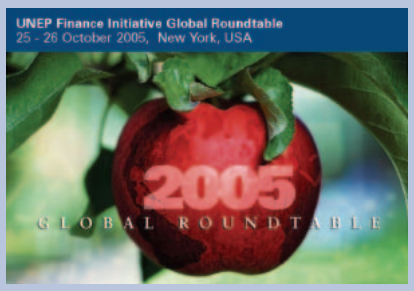
UNEP Finance Initiative
Innovative financing for sustainability

0.618...

UNEP FI, Issue 6, November 2005

The golden ratio... building quantity without sacrificing quality



Klaus Töpfer
Executive Director, United Nations Environment Programme

In coming decades financial institutions and the capital markets they operate in will be required to forge a new approach to business. This approach will give equal position to both the standard business consideration embodied in Return on Investment and the evolving requirement of Responsibility of Investment – the two RoI's.

Our UNEP Finance Initiative 2005 Global Roundtable, meeting here at the United Nations Headquarters in New York City, provides the opportunity for nearly 600 global thought leaders in the world of sustainable finance to strengthen their blueprint for a more responsible and, at the same time, more rewarding approach to the "business of business." The event will build on previous UNEP FI global gatherings of recent years in Tokyo (2003), Rio de Janeiro (2002) and Frankfurt (2000).

UNEP and its 170 partners in the worlds of banking, insurance and asset management are delighted to be bringing the UNEP FI Global Roundtable to the United States of America and, more so, as we are such a short distance from one of the great, iconic bastions of finance, Wall Street.

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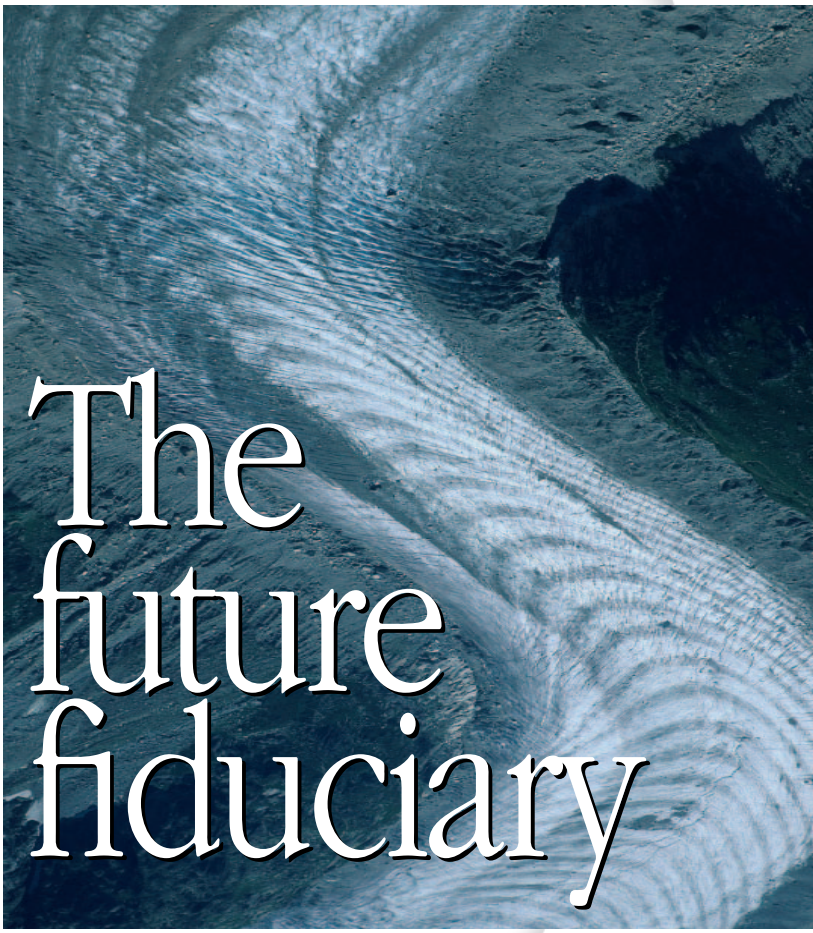

P&A MACDONALD /WWI

The future fiduciary

The legal scope for integrating ESG considerations into institutional investment

Paul Q. Watchman
Partner, Freshfields Bruckhaus Deringer

Despite the evidence that environmental, social and governance (ESG) issues often have a material impact on the financial performance of investments, many institutional investors still insist that their legal duties prevent them from taking such issues in to account.

In response to such resistance, the UNEP FI Asset Management Working Group engaged international law firm Freshfields Bruckhaus Deringer to prepare a report examining the law of investment decision-making in a range of jurisdictions around the world. The report, launched at the UNEP FI Global Roundtable in New York in October, concludes that the belief that it is unlawful to take ESG issues into account is mistaken. In fact, a failure to have regard for such considerations will often be a breach of the legal duties applicable to institutional investors.[1]

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Asset allocation, stock selection and divestment

The report finds that in all jurisdictions examined, the law requires investment decision-makers to follow the correct process in selecting securities and making other decisions about investments. "Decision" in this context means the whole range of decisions that institutional investors make, including decisions about asset allocation, stock selection and divestment, and the manner in which they exercise their rights as shareholders. In common law jurisdictions (such as the UK and the US) the duty to follow the correct process flows from the fiduciary duty of "prudence"; in civil law jurisdictions (such as France and Japan) it flows from the duty to seek profitability and otherwise manage investments conscientiously.

Following the correct process requires decision-makers to have regard for all the considerations that are relevant to a decision. Given the body of evidence demonstrating that ESG considerations often influence investment value, the report concludes that decision-makers are required to take into account (at some level) ESG considerations in every decision they make. Whilst there will inevitably be differences as to how these considerations are weighed – and in certain circumstances it will be proper ultimately to decide that the ESG considerations associated with a particular investment do not have any material effect on value – this does not, however, justify a failure to identify them and to assess their weight.

In common law jurisdictions, fiduciary duties require investment decision-makers to act in the interests of their beneficiaries and not in their own interests. Civil law jurisdictions also have rules requiring decision-makers to act in the "interests" of the beneficiaries. Where the purpose of the investment power is to seek a financial return for the beneficiaries, as in the case of financial trusts such as most pensions, decision-makers must treat this as their overriding objective.

Interests of beneficiaries

However, this does not require the pursuit of profit maximisation on an investment-by-investment basis as is often argued, particularly in the UK (and generally by reference to the misunderstood case of Cowan v Scargill). Rather, the US approach, which looks for a just and reasonable return across a balanced and well-managed portfolio, better reflects modern investment reality and is likely to be the approach that common law courts would endorse today.

Also, a decision-maker may give effect to the views of the beneficiaries on matters beyond financial return. For example, courts in the UK have recognised that beneficiaries' best interests may extend beyond their financial interests to include their views on moral and social matters. A decision-maker who chooses to exclude an investment or category of investments on this basis needs to be able to point to a consensus amongst the beneficiaries, no matter how difficult this may be in practice.

"Beneficiaries' best interests may extend beyond their financial interests to include their views on moral and social matters."

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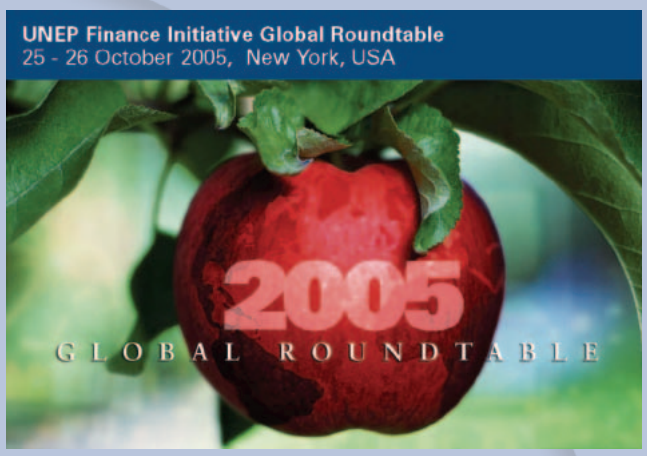
However, the report argues further that there will be a class of investments that a decision-maker is entitled to avoid, even in the absence of express consensus, on the grounds that their ESG characteristics are likely to make the investments so repugnant to beneficiaries that they should not be invested in, regardless of the financial return they are expected to bring. The report does not prescribe the parameters of this class of investments, but suggests that it might include investments that are linked to clear breaches of widely recognised norms, such as conventions on the elimination of child labour.

There may also be cases where a decision-maker has exhausted the financial analysis and is still left with a number of equally attractive investment alternatives. In these cases, the report concludes that the decision-maker would be entitled to select one alternative on the basis of its non-value-related ESG characteristics.

In short, institutional investors who hide behind profit maximisation and the limits supposedly placed by their legal duties do so at their own peril. There is no legal bar to the integration of ESG considerations into decision-making (provided the focus is always on the beneficiaries' best interests), and indeed failure to have regard for such considerations may itself amount to a breach of duty.

1. The jurisdictions examined were Australia, Canada, France, Germany, Italy, Japan, Spain, the UK and the US.

The report will be available on the UNEP FI website (www.unepfi.org) at the end of October.



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The theme for our two days (October 25-26) of discussions: "A World of Risk. A World of Opportunities?" is a suitable one. It intimates the nature of the common environmental, social and economic risks that a globalising world faces. It suggests also the hope and entrepreneurial opportunity that a thriving, vibrant, inclusive market, underpinned and catalysed by sustainable finance, brings.

The UNEP FI Roundtable presents a rich agenda. At the heart of this agenda is the complex question of how modern finance and capital markets can bring the power of the markets and the flexibility of financial engineering to tackle the corrosive issues – environmental destruction, poverty, and social injustice – that lie behind the Millennium Development Goals and plague so many of our fellow human beings.

The 2005 event will give a special focus to the role of institutional investors and the asset management community that serve them, as the question of what will be expected of "The Future Fiduciary" is explored. UNEP contends that our understanding of responsible investment of capital and its allocation to sustainable, productive technologies, companies and communities is set to shift significantly in the near term. Financial institutions that are part of this transition and provide leadership in the way sustainability is embedded in their policies and practices, will become a critical pivot that ensures the markets work more effectively for all.

What was once a niche asset class, under the umbrella term of responsible investment, is set to become mainstream as institutions with trillions of dollars under management embed environmental, social and corporate governance thinking for the long-term in their investment approach. As the world's largest pension schemes, special government funds and foundations adjust this will set in train a new dynamic along the investment chain.

Why is your role in this transition so important? Because the ultimate goal is to ensure that financial institutions and markets play their role in engineering a better quality of life, with a richer, more sustainable basket of products and services, and a sound environment, for more communities worldwide.

The principles for responsible investment

The Principles for Responsible Investment (PRI) is a project convened by the UN Secretary-General and implemented jointly by UNEP and the UN Global Compact. The PRI process is an effort to identify and act on the common ground between the goals of institutional investors and the sustainable development objectives of the United Nations.

Representatives of two of the world's largest investors talk about principles and codes of corporate conduct and their relevance to the Principles for Responsible Investment.

Colin Melvin
Director of Corporate Governance, Hermes Investment Management Limited

Hermes' approach to responsible investment is based on getting companies to change the way they do what they're doing. In the case of equities, this involves calling company directors to account. We've found that this can lead to positive change, which, over the long term, adds value. This is the type of process we are seeking to embed in the Principles. In terms of the inclusion of specific standards or codes in the Principles themselves, our view is that this could potentially be counterproductive in that it may frighten away those who don't agree with certain specific codes, but who would be willing to sign up to a process that can effect positive change.

0.618... Hermes has used specific codes of corporate conduct such as the OECD Guidelines for Multinational Enterprises (see www.oecd.org) when engaging with companies. What has your experience been with these?

Broadly speaking our experience has been positive, but we do take a pragmatic approach. We use whichever guidelines are likely to produce the outcome that we want to see. Standards, however, have an arbitrary element to them. Even those that are very widely agreed upon will not be suitable for all companies at all times. In our experience you have to be careful to focus on the result you want to get, rather than simply on the process by which the result can be obtained.

0.618... The Hermes Principles (see www.hermes.co.uk) contain very strong commitments to corporate responsibility. How have you encouraged companies to comply?

We have sent the Principles to all UK companies twice and we have translated them into a number of languages to promote them in various markets. We have followed up specifically with those companies where we thought there were deficiencies. In relation to the two principles on corporate responsibility, we regard it as very important that companies avoid unnecessary externalisation of costs. As a broadly based investor – a universal investor – we understand that this is generally not in our clients' interests, because the costs will be picked up elsewhere in the portfolio. We therefore encourage companies to avoid such externalisation. We also look to them to engage positively in the regulatory debate, to ensure a level playing field, rather than simply seeking short-term advantage through regulatory arbitrage.

RAY PFORTNER

0.618... How have companies reacted to the Hermes Principles on corporate responsibility, which impose society-wide expectations on them?

Very positively. The problem is less with companies than with the investment industry and with companies' perception of what the industry wants. By and large company directors want to do the right thing for stakeholders; they recognise that in doing so they are likely to maximise value to the owners. Ironically, the constraints on their behaviour are often imposed by the investors themselves. The perception of the investment industry as being interested in short-term profitability is leading directors to make wrong decisions for the wrong reasons. We are seeking to address this by setting out clearly that we expect them to take a different approach.

Laurent Deborde
Head of Financial Risk Management,
Caisse des Dépôts et Consignations (CDC)

Jean Louis Nakamaura
Chief Investment Officer, Fonds de réserve pour les retraites (FRR)

First and foremost we seek to exercise our ownership rights through appropriate governance. Beyond this, our approach to responsibility is shaped by the fact that we are both long-term investors and managers of public funds on behalf of French citizens.

We are especially sensitive to environmental and social issues that may be critical in the long term, both in financial and extra-financial terms. We believe that taking into account environmental and social issues can reduce financial risk. Additionally, this will help protect the non-financial interests of beneficiaries – social fairness, protection of environmental commons and trust in society's institutions.

As investors on behalf of the general public, it is our responsibility to ensure our investments do not breach universal principles strongly supported by the French population, such as the UN Universal Declaration of Human Rights, and other international conventions signed by our government. Additionally, we want to discourage companies from externalising costs onto taxpayers, consumers and competitors. Since we are, in a French and European context, a universal investor with a broad and diversified exposure throughout the market, such externalities only serve to create a downside.

In both these areas, we feel we can benefit from coordination with like-minded investors. The PRI process is certainly a very promising opportunity for this.

0.618... What is your approach to the use of various principles and codes of conduct in your investment processes?

Both Caisse de Dépôts et Consignations (CDC) and Fonds de réserve pour les retraites (FRR) have developed their own codes of governance, which include rules for proxy voting.

Beyond that, we feel that the field of ESG is still in a learning phase. Generally accepted standards of ESG reporting by companies need to be set. Reference to common codes and principles would certainly help to set standards for ESG disclosure. Such disclosure standards should refer to the principles that are at the heart of democracy, such as human rights, or international agreements and declarations that have been developed through democratic processes; they would then serve the additional purpose of aligning company behaviour with public goals . They could also act as a warranty that the non-financial outcomes for beneficiaries (i.e. what happens to the world they live in) are not determined by the whims of investors and companies, but actually reflect democratic and widely agreed upon goals.

Reference to the Global Compact (GC) is promising for both standardisation and normative purposes. The GC has already been widely accepted by large companies globally, and provides a very comprehensive summary of the principles recognised in democracies.

We expect investment principles that refer to the GC to gain the same general acceptance among investors as the GC has gained among corporations. Also, the use of commonly accepted norms and codes will reduce the information cost of adhering to the PRI for smaller institutions that may not have the resources to develop their own processes.

0.618... How would investors implement the Global Compact?

Three specialised firms already offer services based on what appear to be very robust processes to assess compliance with the Compact principles for most of the companies listed in the EuroStoxx 600 Index.

CDC has started assessing company compliance with the Compact Principles. This process is currently on hold as it is expected that the Principles for Responsible Investment will facilitate coordination with other investors and may allow our effort to be more effective and efficient.

For further information on UNEP FI's involvement in the Principles for Responsible Investment, please visit: www.unepfi.org

"Calling company directors to account can lead to positive change, which over the long term adds value. This is the type of process we are seeking to embed in the Principles."

Colin Melvin
Hermes Investment Management Ltd

Rendez-vous with reporting

A review from behind the scenes

The Global Reporting Initiative (GRI) and UNEP FI have been working together to develop a set of environmental performance indicators for financial reporting.

Two stakeholders in this process share their experiences and outline their hopes.

Esther Garcia
Manager, CoreRatings

Utrecht, 25 October 2004. Twenty people representing financial institutions (FIs), rating agencies, NGOs, UNEP FI and the GRI are gathered in a room at Rabobank headquarters.

It is the fourth and last meeting of the UNEP FI / GRI Working Group on environmental indicators for FIs. It has taken us a year to reach this moment. The main objective of this two day meeting is to review the draft indicators developed over the past months and come up with a definitive set of indicators. The task is not easy. The group has to deal with more than 70 responses from the consultation process that took place during the summer of 2004. And most important of all: we only have 48 hours. That was 48 hours to achieve consensus among organisations that traditionally have opposing views. Friends of the Earth and Earthwatch agreeing with Standard Chartered? This was a new level of dialogue.

According to the GRI itself, this session was exceptional. Not only was the topic particularly challenging but also the dynamics within the group was unique for the smoothness of the dialogue and the willingness to find mutual agreement.

Although all representatives had interests at stake, whether to ease the rating process on FIs or to develop a set of indicators that would not be too burdensome on the reporting organisation, we all had one common goal. We were here to take an important step in the world of corporate responsibility (CR) reporting: to set a benchmark that would not only help some companies to become leaders in the field, but that would also encourage other companies to start CR reporting, and ultimately to overcome the lack of uniform and standardised reporting. During the whole process, participants proved themselves worthy of being part of what the GRI is most proud of: stakeholder dialogue.

As a group we inevitably encountered many challenges, and disagreements were frequent in certain areas, namely in terms of terminology and feasibility. The indicators needed to be realistic, appropriate and not too onerous on the reporting organisation, hence the decision to keep the number of indicators to a minimum. One difficulty was that we were dealing with four different business lines: retail banking, commercial banking, asset management and insurance. In addition, it became apparent that not all organisations had the same definition of concepts such as "retail banking", "assets under management" or even "engagement". We compromised to keep the wording of indicators as general as possible, while also providing enough guidelines on what information should be reported by each business line.

Indicator F13 (value of portfolio for each core business line broken down by specific region and by sector), is perhaps one of the most innovative. This kind of information will allow analysts to identify risk exposures, as it will be possible to determine whether an FI's portfolio relies on high environmental impact industries, as defined by the World Bank. However, it is also likely to come in for heavy criticism, as most organisations will be reluctant to disclose such information.

Measuring the success of FIs in driving positive change in clients'/investees' environmental behaviour was also challenging. Do we count the number of companies engaged with, or the voting result in resolutions? Either way, the indicator would not have given us an accurate picture of reality, so we had to compromise with whatever takes us closer to reality, i.e. a "description of interactions".

We left Utrecht with a feeling of achievement. There will, no doubt, be some criticism. Success of the supplement guidelines remains to be seen, but I am confident that the piloting project, to be completed in June 2006, will be the start of a new way of analysing FIs' CR performance.

Esther Garcia was Co-Chair of the UNEP FI – GRI Working Group meeting in Utrecht.

WOLFGANG WEBER / ARGUS

Martin Hancock
Chief Operating Officer,
Westpac London

Global Reporting Initiative (GRI) Sector Specific Supplements add real value to the sustainability reporting process. Not only do they increase relevance, but the whole process, specifically the equal involvement of multi-stakeholders, ensures that the final product has credibility.

We were fortunate in the UNEP FI – GRI Environmental Sector Supplement Working Group to have a highly experienced panel of financial institutions (FIs), and a wide cross section of high profile non-financial stake-holders. In addition, materiality had to be at the forefront of everyone's mind, and this led to some interesting debates and discussions.

It was a great challenge and success for such a diverse group of organisations to come up with such a robust set (13 in total) environmental performance indicators. From the FIs' perspective, the final result would hopefully rationalise the diverse requests for information from civil society. From the stakeholders' perspective, this exercise provided a unique opportunity to literally get round a table and put forward their legitimate concerns.

The key focus of the UNEP FI – GRI Working Group was to look at the indirect aspects of FI operations. This presented many challenges, since in some cases, it was difficult to draw the boundaries around where an FI's influence and impact could or should be.

Another key challenge was to ensure that development of the indicators didn't follow the path of the lowest common denominator. Financial Institutions are at different stages in their level of reporting sophistication, and we wanted to ensure we used the indicators to encourage other FIs to join the sustainability reporting journey. This meant that the indicators had to be achievable, but also, for some, aspirational, as data availability and commercial confidentiality were also considered as potential constraints.

What remains now is to encourage as many FIs as possible to use the indicators in the Pilot Phase of the project, so that we can assess the implications in the field. Westpac will certainly take up this challenge and I would like to recommend that others join us on the journey.

Martin Hancock was Co-Chair of the UNEP FI – GRI Working Group meeting in Utrecht and is currently Chairman of the UNEP FI Steering Committee.

"Global Reporting Initiative (GRI) Sector-Specific Supplements add real value to the sustainability reporting process. Not only do they increase relevance, but the whole process, specifically the equal involvement of multi-stakeholders, ensures that the final product has credibility."

The issue of management and reporting in developing countries and transition economies is dicussed by Robert Tacon of Standard Chartered Bank on page 9.

"Climate change represents the largest single environmental challenge this century. It is all the more dangerous because it is such a slow and hard-to-track phenomenon; it is truly the invisible enemy."

Sir John Bond
Group Chairman, HSBC Holdings plc, at the launch of the Climate Group in April 2004

HSBC

Countering Climate Change

Winds of change

Jon Williams
Head of Group Sustainable Development, HSBC Holdings plc

In December 2004, HSBC announced its intention to become the world's first carbon neutral bank by 2006. As a relatively low carbon emitter compared with some other industries, HSBC's move may seem somewhat out of step for a financial institution. However, when viewed as part of HSBC's long-term view of a low carbon future, things become much clearer, as does the importance of a robust climate change policy framework.

By becoming carbon neutral, HSBC will learn first hand about the opportunities and challenges that come with such an undertaking. Not only will this support its broader commitment to address climate change, but HSBC can apply this knowledge in helping its clients to reduce the CO_2 emissions of their own businesses.

In addition to reducing its CO_2 emissions through energy efficiency and the purchase of green electricity, HSBC plans to achieve carbon neutrality by utilising its core business – lending and investment. Instead of purchasing credits directly from the market, HSBC aims to finance low carbon projects that produce carbon credits which can then be used to offset its own emissions, and potentially those of its clients. This approach reflects HSBC's positioning in both OECD and non-OECD markets, linking carbon reduction initiatives globally.

Although HSBC is prepared to look at a wide range of sectors and geographies, the projects that it prefers include energy efficiency, transport and renewable energy, in Brazil, China,

HSBC supports the development of a long-term climate change policy framework which includes:

- establishing a market-based policy, global in scope, which extends to 2030 and provides indicative signals to 2050;
- providing market-based incentives and support, based on the "cap and trade" mechanism;
- eliminating policy inconsistencies and perverse incentives that undermine climate policy objectives;
- the use of government procurement policies, including developing emissions standards that could be used by government and voluntarily by the private sector;
- addressing climate change and its solutions as part of a wider agenda, including sustainable development, poverty and competition issues in emerging markets.

A strong policy framework does not guarantee complete mitigation of the effects of climate change on the planet and its people, but it does underpin actions taken by business and individuals to reduce their contribution to climate change.

India, and Mexico. The projects are expected to be additional (e.g., building a wind farm instead of coal fired power station) and provide a delivery guarantee. A direct involvement at the project financing level will enable HSBC to assess the environmental credibility of the carbon offset credits it purchases. However, developing low carbon technologies requires long-term project financing over 10 to 20 years, and consequently, a long-term policy framework.

To this end, HSBC has participated in two forums on climate change policy development — the G8 Climate Change Roundtable and the Corporate Leaders Group on Climate Change of the Cambridge Programme for Industry. In its letter to UK Prime Minister Tony Blair, the Corporate Leaders Group said: "We need to create a step-change in the development of low-carbon goods and services […]. To achieve this, we need a strong policy framework that […] incentivises the development of new technologies. Without such policies, our companies are not able to justify to our boards or investors the necessary high up-front investment in low-carbon R&D, technologies and processes."

Te Apiti wind farm pictured above is one of the four projects that make up the HSBC carbon-neutral pilot project which was announced 6 October 2005.

Management and reporting in developing countries and transition economies

Robert Tacon
Head of Risk Monitoring and Compliance Group, Standard Chartered Bank

The social and environmental implications associated with financial institution (FI) operations are increasingly under scrutiny from stakeholders, be they governments, civil society, including NGOs, or the socially responsible investment community. For example, an FI's lending activity has the potential to create negative perceptions of banks amongst these stakeholders but also provides significant opportunity to create positive perceptions by contributing to sustainable development.

Many FIs have made great strides in their approach to recognising their responsibility through changing their lending practices to take into account the impact on both the environment and society. The development of the Equator Principles provides a very tangible example of this progress.

Whilst a lot of this progress has been primarily confined to the OECD markets, we are increasingly seeing strong progress in the emerging markets. ABN AMRO Asset Management in Brazil pioneered the first emerging market SRI equity fund in 2001 and now has in excess of USD 35 million in net assets. Many banks are recognising the positive results of incorporating social and environmental factors into their lending assessments. Initially, these steps tend to concentrate on the indirect impacts, which may arise through the funding of customer activities. Increasingly, banks are also seeing the positive opportunities such as providing new products or "greening" existing products by offering variable funding to sustainable initiatives such as forestry.

The UNEP FI Sustainability Management and Reporting (SMR) work-stream is currently preparing a report that makes the case for developing SMR across all UNEP FI members and beyond. The report is aimed at those institutions especially in developing and transition economies that are on the starting grid of this very exciting journey, and will use real case studies to illustrate the positive impact that SMR can bring to FIs. For instance, improved risk management and disclosure often lead to better access to capital and hence to reduced capital cost. Through SMR, FIs are able to make investors and lenders confident that sustainability risks are managed. This is particularly important in the growing field of socially responsible investment (SRI) in emerging markets. FIs applying SMR and strong corporate governance have a competitive advantage in being able to assure all investors of the quality of their management. The SMR report will be published towards the end of 2005.

Robert Tacon is Chair of the UNEP FI Sustainability Management and Reporting (SMR) Forum.

Michelle Chan-Fishel, Green Investments Program, Friends of the Earth (FoE) USA, and **Pamela Flaherty**, Global Community Relations, Citigroup, discuss how sustainability issues can be integrated into the financial sector. The two 0.618… contributors were responding to questions raised by UNEP FI Chairman Martin Hancock. His questions included:

"Given the myriad of single issues, how should business prioritise what needs to be done? Is it legitimate for business to prioritise in terms of each issue in relation to its particular field of activity?

"Boundaries exist that effect whether business can influence change directly or indirectly. To what extent can these issues be addressed by business? Who is to be listened to? How can stakeholders share the task of effecting change?"

Getting the balance right on the sust

"In a world where much needs to be done in terms of environmental and social issues, businesses are increasingly aware that they have a responsibility to all stakeholders, not just shareholders – the business of business is not just business"

Martin Hancock
Chief Operating Officer, Westpac London

JUE VIVATUCHA/UNEP

Michelle Chan-Fishel
Friends of the Earth

It is certainly appropriate for financiers to prioritize issues.

Indeed, during the drafting of the Global Reporting Initiative's financial sector supplement, NGOs pushed financiers to report on their exposure in different industrial sectors, geographic regions and business lines. We knew that without such disclosure, it is difficult to determine material issues and priorities. For instance, if a financier is a key player in the chemicals sector, then implementing a thoughtful standard on chemicals and/or toxics is critical. Similarly, if a bank does little or no project finance, adoption of the Equator Principles should be a lower priority. What is material to one financier may not be material to another.

However materiality is not just defined in terms of a firm's exposure to particular types of businesses. It may also be determined by social/environmental urgency and the demands of external stakeholders. In fact, stakeholders have already helped redefine material CSR issues for the banking sector: at one time banks identified energy use, paper recycling and philanthropy as

Pamela Flaherty
Citigroup

At Citigroup, we understand that with our position as a leader in financial services comes the responsibility to conduct business adhering to the highest standards, to add value for our clients, our shareholders and employees, and at the same time, to produce positive outcomes in the communities where we do business. We seek advice from our customers, our bankers and other interested parties that want to see us lead effectively and responsibly. This includes engagement with certain external stakeholders – NGOs, socially responsible investors, and community organizations – that may want us to act more aggressively on environmental, social and ethical issues that concern them.

We listen to advice from external stakeholders, and we learn from it. But ultimately, we find it makes the most sense to focus on issues that are central to our business, and where we are confident we can have a direct and positive impact. For example, our operations – in terms of our energy consumption and the type of energy we buy – have a direct impact on climate change. The scale of Citigroup's operations (11,800

key CSR concerns. But as NGOs advocated for different priorities, leadership banks turned their focus to creating responsible financing standards/procedures for core business operations.

Finally, what is material one year may not be the next. For example, in the future, human rights will likely become an important issue for the financial sector, even though today most financiers have not addressed this issue.

Materiality is fluid and largely defined by external parties. Even in the financial accounting world, materiality is largely driven by investor demand – not by what management believes is important. This means that firms must have robust CSR and risk management systems to identify potential matters and to evaluate them for their materiality and implications for the business. Well-governed firms will be able to do a good job in this task, because they will be able to tap the competence and expertise of their own staff and board. They will also be able to solicit the input of external parties (through stakeholder identification, outreach and consultation, for example) and effectively respond to stakeholders' and governments' views of what is important.

There is an ongoing debate about the ability of business to effect change. On one hand, financiers often state that they should engage in controversial activities (e.g. a socially sensitive pipeline) so they can bring higher CSR standards to bear. On the other hand, financiers sometimes claim they have little ability to improve social and environmental conditions, and that such matters must be addressed instead by clients, governments or NGOs. I challenge financiers to not underestimate their role, and to consider the different ways they can effect change through their impact, leverage, and influence. For example, an insurer creates positive environmental impact by insisting that clients meet minimum environmental performance standards. The Equator Principles leverage the power of individual banks through creating industry-level norms. Finally, the Carbon Disclosure Project uses the influence of institutional investors to effect change by requesting climate data from companies.

Through a different lens

tainability highwire

facilities in 102 countries, with 300,000 employees) means that our impact is significant. We track our global energy consumption, are setting goals for the reduction of our energy use, and are identifying innovative, cost-effective opportunities to buy green power. Our progressive human resource policies, including those covering diversity, our community lending practices, and our environmental and social standards for project finance are all examples where we are making a positive difference. At the same time, we are building a healthy, growing business that provides employment, sustainable growth, and tax revenue that supports the economic well-being of communities.

With regard to our suppliers, we have standards that cover ethical business practices, diversity and the environment. For issues involving our customers, the evaluation of materiality and our responsibility is more complex, and our ability to influence is nuanced. With regard to money laundering, corruption, and terrorism funding, our responsibilities are clear, and we have strict standards. However, in instances where our customers are operating legally and making positive contributions to society and economic development, the issue is more complicated. Our dialogues with various stakeholder groups help us identify and understand these issues; educate stakeholders on the workings of international capital markets; and find ways that we can work with stakeholders, clients, and even competitors to institutionalize best practices in environmental and social responsibility. That is why we also ask our stakeholders to engage with our competitors, to help ensure that best practices are adopted across the financial services industry. Creating a level playing field with our competition is particularly important, and that is why the multi-bank approach of the Equator Principles has been both helpful and very successful.

In general, we believe that we can accomplish more by engaging a customer in a discussion of best practices than by disengaging from them. In many instances, our customers are not only receptive to these discussions but are already ahead of us in terms of understanding and addressing complex and challenging environmental and social issues. With engagement, our customers as well as our external stakeholders play an important role in defining the materiality of certain issues and in creating solutions.

UNEPFI Regional Task Forces

In this special issue of 0.618..., UNEP FIs Regional Task Forces present for the first time a joint piece giving financial institutions' regional perspectives around a common theme.

With 2005 being the International Year of Microcredit, and financial institutions increasingly engaging in finding new and innovative ways of bringing the formal banking sector to the unbanked, access to finance has become a burning topic. The following articles provide a global overview of activities by financial insitutions in this area.

Promoting access to finance

Banking the unbanked

Microfinance programme of the Development Bank of the Philippines

Eufemia Mendoza
Senior Assistant Vice President, Development Bank of the Philippines

Micro, small, and medium enterprises are a driving force in the economy and are of pivotal importance in maintaining dynamism in the Philippines into the 21st century. The Development Bank of the Philippines is committed to providing for the financial needs of this sector.

Typical microfinance customers are poor and low-income households involved in micro-enterprises, usually household-based businesses,such as trading, servicing, and food processing. The majority are minimally-educated females, mostly housewives, involved in food processing projects, with a combination of trading, predominantly related to consumable goods especially food. They include market stalls or ambulant vendors.

Lending to micro-entrepreneurs requires certain flexibilities and interventions. Microfinance borrowers have to be trained and prepared to be bankable. Credit consciousness has to be emphasised and inculcated so that borrowers learn to set aside cash or profits for the payment of their loan obligations. At the same time, capability-building for microfinance lenders is essential, particularly with regard to resource generation. Credit enhancements are accomplished through a regular clean-up of loan

Banking on SMEs in Central and Eastern Europe

Mark King
Head of FI and Implementation Support, European Bank for Reconstruction and Development

Growth in small private businesses is key to alleviating poverty and raising living standards. It is particularly crucial in poor countries and can act as a driving force for economic reform as loans to micro and small businesses help increase their growth and stability. Capacity building throughout the financial sector is often necessary for financial institutions to become more acquainted with small and medium-sized enterprises (SMEs) and thus be more willing to provide them with medium and long-term financing.

In Central and Eastern Europe the European Bank for Reconstruction and Development (EBRD) assists SMEs via credit lines to local banks and leasing companies, and through trade facilitation programmes and mortgage lines. The EU/EBRD SME Finance Facility sponsored by the European Commission is a major provider of medium and long-term funds to SMEs in EU accession countries and in some of the New Member States through participating financial institutions. The primary objective of the programme is to ensure that participating financial institutions remain strongly committed to the SME business beyond the end of the programme, in the absence of subsidies.

One example of how the EBRD has been engaged in supporting SMEs is through the launch of a new multi-donor fund to support

maturities and close monitoring and supervision.

Lending to micro-entrepreneurs remains a significant development strategy for DBP as it contributes to the empowerment of the disadvantaged sectors of the Phillipine society in their fight against poverty and ultimately towards attaining a better way of life. Under the DBP Microfinance Program established in 1990, loans are granted on the basis of a borrower's cash flow and are typically unsecured. Loans are usually short-term but may be amortised on a daily, weekly, bi-monthly, or monthly basis depending on the cash flow condition of a borrower. The maximum amount generally does not exceed PHP 150,000 (about USD 2,678), which is equivalent to the maximum capitalisation of a micro-enterprise. The programme may be accessed by micro-entrepreneurs engaged in manufacturing, agri-businesses, and similar livelihood projects. Housing and electrification are also eligible loan purposes.

The programme also provides a profitable product line for microfinance institutions in the country. DBP's partner-MFIs include rural banks, cooperative banks, thrift banks, development banks, commercial banks, savings and loan associations, NGOs, credit unions, and cooperatives. DBP also funds other microfinance wholesalers including the various government institutions formed for the purpose. DBP's partner-MFIs are chosen based on certain criteria which focus on their institutional viability and include assessment of their financial practices, performance, and financial condition. Evaluation of their microfinance operations includes assessment of their efficiency, productivity, and level of outreach.

Additionally, in September 2001, DBP launched a financing programme for micro enterprises, intended to facilitate the access of poor entrepreneurs to formal credit and banking services and to promote the active participation of MFIs in providing micro-enterprises with direct access to these services.

Also starting in 2005, DBP will be monitoring the number of jobs generated under the Microfinance Programme to enable the measurement of economic and social gains.

Eufemia Mendoza is a member of the UNEP FI Asia-Pacific Task Force.

"Lending to micro-entrepreneurs contributes to the empowerment of the disadvantaged sectors of Philippine society in their fight against poverty and ultimately towards attaining a better way of life."

MARK EDWARDS

the Bank's activities in early transition countries (Armenia, Azerbaijan, Georgia, the Krygyz Republic, Moldova, Tajikistan and Uzbekistan). Micro and small business lending is central to the initiative. The ETC initiative is also supported by the US/EBRD SME Finance facility, which promotes private sector growth and economic development in the early transition countries and in South Eastern Europe. A large proportion of the funding is allocated to training staff in local banks, and to reducing legal and regulatory obstacles to small business finance.

In addition, the EBRD has established an environmental credit line agreed between the Hungarian Ministry for Environment and Regional Policy, the EBRD and the EU. The credit line is operated by Budapest Bank, through which loans are provided to private companies for environmental protection investments, to help these enterprises achieve compliance with Hungarian and EU environmental regulations and standards, and to further improve their environmental performance. In cooperation with the Global Environment Facility (GEF), the Bank has also set up a joint credit line through financial intermediaries, for Slovenian SMEs to reduce pollution levels of the River Danube and to control effluent discharges from SMEs into this international waterway.

Mark King is Chair of the Central and Eastern European Task Force.

"Growth in small private businesses is key to alleviating poverty and raising living standards."

UNEPFI Regional Task Forces

Low income banking becomes mainstream in South Africa

Charles Mudiwa
Director, Convenience Banking,
Standard Bank, South Africa

The South African economy is changing as the country's growing population moves into the mainstream, and low-income earners start using transaction and savings accounts. The political environment is changing as well. Banks are now committed to agreements spelled out in the Financial Sector Charter, which sets targets for banks to expand their services to presently unbanked people, and awards points when targets are achieved. Thus Banking is also changing. The traditional markets for retail banking are mainly saturated, meaning that any significant growth has to come from new markets. The obvious strategy to follow, therefore, is to bank the unbanked and to provide more products and services to low-income customers.

But how does a firmly established traditional South African bank change its approach to service a different, lower income, customer segment in a profitable and sustainable manner?

Understanding the need to be proactive, Standard Bank entered the low-income market as of 1994. Through the launch of its E-Bank and its single E-Plan product offering, positioning and delivering, Standard Bank has managed to attract and retain low-income customers.

Although products such as the E-concept were innovative in their time, in fast-moving present-day South Africa, what was good in the 1990s is not effective in today's competitive low-income space. It quickly became apparent that to be successful in the low-income market, a complete rethink was needed of existing banking platforms and cost structures, and indeed, of the full co-operation processes between government and community-based organisations.

Experience has also taught us that low-income customers are becoming increasingly financially sophisticated, that they are resilient entrepreneurs and value-conscious customers. Low-income customers currently constitute 70% of the Retail Bank's customers.

Today, Standard Bank is moving towards a new model to respond to the demands of the South African context – a model that requires constant innovation and a real commitment to meeting customer needs.

The provision of physical access is one issue requiring innovation in order to provide financial services to the unbanked. An innovative solution was found in the "bank in a box" concept – a point of representation that is built off-site and delivered fully functional within 30 days of ordering. This concept allows incredible speed to market while the cost is half that of a conventional branch and it has the same functionality. To date, 28 mobile branches have been placed in urban townships and deep rural areas. All have shown promising sales results.

Other innovations include the bank's use of technology to improve access. Broad-based satellite technology has been used to increase the number of ATM points and communication links in rural areas that lack traditional telecommunication systems. The bank is also currently investigating the possibility of establishing alliances with appropriate retailers in an effort to improve customer access.

A glimpse of social returns in Ecuador's microfinance market

Mónica Hernández-Phillips
Executive Vice-President, Banco Solidario

From December 2003 to December 2004, the Microfinance industry in Ecuador grew by approximately 96%, at which point the total reported portfolio value, according to the Bank Superintendence, was in the range of USD 328 million. Nevertheless, a study by the Salto/USAID project suggests that an additional 467,508 Ecuadorian micro-entrepreneurs need access to financial services in urban areas, plus a large number in rural areas. The urban segment has been served by approximately 442 service points of Microfinance Institutions (MFIs), created in recent years by NGOs, cooperatives, financial institutions and banks.

The number of actors demonstrates how competitive the Ecuadorian microfinance market has become. For clients, this offers a clear benefit, as they can choose between different services and institutions, which are forced to become increasingly efficient and creative. Nonetheless, a competitive market can be a threat if market actors, looking only for short-term financial results, lend irresponsibly, as this can lead to clients becoming over indebted. This, in turn, could affect the very objective of the microfinance industry, which is to promote economic and social development for a more just and equitable society.

Together with a group of other MFIs, Banco Solidario is promoting the following activities to ensure social responsibility in the microfinance market:

In order to better meet customer needs, Standard Bank has also introduced a broader range of solutions, including the FuneralPlan, home loans, Society Scheme accounts, and personal loans, aimed specifically at this market. In line with the Financial Sector Charter, Standard Bank further launched a basic banking account for unbanked individuals on the 25th October 2004 as part of an industry-wide initiative overseen by the South African Banking Association: the Mzansi BlueAccount.

Some 21 890 accounts opened across all participating banks in the first month following the launch. Since July 2005, Standard Bank has had 258 000 Mzansi account holders. Other exciting initiatives include pro-active sales strategies, consumer education activities and relevant marketing and communication. All these strategies are aimed at demystifying banking and placing the sector within reach of all for a sustainable future.

S.J. KRASEMANN

"Low-income customers are becoming increasingly financially sophisticated. They are resilient entrepreneurs and value-conscious customers."

- the establishment of technical credit bureaux;
- the enforcement of strict codes of ethics to ensure the welfare of each client and a healthy and competitive industry in the long-run;
- outreach to new markets and new geographical areas – the penetration rate should reflect the actual number of additional clients served, rather than a higher number of credits to the same number of clients, as this may mean granting more credit than the client can afford;
- the establishment of both financial and social accountability objectives in response to Ecuador's high poverty index – 43% of the population lives with less than $2 a day and 18% lives with less than $1 a day.

Banco Solidario operates according to the concept of "social profitability", an idea which the bank actively promotes within the microfinance industry in Ecuador and abroad. For 10 years now, Banco Solidario has combined financial profitability with social profitability, based upon one principle: "we believe in people for who they are rather than for what they own." However, Banco Solidario's philosophy encompasses more than just the products it offers. For those of us who make up Banco Solidario, we feel our products are just the tip of the iceberg. What we really seek is to improve social and financial opportunities, as well as to change mentalities. The idea is to secure the well-being of all Ecuadorians, especially the poor, who have been held back due to a lack of access to traditional banking products.

Mónica Hernández-Phillips is a member of the UNEP FI Latin American Task Force.

"Banco Solidario combines financial profitability with social profitability, based upon one principle: we believe in people for who they are rather than for what they own."

Insuring for a sustainable future

Climate: a core business issue

Brett Maguire
Corporate Affairs Advisor: Community & Environment, IAG Insurance Group

"There is little doubt that Australia will face some degree of climate change over the next 30-50 years.

The truth is weather and climate are core business for all insurance companies."

A common question posed to Insurance Australia Group (IAG) is "why would an insurance company be interested in climate change?"

The truth is weather and climate are core business for all insurance companies. The fact that 19 of Australia's 20 largest insurance events have been weather related is a simple but startling fact, and explains IAG's urgency in addressing the climate change issue.

Globally, temperatures have risen by 0.6°C over the past century, with the 1990s representing the warmest decade since reliable instrumental records have been available. Research shows small climate pattern changes such as this can result in an increase in the frequency and ferocity of severe weather events.[1]

IAG is the leading motor and home insurer in Australia and New Zealand, so these changes in weather patterns can have a serious impact on our business.

To address the issue of climate change IAG is:

- investing in research in collaboration with organisations like the World Wildlife Fund and the Australian Bureau of Meteorology;
- developing adaptation strategies to minimise risk through research into building material vulnerability;
- investigating strategies that minimise our own and our customers' contribution to climate change;
- promoting environmentally friendly business practices within our supply chain.

IAG's work with the World Wildlife Fund involved a number of climate change experts and resulted in the two groups establishing the Australian Climate Group (ACG). In July 2004 the ACG released a report calling for Australia's political leaders to reduce Australia's greenhouse gas emissions by 60% by 2050.

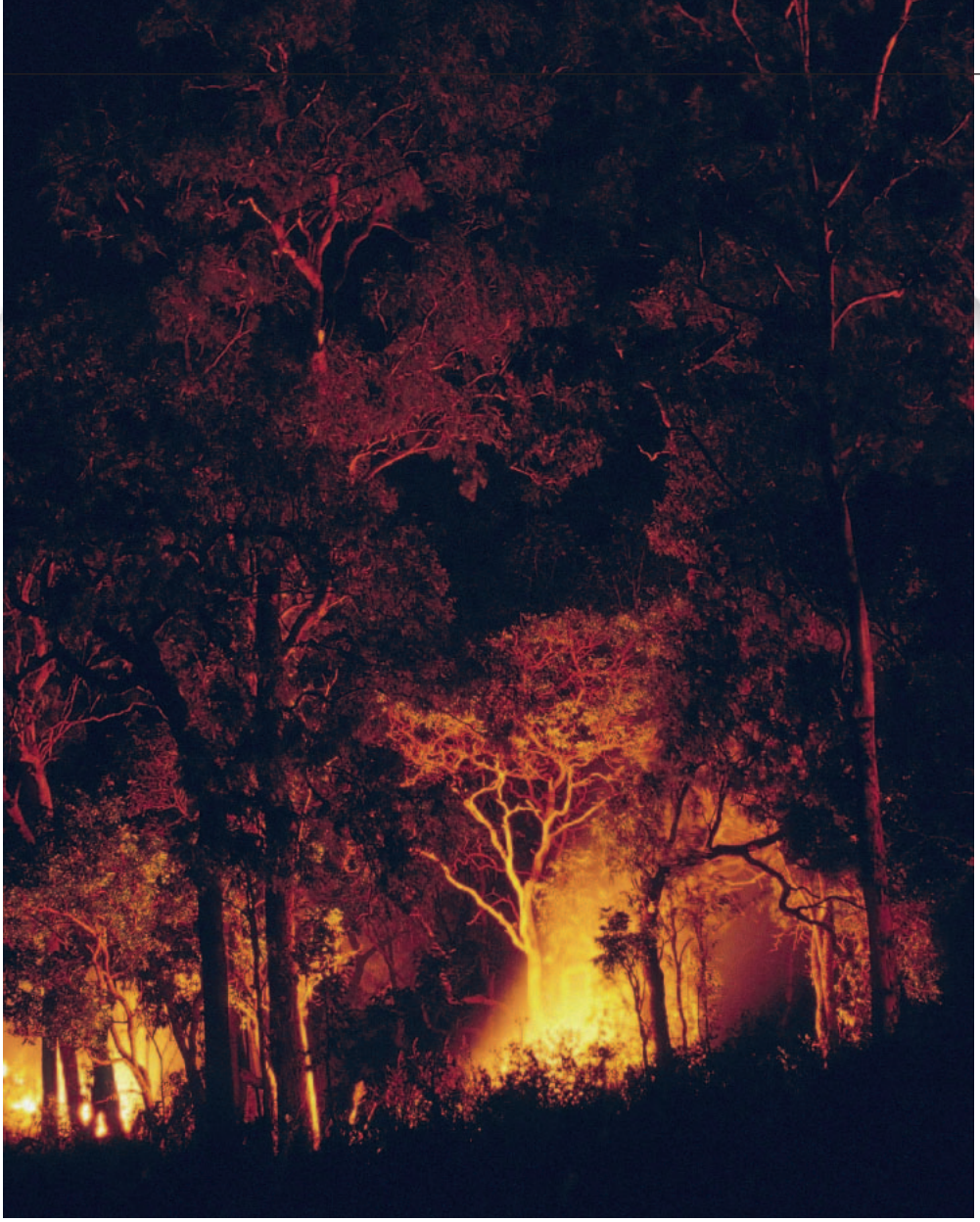
The ACG report became one of the drivers behind the Federal Government's decision to become significantly involved in the climate change debate. In March this year, the Department of the Environment and Heritage released its own report titled *Climate Change Risk and Vulnerability.*

The Federal Government's report supported the view that climate change is real, stating: "there is little doubt that Australia will face some degree of climate change over the next 30-50 years..."

1. Australian Climate Group 2004, Climate Change: Solutions for Australia. Prepared for Insurance Australia Group and World Wildlife Fund.

Driving a deeper

MARTHA COOPER



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"The startling fact that 19 of Australia's 20 largest insurance events have been weather related explains Insurance Australia Group's urgency in addressing the climate change issue."

understanding of sustainability

Mitsuru Muraki
Deputy General Manager, The Tokio Marine & Nichido Fire Insurance Co., Ltd

In recent years, the world has been grappling with natural disasters. Japan has been affected by a record 10 typhoon strikes, while the Japanese insurance industry has made the largest storm-related insurance payout in history, worth approximately USD 6.6 billion in 2004.[1]

Reacting to the new reality of increasingly frequent natural disasters, Tokio Marine & Nichido Fire Insurance has been offering environment related products, such as weather insurance and weather derivatives since 1999 and 2000 respectively, for businesses affected by weather. In addition to this, the company has invested in environmental related ventures including energy efficiency and water purification. As such, the carrying amounts of the weather derivative contracts at March 31, 2004 and 2005 approximately USD36 billion and USD20 billion respectively.

In the future, we foresee further developments in financial products and services associated with environmental risks. The Research on the Scientific Basis for Sustainability (RSBS) project is an international study on the global environment undertaken by over 100 scientists to objectively examine and consolidate the scientific knowledge about sustainability today. The study to be launched this autumn aims to provide a useful information platform for realizing a sustainable society.

As a non-life insurance company dealing with risk management, Tokio Marine & Nichido Fire Insurance finds the study on the objective analysis and assessment of global environmental issues to be in line with its mission and has become the sole sponsor of the project.

1. The General Insurance Association of Japan estimates the losses through natural disasters in 2004 at Yen 727.4 billion

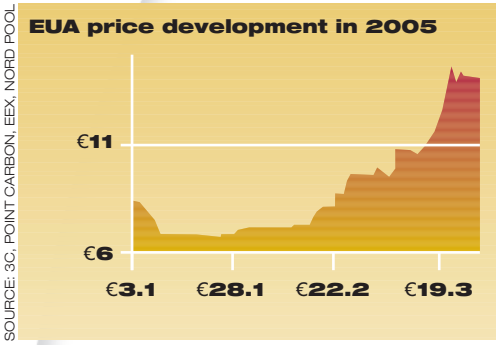
Mitsuru Muraki is a member of the UNEP FI Asia-Pacific Task Force.

Emissions Trading in 2005

Volatile but promising

Dr. Sascha Lafeld
Managing Director,
3C climate change consulting GmbH

Since the birth of the EU emissions trading scheme in January 2005, the price for EU allowances (EUAs) has been highly volatile. Starting at €6-7/t in January, market prices climbed rapidly until July with prices peeking around €30/t. After that, the price came down to a possibly range-bound market of around €20/t in August (see graph below). The reasons for this roller coaster ride are manifold: movements in commodity prices such as coal or gas, political decisions such as the approval of relatively tight national allocation plans in some of the Eastern European Countries and the hot summer in southern Europe all played a significant part. It must be emphasized that such volatility creates a challenge not only for buyers who have to hedge their liabilities, but also for sellers who want to maximize their revenue. However, rapid price movements are typical for new and immature markets, in particular due to limited liquidity in the market. The overall trading volume in 2005 can be estimated at approximately €5 billion.



SOURCE: 3C, POINT CARBON, EEX, NORD POOL

Trading activities with Certified Emission Reductions (CERs) from Clean Development Mechanism (CDM) projects and Emission Reduction Units (ERUs) from Joint Implementation (JI) projects lagged behind experts' expectations in the first half of 2005. By July only 38 million of project-based certificates had been traded. The reasons for this restraint can be seen in the various risks incorporated in CDM/JI projects (see UNEP FI CEO Briefing on Carbon Finance, December 2004). However, the on-going delay of project registration at the CDM Executive Board (CDM EB) and the fact that JI rules and procedures are still to be finalised are also major causes for the CER/ERU market not living up to its potential. By August 2005, only 12 CDM projects had been registered with the CDM EB, generating a rather modest 45.2 million CERs by 2012. The buyer side is more bullish – over €1,2 billion paid into governmental and private carbon funds are due to be invested in emission reduction projects and corresponding reduction certificates.

Dr. Sascha Lafeld is an Advisor to the UNEP FI Climate Change Working Group.

UNEP FI publications

Overview 2004

This summary document provides an overview and introduction to the structure and activities of UNEP FI – through its working groups and task forces, and highlights key meetings and publications from 2004.

0.618... Issue 5

In this issue: UN Responsible Investment Initiative; universal owners, fiduciary duty and materiality; transparency initiatives; Enhanced Analytics Initiative; mobilizing ownership – the civil economy agenda; changing mandates; insights into outsourcing; the new frontier – responsible investment in emerging markets; regulator perspective; regional updates – Brazil, Japan, Emerging Europe, South Africa; UNEP FI publications.

CEO Briefing - Finance for Carbon Solutions

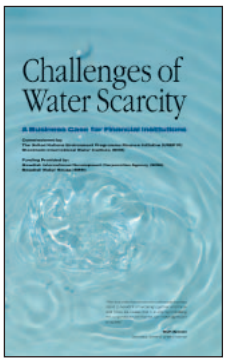
Produced by the UNEP FI Climate Change Working Group (CCWG), this paper focuses on the Clean Development Mechanism (CDM) and builds on the CCWG's work on carbon finance.

The briefing pinpoints barriers to implementation and financing of CDM projects as seen from the financial sector perspective. Recommendations on how these barriers can be overcome are provided.

CEO Briefing - Sustainability Banking in Africa

Summarises the main findings of the Sustainability Banking in Africa Report, produced by the African Institute of Corporate Citizenship (AICC) in 2004. It provides an overview of what sustainability banking means in the African context, analyses the current role of the finance sector in the promotion of sustainability in Africa and in so doing provides examples that are potentially replicable elsewhere across the continent.

Risks of water scarcity



The work presented in this report by the United Nations Environment Programme Finance Initiative (UNEP FI) and the Stockholm International Water Institute (SIWI) highlights the importance of private sector participation in the water sector for the benefit of water sustainability.

The report calls on financial institutions to become aware of the challenges of water scarcity and to engage in actions to overcome them through risk management tools, investments and dialogue with business partners, national governments and local communities.

Publications still to come in 2005

- CEO Briefing: a financial services perspective on Climate Policy post 2012.
- CEO Briefing: sustainability management and reporting in developing and emerging economies.
- Asia Pacific Task Force (APTF) brochure: describing the activites of the newly-launched task force in this dynamic region.

Why 0.618…?

The UNEP FI newsletter is named: 0.618…. Many readers will ask "Why?" The reason behind our choice of name for the newsletter is given in Peter L. Bernstein's book: *Against The Gods. The Remarkable Story of Risk*.

In a fascinating section in chapter two – covering the very beginnings of our modern day understanding of risk – Bernstein explains: "The Greeks knew this proportion and called it "the golden mean." The golden mean defines the proportions of the Parthenon, the shape of playing cards and credit cards, and the proportions of the General Assembly Building at the United Nations in New York… The golden mean also appears throughout nature – in flower patterns, the leaves of an artichoke, and the leaf stubs on a palm tree".

Also known as the Fibonacci ratio, after the 13th century Italian mathematician of that name, the ratio defines the shape of a spiral which appears in some galaxies, seashells and the coil of ocean waves. The journalist William Hoffer remarked: "the great golden spiral seems to be nature's way of building quantity without sacrificing quality."

0.618… believes that for financial institutions the challenges and opportunities posed by sustainable development centre around an ability to build wealth for shareholders and communities while contributing to the protection of the natural environment – in essence, building quantity without sacrificing quality.

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UNEP FI
Innovative financing for sustainability

The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique public-private partnership between the United Nations and the financial sector.

Mission

"To identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations."

Background

The concept of UNEP FI was launched in 1991, when a small group of commercial banks joined forces with UNEP to catalyse the banking industry's awareness of the environmental agenda. In May 1992, the UNEP Financial Institutions Initiative was established, followed by the UNEP Insurance Industry Initiative in 1995. Both Initiatives were merged into the current, joint, Finance Initiative in 2003, following the first joint Annual General Meeting held in October 2003.

Today, UNEP FI is the largest global voluntary partnership of its kind, with some 170 signatories to the UNEP FI Statements. UNEP FI members include bankers, insurers and fund managers, all working together to understand the impacts of environmental and social considerations on financial performance.

Why Join UNEP FI?

Financial institutions are under closer scrutiny than ever before. Investors and regulators are increasingly asking challenging questions about corporate governance, the social and environmental impacts of operations and investments and how institutions support their local communities.

Answering these questions is not easy and requires organisations to change policies and practices. This may seem a daunting task. But membership of the United Nations Environment Program Finance Initiative (UNEP FI) has proved invaluable, helping hundreds of signatories since 1992 to understand stakeholder concerns, exchange best practice and stay on top of the issues.

Membership in UNEP FI is about learning how to turn sustainable development into an opportunity for growth.

UNEP **Finance Initiative**
Innovative financing for sustainability

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