15 January 2024

General Council for Islamic Banks & Financial Institutions (CIBAFI)
Office 71, Building No. 657
Road No. 2811, Block No. 428
Manama
Kingdom of Bahrain

**Comment on CIBAFI's Exposure Draft Titled "Development of a Greenhouse Gas Measurement Tool to Reinforce the Role of Islamic Financial Institutions in Supporting Climate Action"**

To Whom It May Concern:

Thank you for the opportunity to offer feedback on the exposure draft related to the CIBAFI Greenhouse Gas Measurement Tool for Islamic Financial Institutions. Our comment primarily focuses on the alignment of proposed standards with the unique characteristics of Islamic financial institutions (IFIs), concerns related to PCAF requirements for reporting scope 3 emissions, and considerations regarding the timeline and convergence with global standards.

**Aligning Islamic Finance Emissions Reporting with PCAF Guidelines:**

Islamic finance is fundamentally designed to be oriented around the real economy and should maintain that position relating to the emissions it finances, at least to the same degree it applies to conventional banks. As a result, we disagree with the recommendation in the Exposure Draft that makes customer Scope 3 emissions disclosures voluntary without a timeline for convergence with the sector-based phase in of Scope 3 disclosure requirements that are a part of the PCAF standard. Our position does not preclude incorporating transitional arrangements reflecting the size and capacity for Islamic finance that may necessitate some alternative arrangements. However, if such transitional accommodations are provided, they should be temporary and ensure predictability about the timeline for convergence with PCAF guidance.

The Exposure Draft justifies the proposal as follows:

RFI Foundation, C.I.C.
1 The Sanctuary
Westminster, London SW1P 3JT
United Kingdom

> "per PCAF and GHG protocol guidelines, financial institutions shall report counterparties' absolute scope 1 and scope 2 emissions across all sectors for the selected asset classes. For reporting counterparties' scope 3 emissions, PCAF follows a gradual approach, which requires scope 3 reporting for lending to and making investments in companies depending on the sector in which they are active (i.e., where they earn revenues). In the context of Islamic finance, given that most IFIs do not report GHG emissions, **we recommend adopting a phased-in approach that requires GHG reporting only to counterparties scope 1 and scope 2 and leaves scope 3 reporting optional** depending on the sector, data availability, and GHG maturity practices at the level of IFIs and of the countries where they operate. [...] The same reasoning applies to measuring and reporting avoided and removed emissions [which] is optional. However, these emissions shall always be reported separately from the Islamic financial institution's scope 1, 2, and 3 GHG inventories" (emphasis added)

Each of the justifications described in the logic above has merit but as drafted, the standard will make disclosure standards different for IFIs, impairing their comparability with disclosures made by PCAF signatories, and ultimately create frictions that will limit access of IFIs to global responsible finance markets.

The source of our concern about the current text of the Exposure Draft is that it introduces competitive challenges for IFIs as they and the markets in which they operate work pursue desperately needed finance to support the transition to decarbonizing economies in line with national Net Zero targets and the overarching goal set forth in the COP 28 Declaration including:

- "tripling renewable energy capacity globally and doubling the global average annual rate of energy efficiency improvements by 2030"
- Transitioning away from fossil fuels in energy systems, in a just, orderly and equitable manner"
- "Accelerating zero- and low-emission technologies"
- "Accelerating the reduction of emissions from road transport on a range of pathways, including through the [...] rapid deployment of zero- and low-emission vehicles

By weakening expectation for IFI emissions reporting to make optional the disclosure of scope 3 emissions of their customers, it will lead to significantly more limited disclosure compared to PCAF signatories. These banks, if they follow the PCAF Standard phase-in of customer Scope 3 emissions disclosures, will be reporting for full scope 1, 2 and 3 data for customers involved in energy (oil & gas), mining, transportation, construction, buildings, materials and industrial activities.[1]

[1] PCAF. 2022. *Financed Emissions: The Global GHG Accounting & Reporting Standard Part A*, Table 5-2, page 51.

Many banks have set targets for reducing their financed emissions in line with the national Net Zero targets of their home markets, which requires real economy decarbonization that covers all scopes of emissions. Standards covering the same type of activities (financial intermediation) in the same markets presents substantial greenwashing risk through arbitrage between different disclosure standards.

Many IFIs are part of larger banking and financial groups who would be subject to differing standards for a window or subsidiary providing Islamic financial services, which would lead to confusion among stakeholders. It could raise concerns about the potential for greenwashing at the Group level if an entity can reduce its reported emissions by moving financing of activities with large Scope 3 emissions from one part of its operations (conventional banking) to another (Islamic banking).

The risk illustrated in the preceding paragraph is an example of 'paper decarbonization' which refers to financial institutions and investors making changes to their sectoral allocation away from higher emitting companies towards lower emitting companies in order to target a quantitative financed emissions reduction level even if the within-sector intensity of emissions is unchanged, and high emissions companies are moved to less climate aware financial institutions and investors.

It has been of particular concern from investor groups like the Institutional Investor Group on Climate Change (IIGCC).[2] It is of particular concern in the financial sector where financial institutions face pressure from investors, regulators and other stakeholders to reduce emissions and it can often be easier to meet these expectations merely by reducing reported emissions. Due to the lack of transparency on banks' portfolios, there is heightened risk and it can be difficult for banks to rebut these types of greenwashing allegations.

This is an important group for Islamic banks for whom global investors are key stakeholders as shareholders and buyers of sukuk issued by Islamic banks. Many investors take portfolio-wide climate risk into account in their purchases.  If the methodology for disclosure of climate risk includes reporting methodologies that differ materially from those adopted by similarly situated conventional banks or by Islamic banking windows or subsidiaries, it could lead to widening of pricing differentials and higher cost of funds for Islamic banks.

Therefore, we recommend modifications to the Exposure Draft treatment of customer Scope 3 emissions that would offer accommodation reflecting the size, capacity and data availability for IFIs while still provide greater comparability for users of the reported data compared to what is currently proposed.

---

[2] https://www.sgvoice.net/reporting/2203/transition-plans-need-credibility-not-paper-decarbonisation-iigcc/

We recommend that if the PCAF guidance is to be eased for Islamic banks, there should be a specified and limited duration which the disclosure requirements converge to the PCAF requirements. We recommend also requiring Islamic banks who rely on this accommodation to provide a qualitative disclosure of material sources of Scope 3 emissions that will be excluded under the accommodation that would have been quantified and disclosed under the PCAF standard.

**Time Frame and Convergence with PCAF:**

In reviewing CIBAFI's review of existing methodologies (See table below), we noticed a discrepancy between the timeline referenced in the CIBAFI report in Table 22 and the previously referenced Table 5-2 from the PCAF 2022 standard.[3] .

| **Considered Sectors** | **Phase in period** | |
|---|---|---|
| | **PCAF[4]** | **CIBAFI[5]** |
| At least energy (oil & gas) and mining | For reports published in 2021 onwards | From 2021 |
| At least transportation, construction, buildings, materials, and industrial activities | For reports published in 2023 onwards | From 2024 |
| Every sector | For reports published in 2025 onwards | From 2026 |

The material presented by CIBAFI is described as "PCAF follows a phased-in approach requiring Scope 3 emissions reporting depending on the company sector as follows". This provides the impression that the table represents PCAF's guidance despite differences with what is published in the PCAF standard.

If this table is instead referencing the CIBAFI proposal for phase-in of customer Scope 3 emissions, it would be consistent with the points laid out above in our comment and we would support it. However, we would expect this phase-out time frame be included in the Exposure Draft with justification for the alternative timeline as a way to achieve convergence over time with the PCAF standard.

[3] CIBAFI. 2023. *Greenhouse Gas Measurement Tools in the Context of Islamic Finance: A comprehensive review of existing methodologies.*
[4] https://carbonaccountingfinancials.com/files/downloads/PCAF-Global-GHG-Standard.pdf
[5] https://www.cibafi.org/images/FI208
A%20comprehensive%20review%20of%20existing%20methodologies.pdf

We believe this form of timeline would be useful as a part of setting transparent expectations and ensuring clarity in the convergence process that would enable Islamic banks to align with PCAF guidance over time with some accommodation for constraints related to their size, capacity and data availability.

**Sector Guidance: Real Estate and Vehicles**

The treatment of real estate and vehicles for emissions disclosure purposes seems to be a relevant case for distinguishing between Islamic finance and conventional finance, particularly for leasing and diminishing musharaka financing. One of the objectives in the structures of the contracts from a Shari'ah perspective is that the lessor or provider of capital is able to pass operational control to the lessee or managing partner but is not able to separate from the assets they own as they are in a debt-based transaction (whether through murabaha or tawarruq, or using a conventional loan, where the asset leaves or is never a subject of the transaction except as a security interest).

However, under the Exposure Draft §1.3.6, it notes that "PCAF encourages financial institutions to follow and operational control consolidation approach is to be used to allocate financed emissions [and thus] tenant-related emissions shall be categorized as scope 3 from the lessor's perspective." Similarly under ED §1.3.7, it notes that "The operational control approach seems more appropriate when assessing and reporting greenhouse gas (GHG) emissions associated with vehicle assets."

The weakness associated with this treatment in the proposed methodology is that in both cases, the use of operational control methodology moves the relevant emissions outside of the scope for mandatory reporting. This includes both the operational-related emissions of real estate and vehicles as well as the embedded emissions from their construction or manufacture.

In the PCAF methodology, there is justification offered for excluding construction emissions for real estate where the mortgage finance is used for constructing or renovating a house "since the homeowner is not directly accountable for construction emissions [which is] performed by a third party". The same logic is applied to istisna'a finance in the Exposure Draft on the basis that it would not be reportable under PCAF based on the "difficulty for financial institutions to measure financed emissions of a construction or renovation financing unless the project developer reports construction emissions".

However, extending this logic beyond real estate to include vehicle production would create the unraveling of any financed emissions disclosure if the manufacturer could avoid disclosure by omitting 'production emissions'. It is particularly tenuous to provide this accommodation in the case of istisna'a where the contract's validity for advance payment stems from the knowledge of the unique characteristics of the product that is the subject of the istisna'a.

We would recommend limiting guidance that makes emissions reporting optional for Islamic financing transactions only where emissions are not generated as a consequence of the financing. For example, disclosure should be made in a case where the financial transactions are responsible for generating emissions (e.g., financing purchase of new vehicles and construction of real estate) but not where embedded emissions are not created by the transaction (e.g., purchase of existing real estate assets or used vehicles).

**Other comments**

We appreciate the recommendation for a progressive approach to data quality and asset class coverage (ED §2.3.2.5) and suggest a materiality approach informed to begin by a top-down approach to get the general landscape of materiality at the level of key scope 1, 2 and 3 sources and then refined based on the bank's own data along with external data sources as it works to proactively manage its improvements in data quality, including through engagement with its customers on their reported data.

Sincerely,

Blake Goud
Chief Executive Officer
RFI Foundation, C.I.C.