EU Regulation on Deforestation-Free Products:

Guidance and recommendations for corporates and financial institutions

1. Summary

Deforestation and forest degradation significantly contribute to climate change and biodiversity loss. The United Nations Food and Agriculture Organization (FAO) reports that from 1990 to 2020, an area larger than the European Union, approximately 420 million hectares of forest, was lost to deforestation.[1] The Intergovernmental Panel on Climate Change (IPCC) also noted that between 2007 and 2016, 23% of all anthropogenic greenhouse gas emissions stemmed from agriculture, forestry, and other land use. It's estimated that approximately 11% resulted from forestry and deforestation, while the remaining 12% was linked to direct emissions from agricultural practices such as livestock rearing and the use of fertilisers.[2]

The EU Regulation on Deforestation-Free Products (EUDR) marks a significant milestone in addressing deforestation associated with European supply chains by covering commodities associated with both legal and illegal deforestation. This regulation serves as a solid message to entities involved in agricultural commodity production that crops produced on cleared plots after December 31 2020 will not be able to be sold in the EU, and sets a precedent for other consumer markets, encouraging the elevation of global standards for deforestation and conversion free (DCF) trade.

The implementation of this regulation presents both opportunities and challenges. The requirement for due diligence and plot-level traceability of relevant commodities is crucial to ensuring compliance and provides an opportunity for affected companies to build full internal visibility of supply chain dependencies and vulnerabilities. This has wide reaching benefits including meeting the EU requirements on corporate sustainability and scope 3 reporting and the upcoming requirements for due diligence. However, there are information challenges that raise concerns about the most cost-effective approach to meet the requirements while effectively reducing deforestation on the ground.

2. Key aspects and recommendations

- Voluntary certification against credible criteria can demonstrate compliance with the requirements for stakeholders.
- Transition plans provide a structured framework to help companies identify and guide their pathway to eliminate commodity-driven deforestation from their supply chains.
- Reporting plays a crucial role in conducting due diligence and demonstrating compliance with the information requirements, risk assessment, and risk mitigation outlined in the EUDR.
- Shifting from mere legal compliance to implementing best practices is vital for corporate resilience to climate risks.

3. Introduction

The European Union adopted the EUDR in 2023 to curb the EU market's impact on deforestation and forest degradation worldwide, and protect human rights. The EUDR aims to combat deforestation caused by forestry and agriculture by implementing mandatory due diligence requirements that are geolocated to the point of origin and places liability for ensuring the commodity has not been linked to recent (since 2020) land clearance on the operator and trader. This expands the existing due diligence procedure of the EU Timber Regulation (EUTR) to encompass more commodities such as cocoa and chocolate, coffee, soy, palm oil, cattle and beef, wood and rubber. In addition, it introduces several enhancements, including a due diligence statement (Article 4), a geographic information requirement for tracking the origin of commodities (Article 9), increased customs cooperation (Articles 14 and 24), minimum inspection levels (Article 14), and country benchmarking (Articles 25 and 26). The EUDR will consider any product as high-risk if it is linked to deforestation, even if sourced legally as per local laws, marking a key difference from the EUTR, which only addresses deforestation caused by illegal timber logging.[3]

While the Regulation does not currently target financial institutions (FIs), there is a review clause that is foreseen to expand the regulatory coverage and impose new obligations on FIs under the EUDR in the near future.

4. The EUDR in a nutshell

The European Commission will publish a list that categorises countries (within and outside the EU) as low, standard, or high deforestation-risk. The list will be reviewed and updated periodically. As the identification of commodity origins is mandatory under the EUDR through clear geolocation procedures, all commodities will be traceable back to source, regardless of the quantity or value. The regulation applies equally to products made within the EU or globally. Compliance also needs to ensure that the origin of the commodity was not subject to deforestation after December 31 2020.

Companies must implement due diligence systems involving three key steps:
Firstly, collecting information about the commodity, supplier, and location of production (from Article 9 of the regulation).
Secondly, assessing and managing supply chain risk based on the information collected (Article 10).
Thirdly, implementing suitable mitigation measures that reduce deforestation risks to negligible levels (Article 11).

The obligations for operators and relevant authorities are related to the risk level of the country of origin, with simplified procedures for low-risk areas and greater scrutiny for high-risk areas (outlined in Article 13). Steps two and three are generally not required for low-risk countries.

Non-compliance can result in significant fines and possible exclusion from the EU market. The regulation will be implemented by member states through their national laws and compliance will be ensured at the national level.

The incoming regulations will influence predominantly large corporations, providing an opportunity to overhaul existing governance structures and re-examine commitments to sustainability. These new provisions shift from a regime primarily focusing on information obligations to one that demands specific actions and choices for a socially and environmentally sustainable future. This development is part of the EU's ongoing effort to position Europe as a sustainability leader and implement the Green Deal. This mission includes additional corporate sustainability regulations like the Corporate Sustainability Reporting Directive (CSRD) and the proposed Corporate Sustainability Due Diligence Directive (CSDDD), designed to introduce new environmental and human rights due diligence and reporting obligations for businesses.[4,5]

5. Key implications for corporates and recommendations

5.1 Deforestation definitions and scope of ecosystems

The EU law aligns with the UN Food and Agriculture Organization, which defines deforestation as 'the conversion of forest to agricultural use, regardless of whether it is human-induced or not.[6] The current definition has been criticised as being too narrow and will be reviewed after one year to consider expansion into other wooded land, and after two years to consider expansion into other ecosystems.[7]

5.2 Meeting the due diligence requirements

To comply with the EUDR and effectively manage risks and challenges, operators and traders must comprehensively understand their supply chains. This includes knowing the different actors involved and being aware of activities at each stage. This knowledge allows businesses to identify potential risks and challenges, such as supplier compliance and environmental impact. The EUDR does not permit a mass balance approach to commodities and requires that every unit of the relevant commodity is geolocated and covered by the appropriate due diligence process.[8]

Climate Bonds encourages all companies to develop transition plans that identify emission sources and provide guidance on how they can be mitigated through specific pathways, including Scopes 1, 2, and 3, as defined by the Greenhouse Gas Protocol.[9,10] Such plans are increasingly mandatory under recent EU legislation and are integral to the due diligence process. Scope 3 relates to supply chains and the use of sold products where comprehensive mapping of supply chains (CDP) can help companies comply with multiple regulations and enhance resilience to potential climate risks.[11]

5.3 Risk assessment and management

Assessing data gaps and non-compliance risk is crucial in meeting EUDR requirements. Having access to appropriate tools can facilitate risk mitigation and compliance efforts. Therefore, companies need to ensure that their suppliers are aligned with the same standards. This can be achieved by inquiring about suppliers' deforestation policies, procedures, and risk monitoring practices within the supply chain.

Traders and operators gain valuable insights into their processes and risks by connecting the dots across the supply chain and consolidating trusted data. Sector criteria help ensure regulatory compliance, identify areas of value creation, and highlight potential risk areas.

5.4 Traceability, transparency and accountability

The due diligence requirement requires companies to gather data about the relevant commodities, emphasising the importance of transparency and monitoring for the efficacy of due diligence. However, the diverse nature of the commodity-supply chain in the agri-food sector may challenge standardising traceability mechanisms and implementing technologies crucial for verifying sources and audits. The complexity of agri-food commodity-supply chains further underlines the need for guidelines on best practices for traceability and due diligence compliance.

5.5 Reporting and regulatory measure interlinkages:

The EUDR reporting requirement to consolidate all relevant supply chain information must align with existing and proposed sustainability reporting regulations in the EU. This is particularly relevant to the proposed CSDDD, which extends to all operations and relationships across the value chains.[12] Unlike EUDR, however, the CSDDD does not focus on specific commodities or products.

A synergy between these policies would assist in meeting the mandate's disclosure requirements. Therefore, the Commission must clarify how these regulatory measures will consistently address deforestation, biodiversity loss, and climate change. This clarity is expected in the upcoming amendments. Nevertheless, the EUDR is already contributing to the future compliance and applicability of sustainable CSDDD due diligence and reporting obligations by providing comprehensive and strict deforestation-free due diligence requirements.

In addition, companies should pay particular attention to existing national legal frameworks, for example, France, Germany and Norway, which have adopted or are proposing national corporate due diligence rules.

5.6 Downstream operators and smallholders:

Effective engagement with suppliers is vital for successfully achieving no-deforestation goals, advancing supply chain traceability, and tackling non-compliance issues. It is crucial for companies to communicate their expectations to their suppliers clearly. Furthermore, it is essential to recognise that many suppliers, especially smallholders, may require support and assistance to meet the new requirements.

6. Financial institutions

The EUDR does not encompass FIs but contains a review clause (mid-2025) that could result in an extension of its regulatory coverage and new obligations for FIs under the EUDR or other EU legislation.[13] Climate Bonds supports the expansion as FIs are crucial stakeholders in preventing deforestation through capital allocation screening frameworks and identifying progressive projects and clients to invest in and support.

Including FIs under the EUDR also obliges them to report on mandatory and voluntary principal adverse impacts under the EU Sustainable Finance Disclosure Regulation (SFDR) and explain their due diligence procedures. Integrating deforestation due diligence into existing risk management strategies, processes, and systems is essential to meet the requirements of the SFDR. They ensure that these considerations are taken into account right from the start of any commercial decision-making and risk assessments. The advantage of this approach is that it builds upon the substantial resources and procedures already in place within the organisation.

7. Best practice guidelines

Encompassing essential sustainability aspects across commodities and their supply chains is fundamental for the agri-food system transition and tackling deforestation. On this basis, third-party verified schemes and certifications are a valuable tool to support companies progressing from legal compliance to adopting best practices. By enabling verification of land use and manufacturing practices, these criteria offer comprehensive means to verify the due diligence systems of companies concerning sourcing sustainable products, clarify the steps, and help companies identify how they are exposed to risk.

In this context, Climate Bonds is in the process of creating a framework for assessing transition strategies at the organisational level. These comprehensive pathways and sector criteria will provide guidance to achieve agri-food company environmental and social goals and actions, drawing inspiration from the Transition Finance Principles.[14]

7.1 Agri-Food transition programme

The Climate Bonds agri-food transition programme has been designed to assist in developing the transition plans and underlying criteria that can deliver rapid and meaningful climate impact. It aligns with global goals to almost halve emissions by 2030 and achieve net zero by 2050, following the guidelines of the Paris Agreement. Additionally, it addresses other objectives related to the food system.[15]

In pursuit of these goals, development of the Agri-food transition investment criteria began in 2021, and will cover crop production, livestock production, and DCF supply chains. The set of criteria is expected to be ready for Certification under the Climate Bonds Standard between 2023 and 2024. These new criteria are built upon existing agriculture Criteria, which can already be used to certify assets and activities:

- In the whole agricultural production unit,
- Specific intervention in the agricultural production unit, and
- Supporting activities outside of the agricultural production unit.

Currently, the eligibility criteria are divided into two components that must be met: focusing on a) eligible low-emission agriculture (mitigation requirements) and b) climate resilience agriculture (adaptation and resilience requirements).

7.2 Climate Bonds guidance and tools to ensure EUDR compliance

Climate Bonds approach considers agri-food system objectives that extend beyond climate change, including land use changes, biodiversity, water use and quality, food loss and waste, circularity, and a just transition. In particular:

- **Due Diligence:** The upcoming DCF supply chain criteria are being designed to meet the requirements of the EUDR and enable compliance to be demonstrated in one easy step through Certification.
- **Traceability:** In response to the challenge of ensuring supply chain visibility, Climate Bonds offers clear guidelines for operators, traders, and competent authorities on the best practices for monitoring and compliance.
- **Climate Bonds Standard and Certification Scheme:** This initiative, launched in 2012, was originally created to bolster confidence in the green credentials of green bonds and other debt instruments. It serves as a tool to facilitate quick investment decision-making. With the new **Standard (SV4),** the Certification's scope has been expanded to cover general-purpose instruments, such as sustainability-linked debt instruments, assets, and entities. This requires all transition plans to include commitments that are free from deforestation and conversion.[16]

8. Conclusion

The EUDR introduces strict due diligence requirements which go beyond most current supply chain certification schemes that allow for a mass balance approach. Under the EUDR, every unit of the relevant commodity sold in the EU must have the supporting geolocation data and due diligence system. Climate Bonds is developing agri-food transition pathways and associated criteria for the supply chain actors to align with the requirements of the EUDR, while providing a clear understanding to investors of what is green, and clarity to the regulators on sustainable transition narratives.

The framework goes beyond regulatory obligations, encompassing a broader range of sustainability topics. It includes an assessment tool to evaluate entity-level agri-food transition plans and establishes criteria for supply chain procurement strategies. This enables operators and traders to extend their sustainability efforts and go above and beyond what is mandated by regulations.

[1] FAO, 2020, Global Forest Resources Assessment 2020 Key Findings. https://www.fao.org/3/CA8753EN/CA8753EN.pdf
[2] IPCC, 2022, Mitigation of Climate Change. Working Group III Contribution to the IPCC Sixth Assessment Report (AR6) Summary for Policymakers. https://www.ipcc.ch/report/ar6/wg3/downloads/report/IPCC_AR6_WGIII_SPM.pdf
[3] Global Traceability, EUDR – EU Deforestation-free Regulation What is the new deforestation-free regulation and what does it mean for businesses?, https://www.global-traceability.com/eudr-eu-deforestation-free-regulation/
[4] European Comission. Corporate sustainability reporting, https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en
[5] European Comimission, Corporate sustainability due diligence, Fostering sustainability in corporate governance and management systems. https://commission.europa.eu/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_enb
[6] Carbon brief, 03 April 2023, Q&A: What does the EU's new deforestation law mean for climate and biodiversity?, https://www.carbonbrief.org/qa-what-does-the-eus-new-deforestation-law-mean-for-climate-and-biodiversity/?utm_source&#61
[7] FAQ – EU Deforestation Regulation, https://environment.ec.europa.eu/system/files/2023-06/FAQ%20-%20Deforestation%20Regulation_1.pdf
[8] Ibid
[9] Climate Bonds Initiative, Transition Finance for Transforming Companies https://www.climatebonds.net/transition-finance-transforming-companies
[10]Wbcsd, Green House Protocol https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf
[11]CDP, 2022, Scoping Out: Tracking Nature Across the Supply Chain, Global Supply Chain Report 2022 https://cdn.cdp.net/cdp-production/cms/reports/documents/000/006/918/original/CDP-Supply-Chain-Report-2022.pdf?1678870769
[12] Granted Consultancy, What's the difference between a supply chain and a value chain?, https://grantedltd.co.uk/funding-blog/whats-the-difference-between-a-supply-chain-and-a-value-chain/
[13] CDP, Policy Explainer on the EU Deforestation Regulation (EUDR), https://cdn.cdp.net/cdp-production/comfy/cms/files/files/000/007/880/original/CDP_Policy_Explainer_Deforestation_Regulation.pdf
[14] Climate Bonds Initiative, Transition Finance- Unlocking 1.5C, https://www.climatebonds.net/transition-finance-home
[15] Climate Bonds Initiative, Agri-Food Transitions Programme, https://www.climatebonds.net/transition-finance/agri-food-transitions
[16] Climate Bonds Initiative, The Climate Bonds expanded Standard and Certification Scheme, https://www.climatebonds.net/files/files/certification/brochure-climate-bonds-new-standard-and-certification-scheme-05042023.pdf

Proposal for a regulation on deforestation-free products, https://environment.ec.europa.eu/publications/proposal-regulation-deforestation-free-products_en \

Deforestation and forest degradation – reducing the impact of products placed on the EU market, Public consultation, 03 September 2020- 10 December 2020, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12137-Minimising-the-risk-of-deforestation-and-forest-degradation-associated-with-products-placed-on-the-EU-market/public-consultation_en

European Commission, 2022, FAQs: on new rules for deforestation-free products, https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_5919

WWF, 27 June 2022, Financial institutions must address deforestation and conversion risks, https://wwf.panda.org/wwf_news/?5852466/Financial-institutions-must-address-deforestation-and-conversion-risks

ClientEarth, 6 September 2021, Upholding human rights in the fight against deforestation, https://www.clientearth.org/latest/documents/upholding-human-rights-in-the-fight-against-deforestation/

Fern, What is the EU Regulation on deforestation-free products and why should you care? https://www.fern.org/fileadmin/uploads/fern/Documents/2023/What_is_the_EU_Regulation_on_deforestation_free_products_and_why_should_you_care.pdf

KPMG, 13 February 2023 A high-level introduction to the EU Deforestation-Free Regulation. What it means for international supply chains, https://kpmg.com/be/en/home/insights/2023/02/sus-the-eu-anti-deforestation-regulation.html

Preferred by Nature, EUDR – Tackling deforestation and forest degradation in supply chains, https://preferredbynature.org/EUDR

IUCN, 6 December 2022, EU adopts Regulation for deforestation-free products: effective complementary measures key for conservation, https://www.iucn.org/news/202212/eu-adopts-regulation-deforestation-free-products-effective-complementary-measures-key

ClientEarth, December 2021, The proposed EU law on deforestation-free products, https://www.clientearth.org/media/sbjhtw3c/eu-deforestation-proposal_main-elements-and-omissions_dec21.pdf

FAIR, EU Regulation on Deforestation-Free Products, Explained, 09 march 2023, https://www.fairr.org/article/eu-regulation-on-deforestation-free-products/

Global Canopy, 25 May 2023, Financial institutions must act now to end deforestation finance. Here's how, https://globalcanopy.org/insights/insight/financial-institutions-must-act-now-to-end-deforestation-finance-heres-how/

Global Canopy, 25 April 2023, Due Diligence towards Deforestation-Free Finance: Guidance for Financial Institutions, https://guidance.globalcanopy.org/wp-content/uploads/2023/06/DFF_due-diligence_April-2023_English_final.pdf

Prepared by Climate Bonds Initiative.

Lead Author: María Alejandra Pulido

Contributing Author: Rachel Hemingway

September 2023 www.climatebonds.net

Disclaimer: The information contained in this communication does not constitute investment advice in any form and the Climate Bonds Initiative is not an investment adviser. Any reference to a financial organisation or debt instrument or investment product is for information purposes only. Links to external websites are for information purposes only. The Climate Bonds Initiative accepts no responsibility for content on external websites. The Climate Bonds Initiative is not endorsing, recommending or advising on the financial merits or otherwise of any debt instrument or investment product and no information within this communication should be taken as such, nor should any information in this communication be relied upon in making any investment decision. Certification under the Climate Bond Standard only reflects the climate attributes of the use of proceeds of a designated debt instrument. It does not reflect the credit worthiness of the designated debt instrument, nor its compliance with national or international laws. A