EU Regulation on Deforestation-Free Products:

A potential game-changer for commodity-driven deforestation

Key Points

- The Climate Bonds Initiative (Climate Bonds) welcomes the European Union Regulation on Deforestation-Free Products tackling commodity-driven deforestation. To ensure the goals of the regulation are delivered, Climate Bonds recommends that policymakers:
    - Broaden the scope of the regulation to include financial institutions,
    - Include non-forest high-carbon biomes to ensure strong coverage of at risk ecosystems – such as savannahs and grasslands,
    - Design clear, transparent, and inclusive due diligence requirements, which are developed with stakeholders along the supply chains to enable implementation and monitoring.
- High deforestation-free standards in the EU create a risk of a two-tier commodity trading system. Open dialogue and clear communication channels between the European Commission, Member States and third countries are essential for establishing a collaborative framework to avoid redirecting high- risk commodities into alternative markets.
- Independent, third-party deforestation-free certification schemes can be valuable tools for actors to demonstrate EUDR compliance. Collaborating with these schemes will enable the European Commission to ensure robust compliance, enhancing their capacity to deliver credible measures to mitigate risk.

Introduction

Over the period 2000–2018, nearly 90% of global deforestation was caused by agricultural expansion for crop and livestock production. Reducing deforestation is crucial to address a number of social and environmental crises, including the global threats of climate change and biodiversity loss. However, as over 30% of all food produced is traded within value chains that cross international borders at least twice, traceability to origin is challenging.[1] Although deforestation and conversion of ecosystems mainly occurs during production upstream in the supply chain, downstream firms and suppliers have a critical role to play in ensuring that the risk of deforestation is addressed within the commodity supply chains at source.[2] This is the sector of interest that the EUDR is designed to address.

The EUDR marks great progress in efforts to combat upstream deforestation by setting out legal requirements for companies trading relevant commodities in the EU market, affecting both EU and non-EU producers. It establishes a comprehensive due diligence system for operators and traders selling commodities such as cattle, cocoa, coffee, oil palm, rubber, soya, and wood and derivate products within the EU and expands the existing procedures under the EU Timber Regulation (EUTR). These enhancements involve the inclusion of additional commodities; the introduction of several measure such as a due diligence statement, a geographic information requirement for tracking the origin of commodities, increased customs cooperation, minimum inspection levels, and country-risk benchmarking. The EUDR addresses any relevant commodity produced in a context that has caused deforestation, regardless of whether it is sourced legally per local laws, both within the EU and globally, marking a key difference from the EUTR, which only addresses deforestation caused by illegal timber logging.[3]

This paper explores the EUDR's potential impact and offers recommendations for policymakers. This paper is part of an **ongoing series of tools that Climate Bonds is developing to tackle commodity-driven deforestation**. In 2023, Climate Bonds published a guidance briefing note for investors and corporate actors looking to better understand the requirements of the EUDR and launched the public consultation for investment criteria for deforestation and conversion free (DCF) commodities.[4] These investment criteria provide guidance for debt issuers (including companies and banks) on the steps needed to ensure DCF supply chains and allow for certification of the company as deforestation free, providing confidence to investors and customers that the certified entity produces DCF commodities.

The EUDR is likely to have a far-reaching impact on governments and businesses around the world. Governments outside of the EU will need to carefully consider the implications of the regulation and take steps to adapt their agricultural and trading policies and practices accordingly.

EU Member States and the EUDR

Member state governments play a crucial role in the implementation and enforcement of the EUDR. They are responsible for designating the national competent authorities to oversee the due diligence process and to conduct audits on operators and traders to verify compliance. Additionally, Member states are tasked with providing guidance and support to businesses to help them understand and comply with the regulation.

To ensure accountability and transparency, the EUDR establishes comprehensive reporting requirements for both EU Member States and the European Commission. By 30 April each year, member states must submit detailed reports to the Commission outlining all compliance checks carried out, including quantities of products checked, and origin countries. This information is also used to prepare a public disclosure report, which is released by member states by the same deadline. Additionally, the Commission is tasked with compiling an EU-wide review of the regulation's implementation, which will be published annually by 30 October.

These new provisions mark a 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 such as 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.[5, 6]

EU Member States have a crucial role to play in determining the success of the EUDR given their responsibility for conducting compliance checks on companies placing, using, or exporting covered commodities. The number and scope of these checks will be determined based on a risk assessment conducted by operators and traders, considering the types of commodities, supply chain complexity, and national contexts of the producer countries. The EUDR acknowledges the possibility of third-party verification and deforestation-free certifications as tools for assessing the risk, demonstrating due diligence and meeting the regulation's compliance standards.

If companies fail to demonstrate that their products are deforestation-free**, Member States have the authority to take corrective actions,** such as bans on sales or exports, immediate product withdrawals, and product recalls. Additionally, they can impose proportional penalties, fines, confiscations, temporary exclusions from public procurement and funding, and temporary or permanent prohibitions from trading in the EU.

Given the EUDR covers global supply chains, it's effectiveness for companies that operate outside the EU, the EUDR's effectiveness depends on cooperation with other countries and building credible and functional transparency mechanisms. As the directive is implemented at member state level it will be crucial to have both internal and external policy coherence to ensure the EU members act as an effective and consistent trading bloc.

1. How to ensure the EUDR delivers on its goals

The EUDR is a hugely important piece of legislation to reduce agriculture-driven deforestation and biodiversity loss. Although this first iteration of the regulation is significantly stronger than previous anti-deforestation rulesets, there are several gaps and weaknesses that could be addressed to ensure the policy fulfils its mandate.

1.1 Broaden the scope of ecosystem coverage

The definition of deforestation is based on the concept used by the United Nations Food and Agriculture Organization (FAO). However, it has been criticised for its narrow definition. The EUDR only considers deforestation to be the conversion of natural forests to other land uses, such as agriculture or pasture which **fails to address the regulation's objectives to mitigate commodity-driven deforestation and land degradation by omitting other wooded land' and various ecosystems with significant land biodiversity value**.[7] Expansion of the regulation to cover other important ecosystems and forest risk products is required, including lands with high-carbon stocks and high biodiversity value, such as grasslands, peatlands, wetlands and savannahs.

1.2 Expand coverage to include financial institutions (FIs)

The Regulation currently excludes financial institutions which fails to recognise their pivotal role in curbing deforestation through capital allocation screening frameworks and fostering investments in progressive projects and clients. Expanding the EUDR's scope to encompass FIs could effectively **ensure finance flows** towards more sustainable agriculture and away from deforestation and forest degradation, a crucial step towards halting the financing of detrimental activities.

Additionally, FIs have an obligation to report on both mandatory and voluntary Principal Adverse Impacts under the EU Sustainable Finance Disclosure Regulation (SFDR). Including FIs within the scope of the EUDR framework would ensure the integration of deforestation due diligence requirements into existing risk management strategies, processes, and systems, which is crucial for fulfilling SFDR compliance obligations.

1.3 Deliver due diligence through transition plans

Transition plans provide a roadmap for companies to transition their business models towards sustainability, identifying opportunities and risks along all supply chains. These plans should outline the company's strategies, targets, and actions for achieving its sustainability goals, including reducing greenhouse gas emissions, protecting biodiversity, and respecting human rights. They are a tool that has become widely adopted and understood in global efforts to reach net zero and can play a central role in this due diligence process.

Embedding due diligence requirements within the context of transition plans will facilitate the sourcing of deforestation-free commodities as it requires full material scope coverage and ambitious environmental performance targets linked with science-based pathways. [8] Reinforcing due diligence with transition plans will also ensure **harmonisation with other EU regulations** such as the Corporate Sustainability Reporting Directive (CSRD), Industrial Emissions Directive (IED) and the upcoming Corporate Sustainability Due Diligence Directive (CSDDD).[9]

1.4 Strengthen the support for smallholders

The EUDR outlines potential negative effects, such as heightened costs for producers, especially small-scale ones, and the potential shift of buyers toward lower-risk sources. Although steps have been taken to address these issues, including pledging to engage in partnerships with producer nations and conducting a thorough review of its impact on farmers, specifically smallholders, the exact measures still need to be clarified. More **detailed strategies and reasonable efforts** should be made to support smallholders in meeting the requirements that can be delivered through trade incentives or aid programs, offering technical and financial support developed in collaboration with local governments and other actors of the supply chain.

Additionally, establishing spaces for dialogue involving the different stakeholders is crucial for forming formal partnerships and prioritising fair pricing and a liveable income for smallholders.

2. Recommendations for implementation

Policymakers can ensure a smooth, rapid transition and safeguard development priorities.[10] Deforestation policies must be scaled up to secure a global transition to net zero.

2.1 Benchmarking and country risk assessment

The due diligence measures required from operators and traders will depend on a risk rating assigned to the commodity's country of origin to which the level of oversight and monitoring required from member states will also be closely linked to this risk rating. The European Commission will assign a three-tier risk rating to commodity source countries, determined through a separate implementation regulation.

This rating will consider factors like deforestation rates, production trends, legal frameworks, and the inclusion of land use emissions in a country's climate commitments. It also evaluates agreements between producer countries and the EU that aid compliance with deforestation-free product regulations, involving local communities, civil society, and smallholders.

As the due diligence measures and monitoring efforts are linked to the deforestation risk rating, the effectiveness of the EUDR will depend on the robustness of this assessment. The EU Commission should **adopt a transparent and inclusive approach** to this assessment, ensuring that all relevant information is considered and that stakeholders have a fair opportunity to respond to any concerns. This risk assessment should also be reviewed and updated on a regular basis with a transparent and realistic timeline.

Furthermore, the evaluation should only partially reward the presence of agreements but emphasise their actual implementation. Several clarifications are necessary, including whether the risk rating will be national or sub-national and whether it will apply per commodity. In such a context, the European Commission must engage in a dedicated dialogue with countries classified as high-risk or facing potential high-risk classification, aiming to mitigate their risk levels.

2.2 Enforcement schemes and sanctions

Member States are mandated to conduct annual checks on operators based on the risk level of countries or regions assigned by the Commission. This classification determines the inspection proportions per commodity produced in the country: 9% for high-risk, 3% for standard, and 1% for low-risk areas per commodity. For products from high-risk areas, checks must encompass at least 9% of the commodity produced.

Non-compliance with the EUDR requires corrective actions within the stipulated timeframe. Penalties, set by EU Member States, should align with the environmental impact and product value, with fines starting at 4% of the operator's or trader's annual EU turnover. Penalties could involve confiscation of products, transaction revenue, and temporary exclusion from public procurement and funding. Serious or repeated violations may lead to temporary bans on exporting relevant commodities to or from the EU market and limit simplified due diligence for the operator or trader. Implementing these measures might strain budgetary and administration costs for these countries.

To promote **transparency and compliance while avoiding reliance on enforcement measures,** Member States could prioritise leveraging third-party voluntary schemes and certifications to incentivise good practices without solely relying on penalties.

2.3 Global regulatory integration

The EUDR marks a significant milestone in addressing the drivers of global deforestation, building on the work of countries such as France with their 2018 strategy to combat imported deforestation. **The EUDR encompasses both legal and illegal forms of deforestation**, while other important markets only look at illegal deforestation and for limited commodity coverage. For example, the **United States** proposed the Fostering Overseas Rule of law and Environmentally Sound Trade (FOREST) Act in 2021 to increase transparency and reporting in supply chains to combat solely illegal deforestation of cattle and soy. Similarly, **the UK** introduced the Environment Act 2021, which targets imports associated with illegal deforestation.

Climate Bonds recommends that these trade and import frameworks follow the lead of the EU and look to include both legal and illegal deforestation as well as expand to other at-risk biomes. By establishing a collaborative and integrative framework, developing common standards, and streamlining regulatory processes, countries can develop more effective and comprehensive strategies to address global deforestation and land conversion.

2.4 International trade and compliance of non-EU countries

Under the EUDR, companies, local producers and traders from third countries may see increased export-related costs when trading with the EU. Suppliers exporting to the EU must provide traceability reports, with stricter requirements in specific areas like the Amazon. This has prompted concerns from producing countries such as **Brazil, Colombia, Indonesia, Vietnam and Malaysia,** citing potential risks of non-compliance. These countries argue that the regulation contradicts World Trade Organization principles and could burden smaller enterprises with new technology, processes, and administrative expenses for compliance. [11]

This significantly increases the risk that diversion to other markets will occur as farmers, producers, and traders, in response to the EUDR, simply reroute their supply chains to markets where there are less restrictive deforestation-free requirements, continuing business-as-usual practices either for domestic markets or other major international consumer markets like the US and China.[12]

Establishing this collaborative framework with producer countries is crucial to avoid redirecting high-risk commodities into alternative markets. **Open dialogue and clear communication channels** are essential for building trust and fostering cooperation. Tailored support will help countries with different capacities to meet regulations effectively, ensuring consistent implementation across all partners by addressing their specific needs.

2.5 Ensuring a credible transition

Policymakers can guide the transformation of the agri-food sector, **defining credible practices by incorporating transition frameworks and science-based standards** that set clear pathways into their policies and implementation strategies. This can be facilitated by government action to enable sustainable practices and de-risk the supply chain. These practices and frameworks should be codified within a clear and ambitious transition plan that sets the intention as well as clarifies how the goals will be financed and implemented.[13]

The Climate Bonds Agri-Food Transition Programme has been designed to assist in developing the transition plans and underlying investment criteria that can deliver rapid and meaningful climate impact. [14] It aligns with global goals to almost halve emissions by 2030 and achieve net zero by 2050, following the commitments made under the Paris Agreement. Additionally, it addresses other objectives related to the food system, including protecting biodiversity and ensuring a just transition.

2.6 Mobilising investments to meet 1.5°C.

Investment in the sector's transition needs rapid scaling, involving rerouting of finance flows from high to low-carbon activities, and the growth of overall **agri-food investments** based on credible standards that assist both companies and issuers in identifying activities and processes compatible with net zero. [15]

Transition plans are a core tool for mobilising such capital. Companies need them in order to identify the opportunities and risks from climate change in their business model and **plan how to finance and transform operations to align with a sustainable future.** In turn, financial institutions can use these transition plans to identify credible investments.[16] In addition, policymakers and government bodies can use corporate and financial **transition plans as a tool to identify actors to receive subsidies and incentives for transition activities.**

2.7 Climate Bonds guidance and agri-food transition tools to support EUDR compliance.

The EUDR recognises the role of **third-party verification and certification schemes** as tools to demonstrate due diligence and compliance with the regulation's requirements. Policymakers can contribute by signposting such schemes and certifications that support the implementation and enforcement of mandatory due diligence, underpinning a company's own due diligence efforts.

In 2023, Climate Bonds launched global DCF Sourcing criteria that align with the EUDR requirements. These criteria are supported by our global certification framework for green and transition investments based on credible sector pathways and measures (Climate Bonds Standard Version 4.1). The DCF Sourcing criteria encompass:

- **Due Diligence:** The recently launched DCF Sourcing criteria have been designed to meet the **due diligence** 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 (SV4.1),** 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 to eliminate deforestation and conversion from the entity's operations.[17]

Conclusion

Policymakers play a crucial role in reshaping the agri-food sector. Incorporating transition frameworks and science-based standards into policies aids EU Member States and non-EU nations in adeptly navigating the EUDR shift while actively combatting deforestation on a global scale. Collaborating with accredited schemes is pivotal for facilitating EUDR compliance and achieving net-zero goals.

Bringing financial institutions and investors under the remit of the EUDR will ensure all stakeholders are incentivised to act and channel finance to companies driving forward change. Additionally, expanding the coverage of the policy to include more high value and at-risk biomes would ensure the regulation is able to effectively deliver on its goals.

Climate Bonds is working very closely with the public sector, private stakeholders, and financial institutions for the implementation of agri-food transition pathways and to develop robust guidance and criteria for the supply chain actors to align with the requirements of the EUDR, providing comfort and clarity to investors.

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[2]OECD-FAO, 7 July 2023, Business Handbook on Deforestation and Due Diligence in Agricultural Supply Chains https://www.oecd.org/publications/oecd-fao-business-handbook-on-deforestation-and-due-diligence-in-agricultural-supply-chains-c0d4bca7-en.htm

[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] Pulido, M, Hemingway, R, 2023. EU Regulation on Deforestation-Free Products. Climate Bonds Initiative

[5] European Commission. Corporate sustainability reporting, https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en

[6] European Commission, 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

[7] FAO defines 'other wooded land' as 'land not classified as forest, spanning more than 0.5 hectares; with trees higher than 5 metres and a canopy cover of 5–10 percent, or trees able to reach these thresholds in situ; or with a combined cover of shrubs, bushes and trees above 10 percent. It does not include land that is predominantly under agricultural or urban land use.' See: FAO ,2022, The State of the World's Forests 2022. Forest pathways for green recovery and building inclusive, resilient and sustainable economies,

[8] DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main ("DZ BANK") 10 November 2023, Sustainable Finance Bulletin

[9] Ibid

[10] Burge, L., 2023. 101 sustainable finance policies for, 1.5°C, Climate Bonds Initiative, https://www.climatebonds.net/files/reports/cbi_101_policyideas.pdf

[11] S&P Global, 31 August 2023, Global impact of the EU's anti-deforestation law, 31 August 2023, https://www.spglobal.com/esg/insights/featured/special-editorial/global-impact-of-the-eu-s-anti-deforestation-law#:~:text=The%20EUDR%20mandates%20companies%20placing,market%20have%20not%20caused%20deforestation.

[12] The Nature Conservancy, November 2023, Recommendations on the Strategic Framework for Engagement with Producer Countries and Implementation of Article 30 of the EUDR

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[15] Burge L., Accelerating the fossil gas transition to net zero, Climate Bonds Initiative 2022 https://www.climatebonds.net/files/page/files/cbi_gaspolicy_2022_01d.pdf

[16] DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main ("DZ BANK") 10 November 2023, Sustainable Finance Bulletin

[17] 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

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