.munifin.fi/whats-new/releases/munifin-groups-pillar-iii-half-year-disclosure-report-2022-published/>

fluctuating temperatures may require buildings to be more resilient than before, for example.

Because MuniFin only provides customer financing in Finland, MuniFin's customers and thus also MuniFin itself have relatively few physical risks associated with climate change. By global comparison, Finland experiences relatively few extreme weather events that cause damage. Although these physical risks are expected to increase substantially in the future, their economic impact in Finland is projected to be limited in the short to medium term.

Unlike physical risks, the transition risks of climate change are not confined to specific regions. For example, regulatory and political goals aimed at mitigating climate change can affect organisations regardless of their geographical location. As MuniFin's customers operate mainly within a few specific economic sectors, the customer base therefore inherently restricts MuniFin's possible transition risks of climate change, making them more predictable and manageable.

Even though MuniFin considers the ESG risks associated with its customers to be relatively small, the company is nevertheless committed to identifying and managing the most significant ESG risks it is exposed to. The majority of MuniFin's customer finance is focused on the real estate, construction and municipal administration sectors. In line with the principle of materiality, MuniFin's ESG risk management therefore places particular emphasis on these sectors. Accordingly, the ESG assessments of MuniFin's customers must be adequately rigorous, and the financing solutions provided should be able to support the customers on their way to more sustainable investments.

3 How MuniFin conducts customer ESG assessments

Supporting customers' sustainable financial management and long-term goals is a key aspect of MuniFin's products and services. As stipulated in MuniFin's Sustainability Policy⁴, MuniFin's financing processes must be based on reliable financial analyses. These analyses ensure that the customer is in a sound financial and risk position and that the offered products and services meet the customer's needs. MuniFin can offer financing products and services if all the financing criteria are met.

In accordance with the expectations of supervisory authorities, MuniFin's ESG risk management must primarily focus on environmental and climate risks, but also cover social and governance risks. Adhering to its Sustainability Policy⁴, MuniFin is committed to taking environmental, social and governance risks into account in all its operations and developing its ESG risk management methods. MuniFin identifies, defines and manages the most important ESG risks related to its operations and the potential impacts they could have on the company. This section outlines MuniFin's customer risk assessment. Project-specific assessment is discussed in section 4.

MuniFin examines the effects of various climate and environmental risks in a separate materiality analysis, which identifies the risk drivers that are the most relevant for MuniFin's customers – and indirectly also for MuniFin itself – in the short, medium and long term. The materiality analysis involves examining each relevant sector separately in order to identify key sector-specific risks. The materiality analysis is used as a basis for the development of risk management. The goal of this work is to ensure that the environmental and climate risks that are relevant to MuniFin's operations are included in the company's risk management.

MuniFin's lending process includes the customer's overall financial assessment and an ESG assessment. Customer-specific ESG indicators are also included in MuniFin's Risk Appetite Framework, which allows MuniFin to monitor that it stays within its defined ESG risk limits. The ESG assessment emphasises the possible effects of climate and environmental risks, which can materialise for the customer either as direct physical risks or as indirect transition risks (see section 2).

MuniFin's annual customer risk assessment incorporates an ESG risk assessment. Identified risk factors can have an effect on the customer's risk classification and may consequently affect pricing in correlation to the significance of the identified risks. MuniFin employs separate assessment processes for different customer groups and different sectors based on risks pertinent to the customer's operations and reliably available information.

⁴ <https://www.kuntarahoitus.fi/app/uploads/sites/2/2022/11/Sustainability-Policy-6.10.2022-FINAL-EN.pdf>

The customer's ESG assessment is based on public sources of information, such as data and publications by the Finnish Environment Institute. Information collected during the loan granting process, such as location and energy efficiency data, is also used in the assessment, as are ESG data requested from the customer. The assessment emphasises especially the transition risks of climate change, but also other climate and environmental risks.

In 2022, MuniFin joined the Partnership for Carbon Accounting Financials. This industry-led initiative includes more than 400 banks and investors around the globe, aiming to develop and implement a standardised method for greenhouse gas emissions (GHG) accounting for the financial industry to align financial portfolios with the Paris Agreement. As part of this work, MuniFin has developed the calculation of its financed emissions. MuniFin has the possibility of adding aspects such as the customer's emission intensity and the proportion of green or social finance in the customer's total finance as part of ESG assessment.

In order to improve customer awareness and customer interaction, MuniFin has published an ESG application for its municipal customers as part of the company's digital services. The application allows users to view their municipality's current sustainable development status and trends and compare their ranking with other municipalities. Municipalities are graded on a scale of 1 to 5 based on 58 regional indicators, which are based on the UN's 17 Sustainable Development Goals. The application is provided by an external service provider. Through the ESG application, MuniFin can increase transparency and support its customers' decision-making by publishing the sustainability indicators and themes it uses in its own ESG assessment.

MuniFin informs its customers of the importance of ESG risk management and of the increasing ESG requirements. If the customers can improve their operating models in this regard, it will have a positive effect on MuniFin's material risks as well. This work also indirectly supports MuniFin's goal of increasing the demand for green and social finance and their share of total long-term customer finance.

4 Project evaluation

Due to the nature of their operations, MuniFin's customers play an important role in social development and in upholding the core structures of the Finnish welfare state. For this reason, projects financed by MuniFin almost always support Finland's economic, social and environmental goals. The work and investments of MuniFin's customers are crucial to the green transition, which includes mitigating and adapting to climate change and supporting biodiversity.

When MuniFin finances individual projects of its customers the process includes the customer's overall financial assessment and an ESG assessment. Sufficient information of the project is collected to ensure that the offered products suit the customer and the project.

If the project financed is potentially Green or Social MuniFin collects information on the nature and positive impacts of the project to make the assessment as required by the Green or Social Bond framework. It is the customers' responsibility to implement and supervise their projects in accordance with the applicable laws and standards.

The project-specific ESG assessment of MuniFin can consist of both a client-specific assessment and an project-specific assessment, or only a client-specific assessment. This chapter deals with a separate project-specific assessment and client-specific ESG assessment is described in chapter 3.

4.1 Green and social finance

In connection with the financing process, MuniFin encourages its customers to pursue more sustainable investments by evaluating the suitability of the project for green or social finance using specific eligibility criteria. The criteria for green and social finance serve as examples of the best available practices for the customers. To incentivise alignment with these eligibility criteria, MuniFin offers margin discounts for green and social finance. Increasing the share of these types of financing in MuniFin's loan portfolio is part of MuniFin's climate and environmental risk management and also written down in MuniFin's sustainability goals.

MuniFin's principles of granting green finance are set out in the Green Bond Framework⁵, which was updated in September 2022. The framework was drawn up in accordance with the Green Bond Principles of the International Capital Market Association. The Green Bond Principles have been designed for the use of market participants, and they are intended to promote the financing of projects that are sustainable for the climate and environment, as well as to improve access to information. An external review has been conducted of MuniFin's Green Bond Framework and its alignment with the EU Taxonomy. This review is available on MuniFin's [website](https://www.kuntarahoitus.fi/app/uploads/sites/2/2022/12/MuniFin-Green-Bond-framework.pdf).

⁵ <https://www.kuntarahoitus.fi/app/uploads/sites/2/2022/12/MuniFin-Green-Bond-framework.pdf>

MuniFin's Green Bond Framework makes the project eligibility criteria more transparent, which fosters open discussion and allows greener investments to be taken into account already in the planning stage. The framework is suitable for financing low-carbon construction, sustainable public transport, renewable energy and other green projects. Project evaluation is conducted by the Green Finance Team consisting of MuniFin's own sustainable finance experts. The evaluation is based on documents gathered from the customer during the finance granting process. These documents can include, for example, energy certificates, project plans or environmental impact assessment reports.

MuniFin's social finance can be granted to investments that produce widespread social benefits. MuniFin's Social Bonds Framework⁶ lays out the rules for the use of proceeds, the selection of eligible projects, the management of proceeds and reporting. The framework was drawn up in accordance with the Social Bond Principles of the International Capital Markets Association (ICMA). An external reviewer has validated that MuniFin's framework conforms to ICMA's principles and that the financed projects promote the selected UN Sustainable Development Goals.

In the social finance granting process, projects are assessed against MuniFin's Social Bonds Framework using the impact data provided by the customer. The final decision on whether a project is eligible for social finance is made by an evaluation team of social experts that includes two independent members and one MuniFin expert. Eligible projects have positive impacts on their surrounding community: they promote equality, communality, welfare or regional vitality.

⁶ <https://www.kuntarahoitus.fi/app/uploads/sites/2/2020/02/Municipality-Finance-Plc-Social-Bonds-Framework-February-2020.pdf>

5 Monitoring and reporting

MuniFin monitors the ESG risks of its customers as part of its risk management process, which is based on MuniFin's Risk and Governance Framework. In addition to internal control, MuniFin reports on the management of its climate and environmental risks and other ESG risks as part of its half-yearly Pillar III Disclosure Report⁷, compiled in accordance with the Capital Requirements Directive.

MuniFin's annual report and financial statements cover the development of green and social finance and their share of total customer finance. Moreover, MuniFin annually publishes its Green Impact Report and Social Impact Report for the use of its stakeholders. MuniFin internally monitors the development of the share of green and social finance, and uses this figure as an indicator in its company-specific sustainability goals. MuniFin reports on the achievement of its sustainability goals as a part of the sustainability scorecard published in the Annual Report.

MuniFin will continue to develop its ESG indicators, the assessment of its customers and financed projects as well as its internal and external reporting based on material risks.

⁷ <https://www.kuntarahoitus.fi/app/uploads/2023/03/2022-Pillar-III-MuniFin.pdf>

6 Responsibilities and management

In accordance with the management system of MuniFin this document has been approved by the executive management team of the Customer Solutions function.

The main responsibility for the implementation of the processes described in this document lies with MuniFin's Customer Solutions and Risk Managements divisions. MuniFin also has a sustainability management system consisting of three separate working groups that focus on MuniFin's products and services, ESG risk management and the strategic development of MuniFin's sustainability.