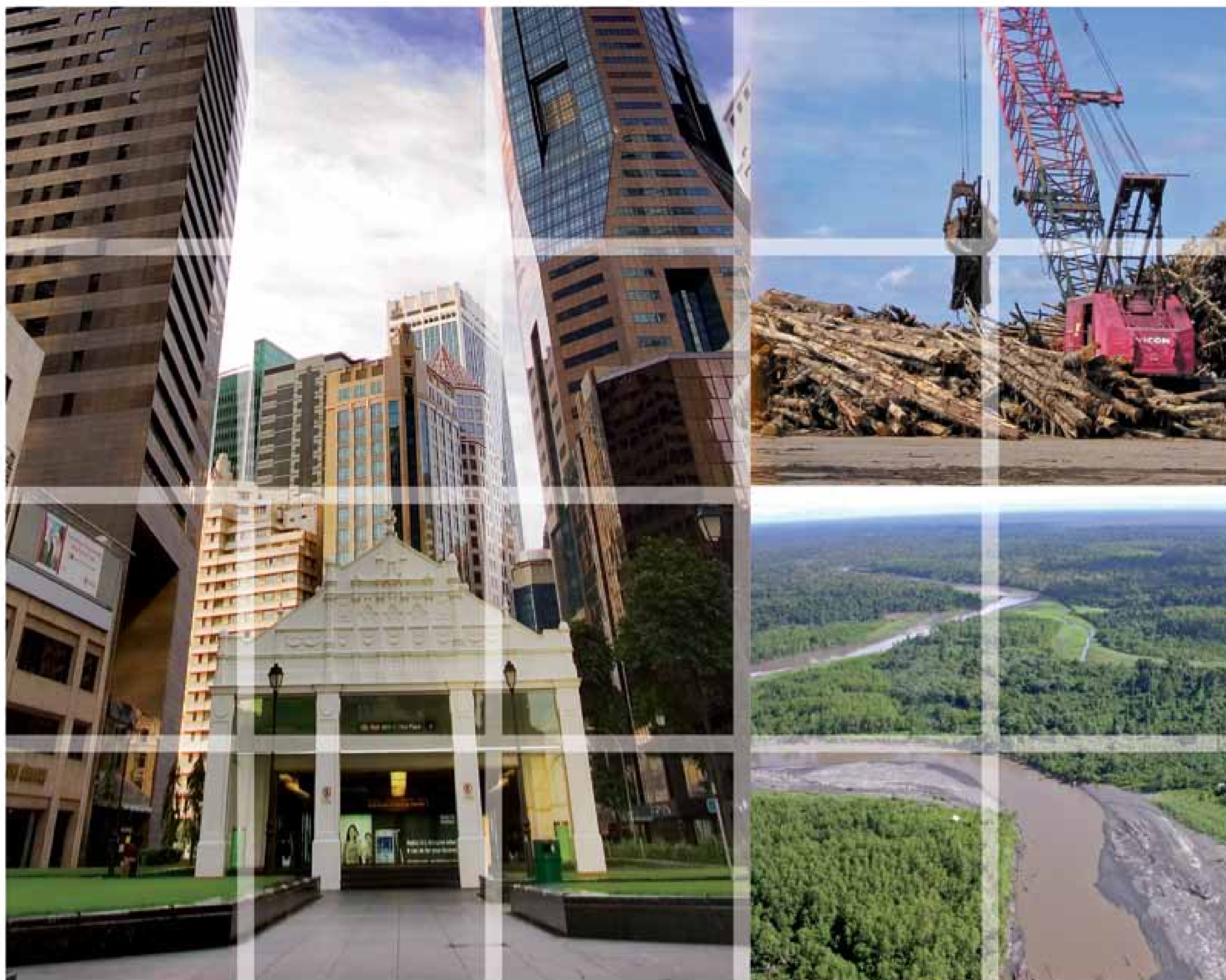
Forests and Governance Programme

No. 11/2007



Debt Settlement of Indonesian Forestry Companies

Assessing the Role of Banking and Financial Policies for Promoting Sustainable Forest Management in Indonesia

Bambang Setiono

CIFOR
CENTER FOR INTERNATIONAL FORESTRY RESEARCH

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Debt settlement of Indonesian forestry companies: assessing the role of banking and financial policies for promoting sustainable forest management in Indonesia/by Bambang Setiono. Bogor, Indonesia: Center for International Forestry Research (CIFOR), 2007.

ISBN: 978-979-24-4680-7
58p.

CABI thesaurus: 1. public finance 2. forest economics 3. companies 4. forestry 5. forest industry 6. monetary policy 7. debt 8. forest policy 9. banks 10. forest management 11. assessment 12. Indonesia

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Photos by Tony K. Tjiptodihardjo, Romain Pirard and Neville Kemp
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Abbreviations and acronyms

ACGL	APP China Group Limited
ACI	P.T. Anugra Cipta Investama
AMC	Asset Management Credit
AMDAL	*Analisis Mengenai Dampak Lingkungan*, Environmental Impact Analysis
AMI	Asset Management Investment
APP	PT. Asia Pulp and Paper
APRIL	Asia Pacific Resources International Ltd.
ATK	Asset Transfer Kit
BAPEPAM	*Badan Pengawas Pasar Modal*, Capital Market Supervisory Agency
BCA	Bank Central Asia
BIS	Bank for International Settlement Standard
BI	Bank Indonesia
BPKP	*Badan Pengawasan Keuangan dan Pembangunan*, State Supervisory Board for Finance and Development
BII	Bank Internasional Indonesia
BPK	*Badan Pemeriksa Keuangan*, the Indonesian Supreme Audit Agency
BPL	P.T. Barito Pacific Lumber
BRPT	P.T. Barito Pacific Timber
BRU	Bank Restructuring Unit
BTO	Banks to be taken over
BUN	Bank Umum Nasional
BLBI	*Bantuan Likuiditas Bank Indonesia*, Bank Indonesia Liquidity Credit
CAR	Capital Adequacy Ratio
CGI	Consultative Group on Indonesia
CLS	Corporate Loan Sale
CRI	Convertible Right Issue
DFF	Donor Forum on Forests
DPR	*Dewan Perwakilan Rakyat*, the Indonesian Parliament
EBITDA	Earning Before Interest, Taxes, Depreciation and Amortization
EFF	Extended Fund Facility
EML	P.T. Enim Musi Lestari
FSPC	Financial Sector Policy Committee
HPH	*Hak Pengusahaan Hutan*, Forest Concession Rights
HPHTI	*Hak Pengusahaan Hutan Tanaman Industri*, Timber Plantation Forest Concession Rights
HTI	*Hutan Tanaman Industri*, Industrial Forest Plantation
IBRA	Indonesian Bank Restructuring Agency
IWGFF	Indonesian Working Group on Forest Finance
IDCF	Interdepartmental Committee on Forestry
IDR	*Rupiah* - Indonesian currency
IMF	International Monetary Fund

INFID	International NGO Forum on Indonesian Development
JITF	Jakarta Initiative Task Force
KPBD	*Komite Penyelesaian Debitur Bermasalah*, Committee on the Settlement of Uncooperative Debtors
KYC	Know Your Customer
MLK	P.T. Muktilestari Kencana
MMDS	Monthly Mandatory Debt Service
MRA	Master Refinancing and Notes Issuance Agreement
MSAA	Master Settlement and Acquisition Agreement
NPL	Non-performing loans
PBI	*Peraturan Bank Indonesia*, Bank Indonesia Regulation
PDBI	*Pusat Data Bisnis Indonesia*, Indonesian Business Data Center
PPAK	*Program Penjualan Aset Kredit*, Loan Asset Sales Program
PPAP	*Provisi Penyisihan Aktiva Produktif*, Productive Asset Allowance Provision
PPATK	*Pusat Pelaporan dan Analisis Transaksi Keuangan,* Indonesian Financial Transaction Reports Analysis Center
RAPP	P.T. Riau Andalan Pulp and Paper
RKPH	*Rencana Karya Pengusahaan Hutan*, Long-term Forest Management Plan
RKL	*Rencana Kerja Lima Tahun*, Five-Year Production Plan
RKT	*Rencana Kerja Tahunan*, Annual Production Plan
RGM	Raja Garuda Mas Group
SIBOR	Singapore Interbank Offered Rate
SHJ	Surya Hutani Jaya
SLJ	Sumalindo Lestari Jaya
SMG	Sinar Mas Group
SML	Senior Amortizing Loans
TSP	P.T. Tunggal Setia Pratama

Acknowledgements

The author greatly appreciates comments from Chris Barr and Doris Capistrano at CIFOR, and from others especially Emile Jurgens from the World Bank, Bintang Simangunsong from the Bogor Agricultural Institute (IPB) and David Brown from the DFID MFP Programme. The author also would like to thank the Indonesian Bank Restructuring Agency (IBRA) for facilitating dialogues and interviews with its staff and Chairman and for providing relevant information for this study. The book would not have been possible without support from members of the Indonesian Working Group on Forest Finance (IWGFF), particularly Binny Buchori, former Chairwoman of the International NGO Forum on Indonesian Development (INFID). Finally, the author would like to acknowledge the generous financial support from the DFID MFP Programme that has made this study possible.

Preface

Ten years later, the reverberations of the Asian financial crisis continue to affect Indonesia's forests. Partly in response to the financial crisis and changing expectations on corporate behavior, banks and other financial institutions have come under greater scrutiny. Recognition of the critical role banks and financial agencies play in every aspect of economic activity has grown over the past decade. However, public awareness of the influence they exert on the use and governance of forests, and actions needed to mitigate any adverse effects remain limited.

In Indonesia, state-owned and international banks and financial institutions have been inextricably linked to industrial growth and wealth creation in the forest sector. During the Suharto regime, state owned and international banks heavily supported wood-based companies to expand their operations and to break into the world market. As a result, in a space of a few years, Indonesian forestry companies became among the major players in international wood markets, particularly in plywood and pulp. Exports of wood-based and pulp and paper products remain among the country's top revenue earners.

However, banks and financial institutions have also been implicated in mismanagement and poor governance of the country's forests. Among others, bank provision of subsidized credit mediated through a system of political patronage has been blamed for inappropriate investment and over-capacity in the country's wood-based industries. Mill capacity of Indonesia's wood-based companies is estimated to be three times more than the amount of wood that could be sustainably harvested annually from plantations and natural forests. This industrial over-capacity continues to be a major driver of deforestation and illegal logging.

The creation of the Indonesian Bank Restructuring Agency (IBRA) to deal with the aftermath of the Asian financial crisis brought much hope and promise of needed reforms in sectors hit by the crisis. This paper chronicles and analyzes what turned out to be a story of dashed hopes and missed opportunities. Sadly, the IBRA story is a story of the road not taken towards better banking practices, sound financial management and improved governance. The story provides many important lessons, for agencies and actors in Indonesia and in other countries. This paper also suggests some means and instruments with which to prevent similar stories from happening again, but these would require more deliberate action and much stronger political will.

Doris Capistrano
Forests and Governance Programme Director

Introduction

1.1 A glimmer of hope

Indonesia's natural forests continue to disappear at an alarming rate. Earlier reports suggest deforestation in Indonesia was occurring at a rate of 1.5 million hectares per year (Walton and Holmes, 2000). At this rate, Sumatra would lose its lowland forests by the year 2005, while those in Kalimantan would be gone after another five years (World Bank, 2001). A more recent report placed the deforestation rate even higher at 2 million hectares annually (FWI/GFW, 2002). The latest report from the World Bank suggests that 2.1 million hectares of forest were lost every year in the period between 1990 and 2000 (World Bank, 2006). With this rate of deforestation, natural forests in many parts of Indonesia will have vanished within the foreseeable future.

Before the Indonesian financial crisis in the middle of 1997, little could be done to change the way Suharto's regime managed the Indonesian forest sector.[1] The Indonesian Wood Panel Association (APKINDO) controlled by Suharto's close associate Mohammad 'Bob' Hasan monopolized the plywood market, the Minister of Forestry had large discretionary power in granting forestry concessions and licenses, and the Minister of Trade and Industry issued milling permits for amounts far in excess of the sustainable wood supply. Local governments and forestry companies ignored the rights of local communities and stakeholders in utilizing forestlands. Furthermore, military personnel and companies reportedly played a major role in businesses in the Indonesian forestry sector (Barr, 2001a).

Despite these grave threats, Indonesian and international civil society organizations saw a glimmer of hope when the Indonesian financial crisis brought down not only Indonesia's 'emerging tiger' economy, but Suharto himself, after thirty-two years in power. Before his departure in January 1998, Suharto entered into an agreement with the International Monetary Fund (IMF) to revitalize the Indonesian economy. The IMF offered a bailout loan agreement worth USD 43 billion to the Indonesian government and, in exchange, the Indonesian government committed itself to major economic, banking, legal, and governance reforms. With input from the World Bank, the IMF introduced a number of forestry reforms aimed at mitigating the deforestation problems mentioned above.

A number of civil society organizations, which would later form an informal network called the Indonesian Working Group on Forest Finance (IWGFF), provided input when the Indonesian government committed to eight forestry sector reforms. At the beginning of 2000, in the process of securing new foreign loans, the Indonesian government made several commitments to the international donor community and the Consultative Group on Indonesia (CGI), including commitments in the forestry sector.[2] Five months later, with support from the Donor Forum on Forests (DFF), the World Bank, and members of IWGFF, the Indonesian government established the Interdepartmental Committee on Forestry (IDCF). The main objectives of the IDCF were to formulate policies and to coordinate the handling and resolution of problems with forest resources management and conservation at both the national and local levels. Functions of the IDCF included forming the National Forest Program, taking measures against illegal logging, instituting a moratorium on natural forest conversion and restructuring wood-based industries.[3]

IWGFF is a loose association of major local NGOs (WWF Indonesia, Walhi, Telapak, Forest Watch Indonesia, and INFID), donor countries

(USAID NRM program and DFID Multistakeholder Programme), CIFOR and several individuals from the academic community. Its secretariat is housed in the INFID office in Jakarta and it has a mandate to work on policies relating to forest finance issues in Indonesia.

One Indonesian government commitment in particular raised IWGFF expectations; it involved directly linking the Indonesian Bank Restructuring Agency's (IBRA) debt restructuring process with a reduction in the processing capacity of the forest industry. At the CGI meeting in 2000, the Indonesian government committed to closing down the highly indebted wood industries under IBRA control and linking the debt write-offs to capacity reduction.

The production capacity of wood processing industries exceeds the sustainable raw material production capacity of natural forests and timber plantations. This forest industry overcapacity is a direct cause of illegal logging in Indonesia (ITTO, 2001). In 1997, the number of sawnwood, molding and plywood mills totaled 2,460 units with a combined annual production capacity of 31.58 million m^3. The estimated real production at that time was 23.38 million m^3 (about 74 percent of total capacity) requiring about 44.34 million m^3 of roundwood. By that year there were also 15 pulp mills with a total production capacity of 3.9 million tons and real production estimated at 3.4 million tons (about 87 percent of total production). At that level of production the pulp mills required about 16.66 million m^3 of roundwood. Therefore, conservatively Indonesian wood processing industries needed about 61 million m^3 of roundwood. This figure was 36 million m^3 higher than the volume the Ministry of Forestry and Estate Crops claimed to be a sustainable annual timber harvest (Barr 2001). More recent data shows wood processing industries' timber consumption in 2002, by which time total production capacity of sawnwood and molding mills was 29.4 million m^3 with real production at 14.1 million m^3 (only 47.49 percent of total capacity). The total production capacity of the pulp mills was 6.1 million tons with real production of 5 million tons. By the year 2002, Indonesian wood industries required about 50.5 million m^3 of roundwood, while the official log production figure for the same year was only 8.1 million m^3 or only 16 percent of wood processing industries' total log requirements (Simangunsong, 2004).

The structural demand for substantial volumes of timber above and beyond those generated by the official log supply is a central factor driving Indonesia's illegal timber trade and the unsustainable management of Indonesian forests. The pervasiveness of illegal logging and the Indonesian government's relatively weak capacity to enforce its own forest boundaries suggests that any efforts to control timber supply without reducing effective demand on the part of the nation's wood-based industries is likely to be futile. Continued demand for illegal timber on the scale that currently exists in Indonesia is likely to keep log removals well above the government's own sustainability targets. In this way, it would appear that any serious attempt to cut harvest levels substantially must, at some point, involve proactive steps to reduce production capacity on the part of Indonesia's wood processing industries (Barr, 2001).

IBRA was seen as an excellent vehicle for reducing the production capacity of Indonesia's wood processing industries. In the process of saving Indonesia's ailing banking system, IBRA assumed control of assets with a total book value of IDR 548.3 trillion or USD 78 billion from the bank recapitalization program (Pangestu, 2003).[4] These assets included more than USD 4 billion in outstanding loans associated with forestry sector investments, as well as several billion dollars worth of pledged fixed assets and/or equity shares in three of Indonesia's largest forestry conglomerates: the Sinar Mas Group, the Bob Hasan Group, and the Barito Group (Barr 2001). IWGFF hoped that IBRA would use its extensive powers to close down or downsize forestry industries to balance supply and demand of wood from natural forests. This agency could do so when it restructured the non-performing loans of Indonesia's wood-based companies and settled the debts of former bank shareholders. Eka Tjipta Widjaja was the former principal shareholder of Bank International Indonesia (Bank BII) who also owned wood-based companies such as Indah Kiat Pulp and Paper and Lontar Papyrus. Bob Hasan was the former principal shareholder of Bank Umum National (Bank BUN) who also owned many wood-based companies such as Kiani Kertas and the Kalimanis group. Bank BII and Bank BUN and their non-performing loans and shareholders' debts came under IBRA control.

IBRA was a super financial agency created by the Indonesian government in 1999 to handle distressed banks, non-performing loans of banks, and debts of former bank shareholders. IBRA was provided with extensive power including changing banks' previous contracts, taking over banks' assets and liabilities, and managing banks.[5] IBRA had the power to do whatever it felt necessary, including designating ownership, managing cash flows, and terminating contracts of the companies under its portfolio. It was also able to issue court orders to protect government and public interest in the banks and have their assets transferred to IBRA.[6] This rule provided IBRA with the authority to take over the control of banks and bank assets (tangible and intangible) both local and international. This power could also be applied to affiliated companies or organizations of debtors transferred to IBRA.[7]

1.2 Objectives of the book

This book was written after IBRA was closed. At that time, IWGFF members' hopes had faded into skepticism. Not only had IBRA failed to close down any forestry companies, it had provided forestry conglomerates with cash flows to expand their business empires and absolved billions of dollars of forestry-related debts at the expense of the Indonesian public.

This book was written for the forestry and environmental community, especially members of IWGFF, and for the general public in order that they may understand the implications of IBRA's failure to meet the government's commitment to the CGI on the future of the Indonesian forestry sector. The failure of the law to adequately govern IBRA and maintain the forests contributed greatly to the financial and environmental problems that IBRA failed to resolve. The law fails when it pursues wrong or inconsistent objectives (FAO, 2002). Problems arise when economic laws and policies, including those of finance, trade and industry, pursue economic expansion, but in the process sacrifice other national objectives such as achieving sustainable forests and utilizing them to improve the welfare of the poor. This book should provide a lesson on the inconsistencies between the Indonesian government's banking and corporate debt policies and its forest industry policies. Banking and financial policies, especially those relating to lending and investment, will continue to influence the economic performance of wood-based companies and their social and environmental responsibilities. Even after being restructured by IBRA, many of these companies still face difficulties in repaying their debts and getting legal wood from sustainable sources.

Hopefully the book will benefit financial policy makers and bankers preparing strategies to deal with the financial situation of forestry companies in the post-IBRA debt restructuring era. Several measures will continue to be introduced by the Indonesian government, especially through the Indonesian Financial Transaction Reports Analysis Center (*Pusat Pelaporan dan Analisis Transaksi Keuangan* (PPATK) to improve the efficacy of the Indonesian financial community in implementing a recently introduced anti-money laundering regime for dealing with forestry crimes. In October 2003, the Indonesian government enacted Law No.25/2003 amending Law No.15/2002, the original Indonesian anti-money laundering law. Among several additions in the new law was the inclusion of forestry and environmental crimes in the list of crimes that would be monitored seriously by the anti-money laundering regime. Following this legislation Indonesia became the first country in the world to include forestry and environmental crimes as predicate offences, or crimes subject to prosecution as money-laundering offences. PPATK in collaboration with IWGFF are developing guidelines for forestry stakeholders on submitting reports relating to forestry crimes to PPATK and for financial institutions in assessing high-risk customers operating in the forestry sector. This book should provide basic information and understanding for anti-money laundering officers, including bank compliance staff on monitoring suspicious forestry company transactions.

The information in this book should also help the banking community to improve their implementation of prudential policies introduced by the Bank Indonesia (BI), the central bank of Indonesia. In January 2005, BI introduced Bank of Indonesia regulation (PBI) No.7/2/PBI/2005 regarding assessment of general bank asset quality requiring banks to assess efforts taken by debtors to maintain the environment. BI also provided details on applying this measure in BI Circular Letter No.7/3/DPNP. Other prudential measures introduced by BI relevant to promoting sustainable forest management include banks' application of risk management and good

corporate governance. These regulations require banks and other financial institutions to establish risk management policies, procedures, and limits relating to credit risk as well as transparent bank management. This book should help banks in implementing these BI policies in the forestry sector.

Finally, this book was also written for the benefit of forestry conglomerates, in the hope they might appreciate the role of public funding in building their empires and might return the favor to the public at some point in the future. The author hopes the book will persuade governments, particularly the Indonesian government, as well as the IMF, the World Bank and donor agencies to be more transparent and wiser when using public funds to bail out forestry companies or any other companies in financial distress. The 'bailing out policy' benefits only the private sector at the expense of the public sector and the forests.

1.3 Outline of the book

This book is organized into six chapters. Following the introduction chapter, Chapter Two looks into opportunities for using banking and financial policies associated with the Indonesian government's banking restructuring program to support forestry sector reform. It discusses specific links between the debt restructuring policy under IBRA control and the Ministry of Forestry's forest industry restructuring policy. It also discusses forestry assets under IBRA management and what it could have done about them. Chapter Three discusses the policy framework surrounding IBRA, the Ministry of Forestry and the international donor community and guides readers through how the Indonesian government implemented the policy and how it was monitored by the international donor community. Chapter Four reviews IBRA forestry company debt resolution policies and practices. Chapter Five discusses the debt settlements of several major forestry debtors including the Sinar Mas, Bob Hasan, Raja Garuda Mas, Djajanti and Barito groups. Finally, Chapter Six provides conclusions and highlights the implications of IBRA debt policy on the forestry, banking and fiscal sectors and closes with some policy recommendations.

Banking and Financial Policies for Sustainable Forest Management

2.1 Introduction

Banking and finance policies capable of supporting sustainable forest management should provide incentives for banks and other financial institutions to review their corporate lending carefully and behave based on serious consideration of risks. Prudential regulations such as the legal lending limit and capital adequacy ratio (CAR) introduced by the Bank Indonesia were aimed at encouraging banks to adopt a more risk-based approach to corporate sector lending. Such policies should prevent banks from lending to high-risk companies such as those with no secure wood supply source, those having problems with local communities, those damaging the environment, or those involved in illegal logging activities.

Prior to the financial crisis, in spite of existing prudential requirements and regulations, banking sector governance remained weak and there was little incentive for banks to review their corporate lending carefully or to behave in a risk-based manner (Pangestu, 2003). The banking sector was concentrated among a few private and state banks. The 10 largest private banks together with the 6 state banks accounted for 75 percent of total bank assets. Majority ownership of state and private banks was concentrated between a few business conglomerates and the government. The top 10 private banks were linked to major business and politically powerful groups. This resulted in information asymmetry or information gaps between the majority and minority shareholders, investors, and creditors. Moreover, the implicit guarantee from the Bank Indonesia that banks should not be allowed to fail - so as to prevent systemic risk to the banking system - had led to moral hazard on the part of bank owners and management (Hadad, 1999). This implicit guarantee induced banks to leverage and encouraged them to exercise less caution in extending loans to high-risk sectors. As a result, commercial bank risk was shifted to the Bank Indonesia while systemic risk in the banking system mounted. Banks also had very closed relationships with conglomerates making it difficult for them to make objective valuations of proposed investment projects (Wardhana, 1998). This practice resulted in Indonesian financial institutions promoting high-risk and low-return financing.

When an independent audit was conducted it was found that most private banks had exceeded the legal lending limit providing loans to affiliated companies. Bank Umum Nasional (BUN) owned by forestry conglomerate Bob Hasan provided 78.4 percent of its total lending or about IDR 8.7 trillion to its affiliates while BDNI Bank provided 90.7 percent worth IDR 24.4 trillion and Bank Danamon provided 43.8 percent worth IDR 12.9 trillion to its affiliates. To get around the legal lending limit, bankers had to create fictitious or ‘paper’ companies with false addresses to make it look like they did not belong to the group (Center for Banking Crisis, 1999).

Banks or their controlling shareholders also violated the Bank Indonesia Liquidity Credit (BLBI) policy. Instead of using the credit to protect banks from liquidity crises, they used it to expand the businesses of conglomerates owned by bank shareholders. Bank shareholders through their conglomerates successfully misappropriated central bank liquidity credit by colluding with banking officers at the Bank Indonesia (Center for Banking Crisis, 1999).

The financial crisis brought down Indonesia’s ‘emerging tiger’ economy. Indonesian government responses to the crisis, such as its introduction of a free-floating foreign exchange policy and a

tight monetary policy, failed to stop the freefall of the Rupiah, capital flight, and bank liquidity problems. The overnight call rate increased to 81 percent and Bank Indonesia Certificate rates more than doubled from 12 to 30 percent in 1997 (Pangestu, 2003). The Rupiah tumbled from IDR 2,450 to the US dollar in June 1997 to IDR 7,500 at the end of December 1998. The Bank Indonesia had to close several banks and provide liquidity support to others in order to rescue the Indonesian banking system.

Banking and financial policies introduced in response to the crisis should have provided opportunities to change banks' risk assessment practices when lending to corporations including forestry and wood-based industries. There are some key principles to adhere to in correcting the banking system in response to crisis and in restructuring the banking system (Claessens *et al*. 1999). First, only viable institutions should be allowed to remain in operation. Second, the costs of restructuring should be allocated in a transparent manner and aimed at minimizing costs to the government budget (taxpayers). Losses from restructuring banks should be allocated to existing shareholders, creditors, and perhaps large depositors. Third, measures introduced for bank restructuring should provide incentives for new private capital. Finally, bank restructuring needs to occur at a sufficient pace to restore credit (to allow businesses to resume operation) while maintaining confidence in the banking system.

The Indonesian government's commitment to the CGI to close highly indebted wood-based industries under IBRA control and link debt write-offs to capacity reduction was consistent with the above principles. In practice, however, this did not happen; the recapitalization program did not lead to a change in bank risk behavior. No politically connected bank shareholders especially to members of former President Suharto's family were disciplined or sanctioned in any way (Pangestu, 2003). For the handful of conglomerates whose banks qualified for this process, recapitalization brought substantial benefits (Barr 2001). Not only were these groups' banks able to stay in business, they were able to unload large sums of bad debt from their balance sheets as well. Moreover, recapitalization helped these groups protect their non-bank assets, which often held outstanding obligations that would be transferred to IBRA or other creditors if the bank became insolvent. In one case, the government injected over USD 900 million in recapitalization funds into a bank that still carried USD 1.3 billion in outstanding loans to affiliated forestry companies on its books (see the discussion on recapitalization of Bank Internasional Indonesia (BII) below).

2.2 Recapitalization of Indonesia's banking sector

With support from the International Monetary Fund (IMF), in 1998 the Indonesian government launched a banking recapitalization program to cope with the financial crisis. Under this program banks were divided into three categories: banks to be frozen (Frozen banks), banks to be taken over (BTO banks), and banks to be recapitalized (Recap banks). Frozen banks were banks that the government decided to close due either to the unwillingness of their shareholders to bring the banks' capital adequacy ratios (CAR) to at least minus 25 percent or because they failed to pass government commercial prospects and fit and proper bank management tests. BTO banks were those still considered operationally viable (having a CAR of not less than -25 percent and passing the fit and proper test) but were unable or unwilling to provide 20% of the recapitalization cost. Recapitalized banks were those IBRA deemed operationally viable in which controlling shareholders had put forth at least 20% of the recapitalization cost. This was the cost necessary to bring a bank's CAR to 4 percent (IBRA, 1999). CAR is a ratio that measures the quality of bank's capital by dividing it by its risk-based assets; the higher the ratio the better the bank. The Bank Indonesia required a minimum 8 percent CAR for a healthy bank. However, best practice for CAR is 12 percent.[8] Table 2.1 shows basic agreements between the government and the banks' controlling shareholders under the recapitalization program. The government issued government bonds to finance the recapitalization program.

By the end of December 1999, the Indonesian government, acting through IBRA, had closed down sixty-four private banks, taken over thirteen and recapitalized a further eleven (IBRA, 1999). The Indonesian government had also recapitalized five state-owned banks and twelve regional banks (BPD). IBRA had closed four more banks in 2000.[9]

Table 2.1 Banks under the Recapitalization Program

Type of Banks	IBRA (GOI)	Bank Shareholders
Frozen Banks	IBRA pays all the bank's liabilities and all bank assets are transferred to and managed by IBRA. The bank is liquidated and IBRA coordinates shareholder settlements.	Shareholders are required to pay back liabilities from banking regulation violations to IBRA, especially liquidity credit (BLBI) and legal lending limit violations.
Taken Over Banks	IBRA takes over management of the bank and injects 100% of the recapitalization cost. GOI shares in the bank are sold and category 5 loans are transferred to IBRA which also coordinates shareholder settlements.	As above
Recap Banks	IBRA injects 80% of the recapitalization cost, and takes over category 5 loans. IBRA does not participate in the day-to-day management of the bank but supervises its management plan.	As above; plus shareholders inject 20% of the recapitalization cost and agree to comply with the management plan.

Source: IBRA strategic plan for 1999-2004

Table 2.2 Costs of the Bank Recapitalization Program (IDR trillion)

Items	Book Value	Actual Value
Total assets transferred	**548.3**	**111.3**
Asset Management Credit (AMC)	275.2	75.5
Loan assets from private and state banks	262.4	
Non-core assets	12.8	
Asset Management Investment (AMI)		
Corporate equity as shareholder settlements	141.1	17.8
Bank Restructuring Unit (BRU)		
Net government investment in recap and BTO banks	131.7	18.0
Total liabilities	**703.6**	**703.6**
Government bonds to the Bank Indonesia	268.3	
Government bonds to recap banks	435.3	
Total assets-liabilities (costs of the program)	**-155.3**	**-587.9**

Source: Pangestu (2003); data as of August 2002

All non-performing loans were stripped from all banks under the program and transferred to IBRA, which also managed all tangible and intangible assets of the frozen banks. IBRA assets also included equity shares in the banks in direct proportion to the percentage of recapitalization funds the government supplied. In addition, IBRA took possession of assets pledged by controlling shareholders for repaying bank liabilities that had resulted from violations of banking regulations, especially those involving infractions of Bank Indonesia Liquidity Credit (BLBI) and the legal lending limit. Table 2.2 provides information on the book value of assets controlled by IBRA and their actual value when they were sold. It also documents the value of government debt issued to finance the bank recapitalization program.

IBRA assumed control of assets with a book value of IDR 548.3 trillion or USD 78.3 billion from the bank recapitalization program (Pangestu, 2003).[10] Of the IDR 262.4 trillion (USD 37.5 billion) of loan assets from private and state banks, IDR 22.54 trillion or about USD 3.22 billion were from loans granted to forestry and wood-based industries (IBRA 2002). IBRA also received equity in some forestry and wood-based companies as collateral for repayment or settlement of bank shareholders' liabilities.

The bank recapitalization program was a substantial burden on the government budget. By August 2002, the government had issued government bonds worth IDR 703.6 trillion or about USD 100.5 billion to rescue the Indonesian banking system. The Indonesian government

had never issued bonds before this program either in local and foreign capital markets. The actual cost of the recapitalization program was IDR 587.9 trillion given that IBRA only managed to collect IDR 111.3 trillion. By the end of its existence in April 2004, IBRA had only collected IDR 141.3 trillion; a recovery rate of only 25.8 percent of its total assets (IBRA, 2004).

The recapitalization program significantly reduced the government's capacity to provide funding for public sector development. For the year 2003, interest payments on government bonds were IDR 55 trillion, a value equal to 85% of that year's state development budget. In the 2000 and 2001 fiscal years, the government paid interest of IDR 34.8 trillion (USD 5 billion) and IDR 56.3 trillion (USD 8 billion) respectively.[11]

2.3 Recapitalization of forestry-linked banks

Prior to the 1997 financial crisis, conglomerates with substantial investments in forestry industries controlled 10 of Indonesia's private banks (see Table 2.3). They used these banks to expand their business interests in the forestry and non-forestry sectors including the financial, property, plantations, trading, and chemical sectors. In some cases these conglomerates expanded their business empires by breaking banking laws. In the years leading up to the financial crisis, these laws were rarely enforced, particularly when they threatened to constrain the lending practices of banks owned by groups with ties to state elites. Indonesia's largest forestry companies took advantage of this weak regulatory environment to obtain large sums of finance at well below commercial lending rates. They did so most significantly through the allocation of related party loans above the government's legal lending limits, the misappropriation of central bank liquidity credits, and the use of financial mark-up schemes (Barr, 2001b and Pangestu, 2003).

Prajogo Pangestu developed his conglomerate from PT. Barito Pacific Lumber, a forestry business with HPH concession rights on 40,000 hectares of forest in South Kalimantan (PDBI 1997). His initial investment in 1977 was only IDR 651.7 million or USD 93,100. However, by the end of 1996 (in only nineteen years) his Barito group had accumulated assets worth IDR 6.7 trillion or USD 957.14 million including the PT. Tanjung Enim Lestari pulp and paper mill in South Sumatra, and the petrochemical company, PT. Chandra Asri. In 1989, Prajogo Pangestu owned 40 percent of shares in Bank Andromeda, while a further 25 percent were held by Bambang Trihatmodjo, a son of former President Suharto. At that time Prajogo also owned 15 percent of shares in Bank Yama. Both of these banks were closed by the government in the financial crisis. Neither, however, was considered to have violated the legal lending limit or the BLBI policy and Prajogo Pangestu was left with no obligation to the government.

Bob Hasan began developing his business in 1970 by investing in PT. Georgia Pacific Indonesia (later became PT. Kiani Lestari), a joint venture with the Georgia Pacific International Corporation, a giant U.S. timber company (PDBI

Table 2.3 Recapitalization of forestry-linked banks

Group	Bank	Controlling Shareholders (% ownership)	Status under IBRA
Barito Pacific Timber	Andromeda	Prajogo Pangestu (40.0)	Closed
Barito Pacific Timber	Yakinmakmur (Yama)	Prajogo Pangestu (15.0)	Closed
Kalimanis	Bank Umum Nasional (BUN) Muamalat Bukopin	Bob Hasan (40.0) Bob Hasan (26.0) Bob Hasan (15.5)	Closed Not in IBRA Recapitalized
Nusamba	Tugu Small banks (BPR)	Bob Hasan (20.0)	Not in IBRA
Raja Garuda Mas	Unibank	Sukanto Tanoto	Closed
Sinar Mas	Bank Internasional Indonesia (BII)	Eka Tjipta Widjaja	Recapitalized and subsequently taken over
Salim	Bank Central Asia (BCA)	Soedono Salim	Taken over
Salim	Risjad Salim International	Soedono Salim	Taken over

Source: Barr and Setiono (2001) and PDBI (1997)

1997). The company had HPH rights covering 350,000 hectares in East Kalimantan. The joint venture also established the Kalimanis Group which comprised PT. Kalimanis Plywood Industries (1973), PT. Santi Murni Plywood (1980), and PT. Kertas Kraft Aceh (1983). With funding from this group, Hasan expanded his businesses to other sectors including trade, plantations, air transportation (Gatari Air Service and Sempati Air), sea transportation (Karana Line and Wasesa Line), paper and banking. He bought Bank Umum Nasional (BUN) in 1990, and after taking over the bank, he invested IDR 1.6 trillion in PT. Kiani Kertas, a pulp mill in East Kalimantan, and one year later established a timber company, PT. Kiani Hutani Lestari, to supply the mill. In addition to controlling 40 percent of BUN bank shares, he also owned 26 percent of shares in Bank Muamalat, and 15.5 percent in Bank Bukopin. He owned 20 percent of shares in Bank Tugu and had equity in many small banks (Bank Perkeriditan Rakyat) through the Nusamba group, his joint venture with former President Suharto.

Bob Hasan's Kiani Kertas pulp project is believed to have benefited substantially from the weak regulatory environment in Indonesia's commercial banking sector. Through 1997, BUN, in which Hasan was the controlling shareholder, reportedly channeled 79 percent of its loans to sister companies. Much of this was channeled to Kiani while the mill was under construction, including a portion of IDR 6.8 trillion in liquidity credits that the bank received from the Bank Indonesia in the early weeks of the crisis to keep the bank solvent (Barr, 2001b).

On August 21, 1998, the government decided to freeze BUN's operations (Pangestu, 2003). This means that either Bob Hasan and the other controlling shareholder (Kaharuddin Ongko) failed to increase BUN's CAR to at least -25 percent, or the bank failed to pass the government fit and proper test. BUN was found to have exceeded the legal lending limit by 78.4 percent or IDR 8.7 trillion (Center for Banking Crisis 1999). Bob Hasan was required to pay IDR 5.34 trillion (USD 763 million) to settle BUN's obligation while Kaharuddin Ongko had to pay a further IDR 8.35 trillion (USD 1,193 million). BUN bank also transferred 2,610 loan accounts worth IDR 3.62 trillion to IBRA (IBRA 1999 b).

Bank Tugu survived the crisis. It was bought in January 2003 by Chairul Tandjung, the owner of Bank Mega, who transformed it into an Islamic bank, Bank Syariah Mega Indonesia (BSMI).[12]

Sukanto Tanoto (Lim Sui Hang) started his business empire in 1971 with his forestry business and began expanding to other sectors after establishing Raja Garuda Mas Plywood with an investment of IDR 1 billion (USD 142,000) in 1973 (PDBI, 1997). Sukanto gained control over more natural forests in Aceh when he took over PT. Overseas Lumber Indonesia, which had HPH concession rights on 250,000 hectares of forest in 1979. He then expanded into oil palm plantations in 1980 in partnership with the Salim group, as well as other plantations and fisheries projects. At the same time, Sukanto diversified into the pulp industry with PT. Inti Indorayon Utama in 1983 and PT. Riau Andalan Pulp and Paper (RAPP) in 1994. Inti Indorayon Utama's cost was about USD 402.2 million while RAPP cost USD 2.15 billion. Sukanto took over PT. United City Bank in 1987. Twenty-five years after his first investment in the forestry sector, his business empire through domestic and foreign investment had expanded into 16 sectors. His conglomerate was valued at IDR 4 trillion (USD 571 million) by the end of 1996.

Sukanto Tanoto took over the United City Bank from its previous owner, James Semaun, and changed its name to Unibank in 1990. In 1997, at the time of the crisis, he turned the bank into a publicly listed company with total assets of IDR 1.9 trillion.[13] At the time of this transaction, he and his partner owned 25 percent of the bank's shares.[14] Unibank was considered healthy by the Bank Indonesia and IBRA in 1997 and did not enter the recapitalization program. Interestingly, only a year after going public Unibank started showing structural problems and was placed under the Bank Indonesia's 'close supervision' category. The Bank Indonesia requested that Unibank replace its board of directors, increase its capital and temporarily cease certain activities. Despite these requests, Unibank's health continued to deteriorate. In November 2000, Bank Indonesia put Unibank into its 'special supervision' category and finally, at the end of October 2001, closed it down.[15] Some analysts suggested the Bank Indonesia should have closed Unibank down in June 2001. However, since IBRA (representing the Indonesian government) did not have funding to repay Unibank customers' deposits, the decision was delayed until October 2001.[16]

Sukanto Tanoto successfully avoided being held liable for the costs of closing Unibank. By the time the Bank Indonesia finally closed it down, Tanoto was no longer the owner, and none of the shareholders owned more than five percent of its total shares. In August 2001, two months before the closure, Bank Indonesia, Bapepam (the Capital Market Supervisory Agency), and IBRA had allowed Unibank to announce changes in the composition of its shareholders, and to break up its ownership into shares of less than five percent. This allowed shareholders to avoid reporting requirements, which applied to transactions involving shares equal to, or more than five percent of total shares. Some analysts felt this move was engineered to protect Sukanto Tanoto, the controlling shareholder of Unibank, from his obligations.[17]

The Indonesian government could not force Sukanto Tanoto to enter a shareholder debt settlement as they did with Bob Hasan. Tanoto had no liability to the government, despite the fact that IBRA had to repay customer deposits of IDR 3.1 trillion or about USD 442 million. The story did not end there however; as a result of IBRA's own regulations it was forced to pay up to IDR 70 billion, or about USD 10 million, towards deposits owned by several subsidiaries of Tanoto's RGM Group.[18]

Eka Tjipta Widjaja (Oei Ek Tjong) began his business in 1969 when he invested in the Bimoli cooking oil plant, (PDBI, 1997). In 1981, following thirteen years in the cooking oil business, he started investing in oil palm plantations in a partnership with the Salim group to secure raw material for his cooking oil plant. In 1972, Widjaja established PT. Pabrik Kertas Tjiwi Kimia and expanded into the pulp and paper sector in the 1980s by taking over PT. Indah Kiat Pulp and Paper and other companies such as PT. Lontar Papyrus Pulp and Paper and PT. Pindo Deli Pulp and Paper. In 1982 he diversified into the financial sector by acquiring PT. Bank Internasional Indonesia (BII).

When the financial crisis hit Indonesia, BII was found to have a negative equity value of IDR 7 trillion (USD 1 billion) requiring additional capital of IDR 11 trillion (USD 1.6 billion) to remain solvent (Barr, 2001). Based on an independent audit guided by the IMF, in April 1999, the Indonesian government considered BII eligible for the recapitalization program. The government injected IDR 8.7 trillion (USD 1.2 billion) in the form of recapitalization bonds into the bank, thereby assuming a 58 percent equity stake. Sinar Mas and the Widjaja family agreed to contribute IDR 4.4 trillion to retain an 18 percent share of BII. Under this scheme, the Widjaja family was still eligible to stay on the bank's board of management. At the time of its recapitalization, Bank Internasional Indonesia had USD 1.2 billion in outstanding loans to subsidiaries of the Sinar Mas Group, mostly to the pulp and paper division, representing 52 percent of the bank's total loans. This constituted a breach of the government's 20 percent legal lending limit to affiliated parties.

The Widjaja family lost control over BII when they failed to repay their debts to their own bank. On March 12, 2001, Asia Pulp and Paper Ltd. (APP), an international pulp and paper company owned by the Sinar Mas Group declared a standstill on the repayment of its debt.[19] APP owed about USD 13.9 billion to international creditors and local financial institutions. Table 2.4 shows the breakdown of the APP debt.[20]

Table 2.4 APP debts

APP Creditors	USD million	% of Total
IBRA (ex BII)	1,059	7.62
Indonesia Bond Holders	230	1.65
Export Credit Agencies (ECA)	960	6.91
Other International Creditors	4,451	32.02
Total APP Indonesia	6,700	48.20
APP China	5,200	37.41
APP Corporate (Singapore)	2,000	14.39
Total	13,900	

Source: Germany Export Credit Agency (2003)

The Indonesian government could have allowed APP Indonesia to die, thereby relieving some of the pressure on the Sumatran rain forests. Instead, it considered the pulp and paper industry a strategic industry and chose to protect Eka Tjipta Widjaja's business empire.

In January 2001, to protect its earlier investment in BII, the Indonesian government took over management of the bank and removed the Widjaja family from its management. Interestingly, this government move to rescue BII for the second time was not considered a recapitalization even though government bonds were issued to finance the bailout, and the

Table 2.5 Sinar Mas Group Debts

No	Company	Principal (USD million)	Interest (USD million)	Total Debt (USD million)	Total Debt (IDR trillion)
1	Indah Kiat Pulp Paper	179.90	1.50	181.40	1,269.80
2	Tjiwi Kimia	82.30	0.50	82.80	579.60
3	Pindo Deli Pulp Paper	63.90	0.55	64.45	451.15
4	Lontar Papyrus	37.10	0.29	37.39	261.73
5	Ekamas Fortuna	0.38		0.38	2.66
6	Purinusa Ekapersada	345.60		345.60	2,419.20
7	Other	347.00		347.00	2,429.00
8	Rupiah loans				1,814.00
	TOTAL	1,056.18	2.84	1,059.02	9,227.14

Source: Wright (2001)

methods used were the same as before. The Indonesian government transferred the USD 1.2 billion of BII's non-performing APP Indonesia loans, including unpaid interest to IBRA.[21] Taking these loans into account, the Sinar Mas Group was the largest forestry debtor under IBRA with total debts of IDR 9.23 trillion (see Table 2.5).

In return for the Sinar Mas Group debt, BII initially received IDR 14.6 trillion worth of recycled government bonds. To protect BII against a fall in the value of the Rupiah, in November 2001 the government replaced the recycled bonds with a currency hedged bond worth USD 1.06 billion. This bond was set up to mature at the same time as the Sinar Mas Group debt in BII and had an interest rate equal to two percent over the Singapore Interbank Offered Rate (SIBOR, plus two). When the hedge bond was issued SIBOR was 4%.[22] Therefore, annual costs to the government in dealing with the APP debt crisis equaled about USD 64 million, plus the foreign exchange subsidy necessary to maintain the value of the bond at USD 1.06 billion when the Rupiah weakened. When the Rupiah weakens against the US dollar, the subsidy increases and when the Rupiah strengthens the government records revenues since it then issues a smaller hedge bond in Rupiah.

By injecting recycled bonds into BII, IBRA could have been considered in infringement of the Law on the National Development Program. The Indonesian Parliament (DPR) rejected the recycled bond arrangement since it could easily have been considered a second recapitalization of BII,[23] which, would have been in contravention of a law previously issued by the Indonesian Parliament. To save BII, the options IBRA should have considered were an acquisition, a merger or liquidation, not a second recapitalization.[24] However, the Bank Indonesia argued that the bond transfer was not a second recapitalization, because government ownership in BII was unaffected by the issue and BII remained responsible for repaying the government bonds. To ensure repayment, IBRA signed a memorandum of understanding with Sinar Mas and BII in March 2000 extending the tenor of the loans to 30 months and securing pledged collateral from Sinar Mas valued at 145 percent of the amount owed. Collateral assets included equity shares in New York-listed Asia Pulp & Paper and other operating subsidiaries worth IDR 23 trillion. The government also took over all remaining shares in BII owned by the Widjaja family.

2.4 Shareholder settlement policies and sustainable forest management

The Indonesian government commitment to the CGI to close highly indebted wood-based industries under IBRA control and link the debt write-offs to capacity reduction could have led to a financial policy that would have promoted sustainable forest management. The shareholder settlement policy was a debt policy suitable for this purpose.

The Financial Sector Policy Committee's (FSPC) policy on shareholder settlements depended on the type of settlement of the shareholders' liabilities. If the shareholders entered into the Master Settlement and Acquisition Agreement (MSAA) or the Master Refinancing and Notes Issuance Agreement (MRA), IBRA could sell the assets pledged by the shareholders directly to help settle their liabilities. If the shareholders had not signed an MSAA or MRA, the pledged assets would just

be treated as collateral and only used to settle conglomerates' debts after all other assets were used up for debt settlement. Soedono Salim and Bob Hasan both signed MSAAs, while Eka Tjipta Widjaja only signed a simple long-term loan agreement.

The shareholder settlement policy involved a process whereby former shareholders or debtors were requested to pay back their debts using cash, non-cash assets, and/or promissory notes (debt acknowledgment). The non-cash assets included both physical and financial assets. Physical assets could take the form of land, property, plants and machinery, while financial assets were mostly bonds and equity shares. IBRA and the shareholders could sell the non-cash assets as part of the debt settlement.

To determine the amount of a shareholder's obligation, IBRA performed financial and legal due diligence over banks that had been taken over or frozen. The bank shareholders had to enter an MSAA program if the results of the due diligence process showed they were in violation of the legal lending limit with parties affiliated to the bank (the shareholder's own companies) and/or were party to other banking irregularities. If the bank shareholders cooperated with IBRA to settle their obligations, they were able to enter into the MSAA process. Otherwise, they had to meet with the Committee on the Settlement of Uncooperative Debtors (*Komite Penyelesaian Debitur Bermasalah* or KPBD). The members of KPBD were the State Attorney General, the Minister of Finance, the Chairman of IBRA, Chairman of the State Supervisory Board for Finance and Development (*Badan Pengawasan Keuangan dan Pembangunan* or BPKP), and a member of the Indonesian Police Department.

IBRA tried to persuade shareholders to enter into Master Settlement and Acquisition Agreements (MSAA), thereby requiring them to settle their obligations through cash and asset settlements. For asset settlements, shareholders needed to pledge their personal assets as collateral for their obligations. The pledged assets would then be transferred to a holding company specially established to manage and conduct asset sales. The MSAA signatories owned all the shares of holding companies. These signatories were, in turn, shareholders of the banks themselves. IBRA did not want to take over ownership of holding companies, but rather maintain the right to influence their management. IBRA argued that the owners of the holding companies should be responsible for repaying the shareholders' financial obligations.

Holding companies issued Convertible Right Issues (CRI) worth the value of the shareholders' obligations, minus the cash payments already made, and were responsible for paying off the CRIs. A share of the holding company was also pledged to IBRA as repayment of the CRI. If the value of the pledged assets did not equal the amount of the shareholder's obligation, the shareholder then entered into a Master Refinancing and Notes Issuance Agreement (MRA). Under MRAs, the holding company issued Promissory Notes instead of a CRI.[25]

IBRA failed to use any of the forestry assets owned by the Salim Group or the Bob Hasan Group to offset the obligations of these conglomerates even though these assets were managed by Holdiko Perkasa and Kiani Wirudha holding companies respectively. Even though, Holdiko Perkasa was successful in selling most of the Salim Group's pledged assets, it failed to sell any of Salim's forestry companies.

The forestry conglomerate settlement process was more like a debt restructuring than a debt settlement process. As in the previous corporate debt restructuring, the debt settlement process was favorable to conglomerates. The shareholders were allowed to remain in control of the company's business operation even though their shares had been pledged to IBRA. In addition, IBRA's weak monitoring system, coupled with Indonesia's generally unfavorable economic conditions, and increasing environmental pressures and social conflicts contributed to the decrease in value of IBRA's pledged forestry assets. This, in turn, contributed to delays in the debt settlement and shareholder settlement processes. Ultimately this resulted in a very low recovery rate. The debt settlement of Indonesia's five largest forestry debtors will be discussed specifically in Chapter Five.

Bob Hasan

Bob Hasan was obliged to repay BLBI liquidity credit in the amount of IDR 5.34 trillion. To settle his debts, IBRA received pledged shares of thirty-one of Bob Hasan's companies. Except for Kertas Kraft Aceh, IBRA gained control over 30%

Table 2.6 Bob Hasan's Forestry Assets Pledged to IBRA

No	Company Name	Line of Business	Location	Shares pledged (%)
1	PT. Essam Timber	Logging (HPH)	East Kalimantan	60
2	PT. Jati Dharma Indah	Plywood & Logging	Maluku & Papua	100
3	PT. Jati Maluku Timber	Logging (HPH)	Maluku	100
4	PT. Kalhold Utama	Plywood	East Kalimantan	37.1
5	PT. Kalimanis Plywood	Plywood	East Kalimantan	100
6	PT. Kiani Hutani Lestari	Logging (HPHTI)	East Kalimantan	60
7	PT. Kiani Kertas	Pulp & Paper Mill	East Kalimantan	100
8	PT. Kiani Lestari (A)	Logging (HPH)	East Kalimantan	98
9	PT. Kiani Lestari (B)	Logging (HPH)	East Kalimantan	98
10	PT. Santi Murni	Plywood	East Kalimantan	82
11	PT. Wenang Sakti	Logging (HPH)	North Sumatra	100
12	PT. Tanjung Redeb Hutani	Logging (HPHTI)	East Kalimantan	60
13	PT. Belantara Pusaka	Logging (HPHTI)	East Kalimantan	60
14	PT. Alas Helau	Logging (HPH)	East Kalimantan	70
15	PT. Prima Maluku Timber	Logging (HPH)	Maluku	100
16	PT. Wanagalang Utama	Logging (HPH)	Papua	100
17	PT. Kertas Kraft Aceh	Paper Mill	Aceh	3.7

Source: IBRA

Table 2.7 Salim Group Pledged Forestry Assets

Company Name	Line of Business	Capacity/ forest area	Majority Ownership
Duta Rendra Mulya	Logging	40,500 ha	8.36% IBRA 91.64% other
	Plywood	189,750 m^3/yr	
	Glue	30,000 tons/yr	
	Blockboard	11,500 m^3/yr	
Kayu Lapis Asli Murni	Plywood	66,000 m^3/yr	9.45% IBRA 39.57% Oceanis Timber 29.42% Hanurata & Co 19.61% Rejo Sari Bang
	Blockboard	6,900 m^3/yr	
	Fancy carpet	1,800 m^3/yr	
	Fancy floor	20,000 m^3/yr	
Melapi Timber	Logging	150,000 ha	49.5% IBRA 29.7% Hanurata & Co 19.8% Rejo Sari Bumi
	Plywood	40,250 m^3/yr	
	Fancy wood	51,750 m^3/yr	
Unitama A Shipping	Barge & Tug Boat Rental		99% IBRA
	Heavy equipment rental		
	Shipping dock		

to 100% of the shares of these companies. Out of these thirty-one companies, seventeen were in forestry-related businesses. In turn, out of these seventeen companies, thirteen were also indebted to IBRA, making IBRA both creditor as well as shareholder of these companies. The debts of the seventeen forestry companies totaled IDR 7.04 trillion. Table 2.6 above shows a summary of these seventeen forestry companies.

Soedono Salim

Soedono Salim had to repay loans in the amount of IDR 52.63 billion. A small part of the assets, which were pledged to IBRA as settlement of his debts, were shares of Salim Group forestry companies. Table 2.7 shows the details of Salim Group forestry assets pledged to IBRA. IBRA did not have majority ownership (or controlling shareholdership) in these companies. In the timber sector, IBRA controlled 49.5% of the ownership of PT. Melapi Timber (MT) and 8.39% of the ownership of PT. Duta Rendra Mulya (DRM). MT held a 150,000 hectare forestry concession while the DRM forestry concession area covered 40,500 hectares. MT and DRM are both integrated forestry industries with mill capacities of 92,000 m^3 per year and 201,250 m3 per year, respectively.

2.5 Corporate debt policy and sustainable forest management

IBRA managed significant debts of forestry companies and other Indonesian companies. By December 31, 2002, IBRA held 234 forestry-based accounts with a total outstanding value of IDR 22.54 trillion or about USD 3.22 billion (IBRA, 2002). These debts were non-performing loans (NPLs) that were stripped off the books of banks under IBRA control. NPLs were defined as loans on which the borrower had not paid principal and/or interest for more than 270 days.[26] We will refer to this type of debt as corporate debt. This will serve to distinguish it from debts of bank shareholders that their banks incurred through violations of banking regulations, especially infractions involving the liquidity credit program (BLBI) and the legal lending limit. These latter debts we will refer to as shareholder settlements.

Table 2.8 shows the total NPLs related to forestry companies transferred to IBRA. This number is larger than the previous NPL figure due to the inclusion of NPLs of group companies not related to forestry.

State banks were involved in the largest transfers of NPLs to IBRA. Several of these state banks later merged with other state banks such as Bank Mandiri, Bank Bumi Daya, Bank Dagang Negara, Bank Exim, and Bapindo. Together, they accounted for USD 1.8 billion, or 44% of total forestry sector NPLs transferred to IBRA. Table 2.8 shows the ten banks with the highest forestry sector NPLs. (Bank Danamon was the largest private bank transferring forestry debts to IBRA, with a total transfer of USD 752 million).

Approximately one-third of the forestry NPLs transferred to IBRA came from the Barito Group. This group had NPLs at state banks and private banks of USD 485.33 million and USD 773.35 million respectively. The Barito group debts (not all of which were forestry debts) transferred to IBRA totaled USD 1.26 billion. The second largest forestry debt transferred

Table 2.8 Banks with Forestry NPLs

No	Bank	USD million
1	Bank Mandiri	1,796.25
2	Bank Danamon	752.08
3	Bank Umum Nasional (BUN)	233.48
4	Bank Central Asia (BCA)	218.17
5	Bank Rakyat Indonesia (BRI)	175.97
6	Bank International Indonesia (BII)	146.92
7	Bank Dagang Nasional Indonesia (BDNI)	129.63
8	Bank Tabungan Negara (BTN)	104.58
9	Bank Negara Indonesia (BNI)	89.72
10	Bank Duta	79.41
11	Other private banks	96.31
	Total	4,122.53

Source: IBRA; exchange rate = IDR 7,000 per USD

Table 2.9 Forestry companies with the largest NPLs (USD million)

No	Forestry Company	State Banks	Private Banks	Total
1	Barito group	485.33	773.35	1,258.68
2	Bob Hasan group	355.00	306.42	661.43
3	Djajanti group	535.31	1.04	536.35
4	Sinar Mas Group	1.89	355.35	357.24
5	RGM group	121.06	215.92	336.98
6	Indhasana	205.59	3.86	209.45
7	Sumatra TUD	-	139.69	139.69
8	Batasan group	72.54	27.26	99.80
9	KLI group	82.23	-	82.23
10	Hutan Raya Indonesia	75.38	5.99	81.37
	Total	1,934.33	1,828.90	3,763.23

Source: IBRA, December 2000; exchange rate = IDR 7,000 per USD

to IBRA involved NPLs of the Bob Hasan Group, which totaled USD 661.43 million. This consisted of unpaid debts to state banks totaling USD 355.00 million and unpaid debts to private banks totaling USD306.42 million. Table 2.9 shows the ten forestry companies with the largest NPLs.

By managing the debts of most of Indonesia's major forestry companies, IBRA had the potential to exercise significant influence over the country's forestry sector. Based on data of 110 forestry companies made available by the Ministry of Forestry and IBRA, we can assess the impact of IBRA's policy on forest sector industries.

About 78% of Indonesia's installed pulp capacity and 58% of its installed paper capacity were 'controlled' by IBRA. All major Indonesian pulp and paper companies were under debt protection from IBRA. These included Indah Kiat Pulp and Paper, Lontar Papyrus, Riau Andalan Pulp and Paper, Inti Indorayon Utama, Kiani Kertas, and Kertas Leces. IBRA also 'controlled' about 60% of the installed plywood capacity and 75% of the installed blockboard capacity. These included plywood producers Artika Optima Inti (310,000 m^3/yr) and Nusantara Plywood (235,000 m^3/yr), which were both owned by the Djajanti group. In the logging business, IBRA controlled debts of HPH concession companies; debts that in turn represented about 58% of the total HPH concession area allocated to the private sector during the Suharto era. Table 2.10 shows the influence of IBRA in the main forest industry sectors.

In principle, IBRA had enough authority to promote forestry reform initiatives. It was vested with far-reaching authority to take legal actions over bank assets and liabilities under restructuring. IBRA had the power to take the rights of not only the bank shareholders but also those of the boards of directors. Its policies could also be extended to directly affiliated companies. IBRA could control, manage, and exercise ownership of all bank assets and the rights to bank assets, both domestic and overseas. Importantly, IBRA could rewrite, cancel, terminate and/or change contracts that bound banks to third parties.

With these powerful mandates IBRA had a very real and great opportunity to integrate economic policies and sustainable forest policies. Many analysts believed that through effective management of forestry assets under its control, IBRA could have helped the Indonesian government to achieve the following objectives: (i) reduction of the Indonesian government's budget burden and deficit; (ii) elimination of inefficient forestry companies; (iii) strengthening and improvement of viable forestry companies; (iv) reduction of excessive wood processing capacity and (v) more effective and environmentally sound procedures for wood processing companies.

2.6 Indonesian post-IBRA banking policy

Banking and financial policies after IBRA will continue to influence the management of Indonesia's forests and the welfare of Indonesian people. Prudent banking and financial policies can facilitate the flow of capital from forests to other economic sectors or vice versa. These policies should avoid giving an implicit guarantee that banks, especially big banks, cannot fail. When a bank's failure is a real risk, it would not provide implicit guarantees to big companies and would not allow uncompetitive use of forest capital or the flow of proceeds from forestry crimes. With more international banking practices looking for projects that support social and environment factors, Indonesian banking policies can be used to promote more and more flow of capital to the forestry sector.

Table 2.10 IBRA and the Indonesian Forest Sector

Industry	National Capacity/Area	Capacity/Area Controlled By IBRA	% Controlled by IBRA
Plywood	9,433,095 m^3	5,620,993 m^3	59.59
Blockboard	2,085,738 m^3	1,561,422 m^3	74.86
Sawmills	11,048,083 m^3	978,000 m^3	8.85
Pulp	5,888,100 tons	4,602,000 tons	78.16
Paper	9,904,080 tons	5,732,300 tons	57.88
Private HPHs	32,062,785 ha	7,622,656 ha	23.77

Source: Ministry of Forestry and IBRA

The post-IBRA banking policies for promoting sustainable forest management are especially relevant because of the remaining non-performing loans of wood-based companies. Although, IBRA sold most forestry debts, including forestry pledged assets, the majority were sold to government owned banks (see Chapter Four for a detailed discussion). In fact, these debts are still difficult to restructure and consequently increase NPLs of stated-owned banks that were 'forced' to buy the debts. Bank Mandiri recently announced that the debts of four forestry conglomerates it had bought from IBRA were non-performing. The Raja Garuda Mas Group, the Djajanti Group, and Kiani Kertas have contributed significantly to Bank Mandiri's NPL level, which stood at 26 percent by June 2006.[27]

According to Bank Indonesia Regulation (PBI) No. 6/9/PBI/2004, banks can be subject to intensive supervision by the Bank Indonesia (BI) if BI finds they are at risk of bankruptcy. Several criteria are used to evaluate this risk, including having NPLs exceeding 5 percent of the bank's total loans. Based on this criterion Bank Mandiri should be under intensive Bank Indonesia supervision.

Banking policies post-IBRA should also be used to address the structural demand for timber in excess of the volume that can be supplied legally. BI Regulation No.7/2/PBI/2005 from 2005 regarding the assessment of banks' general asset quality, and its implementation policy, the BI circular letter No. 7/ 3 /DPNP (hereafter referred to as PBI No.7/2005), are policies that could be implemented to address the structural overcapacity. They could be used to request wood-based companies such as plywood and pulp companies to disclose their sources of wood supply and encourage them to develop a secure resource base for wood supply from timber plantations. Banks and other investors still pay little attention to how these companies obtain their wood supply. Although wood cost is a major source of competitiveness for Asian and Latin American pulp companies, between 1 July and 31 December 2003 only 7 documents out of 1,585 relevant publications dealt explicitly with this issue (Spek, 2006).

Securing a sustainable supply of wood, besides reducing pressure on forests, also makes good business sense for wood-based companies. The current cost advantages of Indonesian pulp companies over their competitors in developed markets is eliminated by high interest rate charges by holders of debts (Spek, 2006). Part of the risk premium charged by investors may be derived from perceived raw material supply risks. A secure wood supply can reduce this risk and would lead to a lower cost of capital for wood-based companies. Moreover, overall the Indonesian forestry sector currently suffers from a tarnished reputation which may harm its competitiveness in export markets in the long run.

Banking policy PBI No.7/2005 requires banks to assess the quality of their earnings assets (for example bank loans) and assign a classification of current, special mention, sub-standard, doubtful, or loss to each loan on their books. Bank loans (earning assets) include those loans provided to wood-based companies. The policy also requires banks to apply a uniform quality classification to multiple accounts of earnings assets used to finance one debtor as well as earnings assets extended by more than one bank to one debtor.[28] The quality of earnings assets (banks loans) used to finance forestry-based debtors shall depend on security of wood supply to feed the mills, since from the demand side the wood-based companies shall have a good prospect, these loans could easily become NPLs when forestry companies fail to service their debts due to the lack of a secure wood supply.

Banks could make loans to wood-based companies contingent upon a reasonable wood procurement plan that secures an adequate wood supply from a sustainable resource base, such as timber plantations or certified natural forest. The Ministry of Forestry can help to develop an indicator of wood supply quality for each wood-based company. The wood procurement plan and the wood quality indicator would provide information to banks allowing them to assess wood costs, wood markets and competition, and the capacity of the company's management to support the government's policy on sustaining forests and protecting the environment.

This key banking policy could also be used to once again link debt restructuring processes to the restructuring of wood-based industries. Regulation PBI No.7/2005 allows banks to restructure their non-performing loans (debt restructuring) for debtors that have good business prospects and are able to repay their debts after restructuring. The debt restructuring

process should follow the prudential principles, the financial accounting standards, and the Indonesian banking accounting standards. First, banks should analyze the causes of loan non-performance, estimate the potential debt repayment level before and after restructuring, and assess the need for restructuring the organization of the debtor companies. Second, banks should disclose the approaches and assumptions used in financial valuations. For wood-based companies, banks should disclose the wood supply information that they use to arrive at debtor's projected cash flows. Finally, banks should provide recommendations for reducing interest rates, writing off loan principal and/or unpaid interest, extending terms of loans, and providing other facilities. The first two procedures should be able to link debt restructuring and wood-based industry restructuring. In their recommendations, banks should only provide facilities (incentives) to wood-based companies with reasonable wood procurement plans.

The most encouraging feature of PBI No.7/2005 for promoting sustainable forest management is that banks are required to assess the capacity of the board of management of large-scale debtors to conserve the environment. The policy suggests that banks should use an Environmental Impact Analysis (EIA or AMDAL) issued by the Environmental Office to review the suitability of the debtor's management plan for conserving the environment. After lending has taken place, banks are required to monitor the company's environmental performance. To fulfill this requirement, banks have to evaluate another report produced by the Environmental Office called the PROPER. This report categorizes the environmental performance of companies as gold, green, blue, red, or black. A gold rating is the best while a black rating is the worst. All large wood-based companies and timber plantation companies (HTIs) are required to have AMDAL and PROPER reports (Apriani, 2005). The AMDAL document should provide information on how a wood-based company plans to conserve forests by providing a plan to develop a secured resource base for wood supply. The PROPER should contain information on the quality of timber supplied to wood-based companies and the capacity of their management to assure they do not originate from national parks, protected areas or illegal activities.

The post-IBRA banking policy can also be used to reduce the flow of capital out of the forestry sector. In the past, violations of the legal lending limit allowed forestry conglomerates to move capital from forests to other economic sectors, thereby reducing the amount of capital available for investments in sustainable forest management and conservation. Regulation PBI No.7/3/PBI/2005 sets the legal lending limit for related parties at 10 percent of the bank's total capital. A related party is defined as an individual or company/organization that has direct or indirect control of the bank, through ownership, management, and or financing. An entity receiving benefits from bank financing to a related party is also a related party. A company/organization that has financial interdependence with the bank is also considered a related party. A company/organization providing a financial guarantee to a related party is also a related party. A controlling party is an individual or an organization that directly or indirectly owns or has the option to own (individually or in collaboration) 10 percent of bank shares or shares of other companies/organizations. Controlling parties are also those acting in concert to control banks or other companies with or without agreement so that together they own or have the option to own 10 percent or more of a bank's or company's shares. The legal lending limit for one debtor that is not a related party is 20 percent of the bank's total capital and 25 percent for one group of debtors. Banks are required to implement prudential principles and risk management when providing funding especially for a related party or when the funding is large exposure funding. They are required to have standards and criteria for the selection and assessment of debtors or groups of debtor's feasibility.

Finally, the banking policy can be used to prevent the flow of illicit money from illegal logging to actors masterminding forestry crimes and the corrupt government officials supporting them. Since 2001, the Bank Indonesia has required banks to have a Know Your Customer (KYC) policy to prevent them being used for money laundering. In 2005, the Bank Indonesia strengthened this regulation by imposing sanctions on banks found not to be properly implementing the KYC principles.

Policy Dialogues

3.1 Looking for illegal loggers

The first three years of the financial crisis were a collaborative period for Indonesia's civil society and its international donors. It was the first time NGOs could speak freely about their concerns on forestry. It was also the first time that the Ministry of Forestry was forced to recognize illegal forestry activities, overcapacity of the forest industries and other structural problems within the forestry sector. The CGI forum made the Indonesian government recognize the role of inter-ministerial cooperation in tackling forestry issues. To implement the eight forestry reform agendas, the Minister of Forestry needed the support and involvement of other responsible government institutions as well as the NGOs.

With support from forestry donor countries and the World Bank, the Indonesian government established the Interdepartmental Committee on Forestry (IDCF) in June 2000.[29] The Coordinating Minister for Economic Affairs headed the IDCF and the Minister of Forestry served as the Vice-Chairman (The Coordinating Minister for Economic Affairs, like the CEO of a very large company, controls many departments, including finance, trade, investment, industry, forestry, and agriculture).[30] The Coordinating Minister for Economic Affairs also controlled IBRA.

Earlier, in December 1999, with support from the International Monetary Fund (IMF), the Indonesian government had established the Financial Sector Policy Committee (FSPC). The main mandate of the FSPC was to formulate policies for restructuring banks and debts. The Coordinating Minister for Economic Affairs headed this important institution. Members of the FSPC included the Minister of Finance, the Minister of Industry and Trade, the Minister of State-Owned Enterprises, and the Chairman of National Development Planning. FSPC policies on debt restructuring were to be the guidelines for IBRA debt policy. FSPC policy, in turn, was established to resolve non-performing loans of almost all major companies in Indonesia, including Indonesian forestry conglomerates.[31] However, the Minister of Forestry was not a member of the FSPC.

Within this context, the civil society groups were ready to pressure the companies involved in illegal logging. The groups suspected a connection between illegal loggers and the forestry industries, many of which were operating under IBRA control. Indonesian wood-based industries had an installed capacity of more than 60 million m^3 per year (Barr, 2001). This wood demand far exceeded the Ministry of Forestry's often stated national sustainable harvest level of 25 million m^3 per year.[32] Recognizing the excessive wood demand, the Minister of Forestry, as part of the forest industry restructuring process, had introduced the Soft Landing Policy. The policy was created to reduce, in stages, the annual allowable cut from natural production forests. Under this policy, the Ministry of Forestry set much lower wood supply targets for the upcoming years; from 6.89 million m^3 for the year 2003 to only 5.7 million for the following year. One aim of the policy was to force the forestry industries to use imported wood and wood from timber plantations. Reports by NGOs, the media, and research institutions, however, showed increasing illegal logging activities throughout the country and lack of progress in timber plantation development and wood imports. The huge gap between supply and demand of wood in Indonesia perpetuated illegal forestry activities. The cost to the government of these illegal forestry practices was estimated at around USD 3 billion.[33]

IBRA served as a perfect vehicle to expose the link between the illegal loggers and the forestry industries. IBRA 'controlled' all of the major forestry companies that were suspiciously involved in or had triggered illegal forest activities. In the process of restructuring the debts of these companies, IBRA should have conducted due diligence procedures to assure that the proposed debt restructuring would not pose unnecessary risks to IBRA. To minimize IBRA's potential losses due to illegal forest activities, the civil society organizations suggested
that IBRA should require forestry industries to perform log-tracking audits. This type of audit would provide information on the sources of the wood used by industries. Industries, which the audit proved were using illegal sources of wood, could then be closed or downsized. The civil society also suggested that forest resource assessments be conducted for forestry companies under IBRA.[34]

In its efforts to restructure the forestry industry, the Ministry of Forestry also tried to prove a connection existed between forestry industries and illegal logging activities. The Forest Industry Restructuring Task Force was established by the Ministry in October 2001 and given the task of designing criteria and indicators that could been used to assess whether an industry was involved in illegal forest activities. Based on a recommendation of the task force, in February 2002, three months before IBRA launched its debt fire sale program (discussed later); the Minister of Forestry recommended that IBRA should close four companies and downsize two other companies under its control. Table 3.1 presents the recommendations for those companies.

3.2 Show me the money

Unfortunately, IBRA was not interested in examining the connection between forestry industries and illegal logging activities. It was a big blow to the civil society when IBRA openly declared that it was not responsible for dealing with illegal activities of forestry companies. According to IBRA's Chairman and Vice Chairman[35] IBRA was more interested in maximizing value of the assets under its portfolio, and its foremost concern was the commercial settlements of those assets. They emphasized that IBRA preferred to think of itself as a creditor that maintained a creditor-debtor relationship with its debtors. Specifically, they considered it the responsibility of the technical ministers to close the forestry industries or downsize their capacities. They indicated that IBRA welcomed any decision made by the Minister of Forestry or the Minister of Trade and Industry to close or reduce the capacity of any company under IBRA's control. However, following such actions, IBRA would request that the Ministry of Finance and the FSPC agree to writing off the debts of those companies.[36]

IBRA's approach which some observers referred to as 'show me the money first' was reflected in many dialogues involving staff from IBRA, technical departments, and NGOs. IBRA would request that IWGFF submit a proposal that could show the value and recovery rate of forestry debts after closing or downsizing some forestry companies. IBRA would then agree with the proposal if it produced a recovery rate that was higher than IBRA's estimated one. The economic advisors of the World Bank and the IMF supported IBRA's position. Representatives from both institutions would make the same request when they discussed the civil society demands. However, since IWGFF lacked the easy access that the IBRA consultants had to the information on the forestry companies, they could not respond quickly to these requests.

The focus on debt recovery was the reason behind IBRA's decision not to respond to the Ministry of Forestry's letters. The Minister

Table 3.1 Recommendation by the Minister of Forestry for IBRA on Feb 7, 2002

Debtor	Obligor	Recommendation
PT. Batasan	Batasan Group	Close
PT. Hutrindo Jaya Fiberboard	Hutan Raya Indonesia	Close
PT. Sumatera Timber Utama Damai	Sumatera TUD	Close
PT. Balok Mas Wood-Based Industries	Balok Mas	Close
PT. Hargas Industries Indonesia	Hargas Industries	Downsize
PT. Kayan River Indah Plywood	Kayan River Indah Ply.	Downsize

of Forestry sent three letters to the Minister of State-Owned Enterprises who was IBRA's supervisor and a member of the FSPC. Copies of these letters were also sent to the Coordinating Minister (the head of the FSPC and the IDCF), the Minister of Industry and Trade (a member of the FSPC), the Minister of Finance (a member of FSPC), and the Chairman of IBRA. In the first letter, sent in October of 2001, the Minister of Forestry requested that IBRA re-evaluate the wood supply for sixty-four companies that had IBRA approval for debt restructuring. The letter also requested that IBRA consider the wood supply in the debt restructuring of forty-four companies under review by IBRA. In addition, the Minister of Forestry asked for clarification regarding twenty-seven forestry concessionaires (HTI and HPH) under IBRA, which were being considered as possible pledges towards collateral. This was a controversial issue because the Ministry of Forestry regulations did not allow for HPH concessions and HTI plantation licenses to be pledged as collateral.[37]

The Minister of Forestry's second letter, sent in January of 2002, provided information regarding the performances of forestry companies under IBRA. According to the letter, there were five HPH companies without new licenses and three HTI companies with unpaid reforestation fees in the amount of IDR 135 billion. Besides this, portions of the timber plantation owned by Kiani Kertas Pulp and Paper had been destroyed by fire in 1997, and thirteen wood-based companies had questionable sources of wood supply. In February of 2002, as a follow up, the Forestry Minister sent a third letter in which he recommended that four wood-based companies be closed and two others undergo capacity reductions.[38]

3.3 The civil society response

Disappointed by IBRA's lack of response, IWGFF changed its strategy and decided to approach the Indonesia country director of the World Bank and the IMF. They considered these two institutions as having leverage with the Coordinating Minister, who in turn led both the IDCF and FSPC. Twice a year, the World Bank, as part of the CGI loan pledging process, meets with the Coordinating Minister of Economic Affairs to discuss how much financing the Indonesian government needs to maintain macroeconomic stability, financial sector reform, governance and legal reforms, and its poverty reduction program. At the same time, the IMF meets with the Coordinating Minister of Economic Affairs to discuss the balance of payment problems that require fundamental reforms in the economy. The civil society groups believed that the World Bank and IMF could use their leverage to change IBRA's debt policy concerning the forestry industries. Table 3.2 shows Indonesia's financing needs since 2002, and the CGI loans that were provided to the Indonesian government. It also shows the Extended Fund Facility (EFF) provided by the IMF and drawn by the Indonesian government for the years 1998, 2000, and 2003. Indonesia needed about USD 3 billion every year from the CGI to finance its budget deficit and the Indonesian government borrowed USD 15.7 billion from the IMF until 2003.

The World Bank is the largest donor institution of the CGI and is also active in supporting policy reform in the Indonesian forestry sector. Every year, the CGI and the Indonesian government discuss progress of reforms in the Indonesian forestry sector, as well as poverty and other governance issues before agreeing on the amount of financial assistance given to Indonesia. The

Table 3.2 CGI and IMF Financial Assistance to Indonesia

Foreign Assistant	USD million		
	2002	2003	2004
Indonesia's requests to the CGI			
Upper limit	3,500.00	2,800.00	3,000.00
Lower limit	3,000.00	2,400.00	2,500.00
CGI Pledged Loans	**3,140.00**	**2,700.00**	**2,800.00**
	1998	**2000**	**2003**
Indonesia's requests to the IMF			
Agreed	11,740.49	7,010.63	5,405.96
Drawn	5,166.23	5,182.01	5,405.96

Source: The World Bank and IMF

World Bank provides key input to donor countries on the amount of financial assistance needed by Indonesia. The IMF provided financial assistance to Indonesia based on conditionalities that included monetary and fiscal policies as well as the banking recapitalization program managed by IBRA.

The IWGFF expectation of the Coordinating Minister for Economic Affairs was politically and operationally correct. He 'controlled' two key deputies that could have linked timber processing capacity reductions with IBRA's goal of maximizing the debt recovery rate. The Deputy Coordinating Minister for Natural Resources and Agricultural Development in charge of forestry issues was the Secretary of the IDCF, while the Deputy Coordinating Minister for Investment and Business Development became the Secretary of the FSPC. In April 2002, the Deputy for Investment was elected Chairman of IBRA, a position he assumed while retaining his previous posts. Effective coordination of the two deputies should have provided a win-win solution for IWGFF and IBRA.

The World Bank sent a letter to the Coordinating Minister for Economic Affairs in March 2002, one month before IBRA started a fire sale of debt from its portfolio. This letter addressed the need to restructure the forest industry and to deal with the forest sector debt in ways consistent with sustainable forest management.[39] Copies of this letter were sent to the Ministers of Finance, Industry and Trade, State-Owned Enterprises, Environment and Forestry, the Chairman of IBRA and the Chairman of the Jakarta Initiative Task Force (JITF). The World Bank reminded the Indonesian government of the lack of any consideration of timber supply in IBRA's ongoing debt restructuring and asset sales. It pointed out that IBRA and the FSPC should consult with the Ministry of Forestry on their actions to restructure forestry debts.[40]

In order to add to the pressure on IBRA, a former Deputy Chairman of IBRA, with input from members of IWGFF, in June 2002 sent a confidential letter to the Coordinating Minister for Economic Affairs, to change IBRA's debt policy on the forestry sector (Salim, 2002). Members of IWGFF also met with the Senior Resident Representative of the IMF in Indonesia and the Country Director of the World Bank in Indonesia to request that the IMF change the FSPC's policy on forest companies' debt restructuring. In response to this request, the World Bank invited IWGFF and CIFOR to make a recommendation to the Head of FSPC. The meeting also suggested that the IMF and the World Bank would write a new letter to the Head of FSPC. However, such a letter was never sent out.[41]

In January of 2003, IWGFF provided a response to IBRA's request for a recovery rate proposal. Based on this input, the Donor Forum on Forestry (DFF) sent a letter to the World Bank and the IMF. IWGFF suggested that IBRA might be able to recover as much as USD 945 million (a 63% debt recovery rate) if due diligence and valuation processes were conducted. If IBRA were to close down 50% to 65% of the wood processing capacity represented in its portfolio, preliminary analyses indicated that it could still recover 23% to 32% of the value - between USD 350 million and USD 486 million (Brown, 2003). Earlier analysis suggested that closing down all non-HPH backed plymills in exchange for debt forgiveness and closing down 20% of the HPH backed capacity would result in a 22.1% recovery rate (Spek, 2002). A similar analysis using a larger data set also arrived at the same conclusion. IBRA would receive a 25 percent recovery rate while downsizing 60 percent of the capacity of wood-based companies under its portfolio (Simangunsong and Setiono, 2004). Further quantitative analyses were offered to IBRA through the World Bank and the IMF. IWGFF also asked for assistance in getting more complete data in order to refine its analysis. The group showed that linking the debt restructuring process to the closing and downsizing of forestry industries, would amount to a higher recovery rate than IBRA had estimated.

3.4 The final decision

Ultimately, the Coordinating Minister for Economic Affairs did not request that IBRA change its debt policy for forestry industries. Instead of responding positively to the IWGFF demand, the FSPC decided to agree with the recommendation proposed by the Minister of Industry and Trade to provide the easiest debt resolution option for six industries, including the pulp and paper and wood industries. These industries were considered to be strategic industries.[42] However, it was unclear what criteria and indicators the Minister of Trade

and Industry used to categorize the wood-based industries as strategic industries.

Moreover, while the World Bank, the IMF, the Coordinating Minister for Economic Affairs, and the NGOs were discussing an alternative debt strategy for the forestry companies, IBRA went ahead and sold almost all of the forestry debts. In March 2002, the FSPC had issued a policy called "the Revitalization Policy for Strategic Industries under IBRA." Under this policy, the FSPC demanded that IBRA sell un-restructured loans of textiles, electronics, shoes, pulp, paper, and wood industries (worth IDR 33.99 trillion or USD 5 billion) in March and April of 2002. IBRA was directed to cooperate with the Minister of Industry and Trade.[43] In effect, this proved to be a fire sale of a large amount of debts at prices well below their nominal value. Under pressure from the IMF to speed up asset sales (discussed later), in May of 2002, the FSPC sent a 'warning' letter to IBRA to speed up the process of selling the un-restructured loans of these strategic industries.[44] By the end of December 2002, IBRA had sold restructured and un-restructured loans of wood-based companies worth IDR 19.78 trillion or about USD 3 billion. This represented about 90% of the total forestry debts under IBRA's Asset Management Credit Unit (AMC). The sale was never announced publicly.

The FSPC decision dealt a heavy blow to Indonesia's forests. Voicing his regret at the decision, the Minister of Forestry stated that, "IBRA's debt policy to allow forest companies to remain in business has contributed to the over capacity that demands more raw materials than Indonesia's forests can supply. This is shown clearly with the selling of forestry debts by IBRA at any price. It will definitely have negative impacts on sustainable forest management." [45]

3.5 Underlying factors

IWGFF had shown its calculations on the value of maintaining forest sustainability to the Head of the World Bank and the IMF, as well as to the Head of the FSPC and the IDCF. It had shown how sustainable forests could contribute USD 565 million annually with the addition of up to USD 400 million from the value added after wood processing. The sustainable forests could also generate tax revenues of USD 300 million every year (Brown, 2003). These sustainable forest revenues, although not large enough to cover all the country's financial problems, could still make a significant contribution towards solving the larger financial dilemma faced by the Coordinating Minister, the World Bank, and the IMF.

These groups, however, were more concerned with financing the annual government budget deficit and repaying the government's foreign and domestic debts. Following the financial crisis the government's debt reached a critical level. Before the financial crisis in 1997, the government's debt as a percentage of its GNP was less than 30%. After the crisis, this ratio reached close to 100% (Nehru, 2000). If economic growth does not return to pre-crisis level and the government fails to reduce its debt burden, the financing need will continue to increase. Table 3.3 shows the World Bank's analysis of the Indonesian government's financing needs for the year 2004.[46]

IBRA's asset sales and the sale of the government stakes in state-owned enterprises (privatization) provided one source of financing for the Indonesian government. Even though these sales added up to only 11.43% of the total financing need, they still reduced the amount of foreign assistance needed by Indonesia. Due to this fact, it became an uphill battle for IWGFF

Table 3.3 Indonesia's Financing Need for 2004

	USD billion	% of Total
Budget Deficit	2.90	27.62
Payment of Domestic Debts	2.40	22.86
Payments of External Debts	5.20	49.52
Total Financing Need	10.50	
Sources of Finance:		
Withdrawal of bank deposits	2.20	20.95
Issuance of Government Bonds	3.80	36.19
Privatization and IBRA asset sales	1.20	11.43
Non-CGI foreign finance (including Export Credit Agencies)	0.50	4.76
CGI Financing	**2.80**	**26.67**

to influence the way IBRA managed the forestry debts.

According to the IMF, the quicker sale of IBRA's assets was the key to Indonesia's economic recovery. Horst Koehler, upon his first trip to Indonesia as the Managing Director of the IMF, stated that, "Faster privatization of IBRA's holdings would help the country regain international confidence and investment. Without clear and sustained progress, Indonesia would remain off the maps of international investors."[47] It remains to be seen how the IMF will react to the Minister of Forestry's assessment that IBRA's sales of forest debts will have a negative impact on sustainable forestry. It also remains to be seen whether the fire sale of forestry debt will return international confidence and investment to the forestry sector.

The Debt Policy

4.1 Debt restructuring policy

This chapter discusses the FSPC debt restructuring policies, IBRA's interpretation of the policies, and the settlement policy for corporate debts and financial obligations of bank shareholders. As discussed in Chapter Three, the FSPC did not issue a special debt policy for forestry companies and conglomerates. It issued general debt restructuring policies for all non-performing loans under IBRA and for all financial obligations of shareholders. However, the FSPC also made specific debt settlement policies for the top fifty debtors and all bank shareholder settlements.

The FSPC categorized debtors into categories A, B, C, and D. Table 4.1 provides the summary of criteria and general debt resolution for each category. Debt restructuring allowed debtors not to pay their debt principal and/or interest for certain periods; in some cases it also reduced the amount they had to pay. The FSPC debt restructuring policy suggested that only debtors under categories A and B would receive the benefits of debt restructuring. Category A debtors would be offered debt rescheduling first. If part of their debt was unsustainable, IBRA looked for equity in the debtor company that could be used in exchange for the unsustainable part of the debt (debt-to-equity swap). IBRA also accepted other assets of debtors to replace unsustainable debts (debt-to-asset swap). Alternatively, the debtor could sell assets and use the proceeds to repay the unsustainable portion of the debt. For category B debtors, FSPC required the debtors to supply new capital or to do an asset swap for the unsustainable portion of the debts, before IBRA would allow debt rescheduling.[48] Supplying new capital or doing an asset swap was a sign of good intentions by a debtor in settling debts. However, more often IBRA categorized debtors with good intention to repay debt as cooperative debtors. The FSPC required that IBRA liquidate and/or litigate debtors under categories C and D.

A sustainable debt is defined as a debt that can be served by a debtor based on the debtor's ability to generate cash flow. Under the FSPC system, the cash flow could serve as debt repayment over a maximum of 10 years, with a two-year interest free (grace period), with an 18% interest rate for Rupiah denominated loans and a 10% rate for US dollar denominated loans. A debtor is allowed to pay a maximum balloon payment (a large one-time payment) of 30% of the loan principal, at the end of the period. Unsustainable debts consist of debts that cannot be serviced by a debtor's available cash flows, after the payment of all liabilities on sustainable debts. Unsustainable debt is defined as an amount that cannot be repaid from normal operational cash flow. The solution to this

Table 4.1 Debtor Category, Criteria, and Solutions

Category	Criteria	Solution
A	Good business prospect with good intention	Loan rescheduling, assets sales by debtors, debt-to-equity conversion
B	Poor business prospect with good intention	Capital injection, asset swap, and Debt-to equity conversion
C	Good business prospect with poor intention	Litigation and foreclosure
D	Poor business prospect with poor intention	Bankruptcy and liquidation

Source: IBRA Strategic Plan 1999-2004

problem involves cash payment, asset swaps and/or equity swaps, with the combined assets and equities having a market value equal to the value of the unsustainable debt.

IBRA found that 78.19% of the forestry corporate debtors fell under category B, while 10.16% fell under category A. Another 5.92% of the debtors fell under category C, and 2.84% fell under category D. Forestry debtors under category B included the Bob Hasan Group, Raja Garuda Mas Group, and Djajanti Group. According to IBRA, forestry debtors with good business prospects included the Barito Group and Surya Dumai group. The Barito Group on the other hand, was considered to be an uncooperative debtor (category C).[49]

Generally debtors reported high sustainable levels of debt, sometimes as high as 70%. In contrast to this, IBRA's findings indicated that a more accurate estimate of average sustainable debt would have been around 30%. According to IBRA officers, many of the companies actually had sustainable debt levels as low as 10%. In some cases, after the due diligence process, IBRA found negative cash flows existed while debtors had been reporting a high sustainable level.[50] The Sinar Mas Group and the Raja Garuda Mas Group, the two largest pulp and paper producers in Indonesia, had the largest repayment capacities out of all the companies. IBRA determined their sustainable debts to be 56.11% and 95.58% respectively. However, the Sinar Mas Group provided cash and asset swaps for 28.32% of its total debts. This Sinar Mas Group debt was not related to debts of APP Indonesia discussed later in Chapter Five. The Djajanti Group and the Indhasana Group had the worst solvency problem, with each having a 100% rate for unsustainable debts. The Barito Group and the Surya Dumai Group also had poor solvency with unsustainable debts of 84.92% and 77.99%, respectively. Table 4.2 shows IBRA's assessment of the debt repayment capability for the top seven forestry debtors.

Table 4.3 shows the debt settlements negotiated by IBRA and the forestry debtors on unsustainable debts. The owners settled all unsustainable debts without cash settlements, asset swaps, or new capital insertion. The FSPC guidelines required that IBRA use its power to force the debtors to pay the unsustainable debt. In this respect, IBRA was negligent in its duty when it failed to obtain the maximum value from debts owned by the Barito Group and the Djajanti Group. Unsustainable debts of these companies were transferred to new holding companies by IBRA. The value of these holding companies was much less than the value of the existing subsidiary companies of these groups, which were not under IBRA control, especially those located abroad. IBRA had the mandate and authority to trace assets of the company owners, but failed to use it properly. It was unclear how much new capital the owners of the Barito Group and Djajanti Group supplied to the proposed new holding companies. Any cash they had should have been paid directly to IBRA for the unsustainable part of their debts. IBRA also made no disclosure on how it managed the holding companies created by the unsustainable debt in the forestry sector. However, inferring from the Supreme Audit (BPK) report on the sale of the Bob Hasan Group's debts (discussed in Chapter Five), it suggests IBRA canceled the settlement of unsustainable debts and put all these debts in the fire sale program.

Reportedly some debtors succeeded in selling assets (particularly their overseas assets) without consent from IBRA. Not only did they sell these assets without IBRA consent, but they also

Table 4.2 IBRA Debt Settlement for the Largest Forestry Sector Debtors

Obligor	Total Loans (IDR billion)	Cash and Asset Settlement (%)	Sustainable Debt (%)	Unsustainable Debt (%)	Category
Bob Hasan Group (17 firms)	6,016.70	12.61	41.13	46.26	B
Barito Group (17 firms)	4,671.05	0.00	15.08	84.92	C
Raja Garuda Mas (13 firms)	2,405.29	0.42	95.58	4.00	B
Djajanti Group (15 firms)	3,995.03	0.00	0.00	100.00	B
Sinar Mas Group (22 firms)	872.19	28.32	56.11	15.57	B
Indashana Group (3 firms)	1,466.16	0.00	0.00	100.00	B
Surya Dumai (10 firms)	2,074.29	0.08	21.92	77.99	A
Total	21,500.71	5.92	32.83	61.24	

Source: IBRA press releases, 2000 and 2001

Table 4.3 Terms of Settlement for Unsustainable Forestry Debts under IBRA

Debtors	Category	Unsustainable Debt (USD million, IDR billion)	Terms
Bob Hasan Group:	B		
Kiani Kertas		USD 252.17	Convertible bonds
Kalimanis Plywood Industries		IDR 172.01	Debt transfer to holding company
Wenang Sakti		IDR 60.44	Debt transfer to holding company
Jati Maluku Timber		IDR 18.56	Debt transfer to holding company
Kiani Sakti		IDR 363.96	Debt transfer to holding company
Barito Group:	C		
Chandra Asri		USD 463.60	Debt-to-equity swap
Inter Petrindo Inti Citra		IDR 342.5	Debt transfer to PT. Zillion
Raja Garuda Mas Group	B		
Sola Gratia Ply Ind. Co. Ltd.		USD 18.17	Debt-to-convertible bonds
Djajanti Group:	B	IDR 3,995.03	Debt transfer to a new holding company
Indhasana Group:	B		
Kertas Basuki Rahmat		IDR 1,366.36	Debt-to-equity swap
Kertas Blabak		IDR 81.8	Debt-to-equity swap
Surya Dumai Group:	A		
Arindo Tri Sejahtera		USD 5.02	Granting shares of Surya Dumai Industri (SDI)
Ciliandra Perkasa		IDR 55.41	Granting shares of SDI Tbk.
Muriniwood Indah Industry		IDR 16.96	Granting shares of SDI Tbk.
Perawang Lumber Industry		IDR 228.37	Convertible bonds or shares of SDI Tbk.
Surya Dumai Finance		IDR 196	Convertible bonds or shares of SDI Tbk.
Surya Dumai Industri		IDR 745.62	Convertible bonds or shares of SDI Tbk.

Source: IBRA press releases, 2000-2001

failed to use the proceeds to pay their debts to IBRA. In September of 2000, Marimutu Sinivasan, the controlling shareholder of the Texmaco Group, succeeded in selling his 60% stake in the German polyester producer Trevira GmbH for around USD 120 million. He also managed to divert his stakes in the UK garment maker SR Gent PLC, to a British Virgin Island company that he controlled. All of these transactions he conducted without informing IBRA (Montlake, 2001). IBRA also failed to trace the Sinar Mas Group's overseas assets. Asia Food & Properties Ltd. (AFP) and Golden Agri-Resources Ltd. (GAR), two Singapore based Sinar Mas Group units, had placed approximately USD 247 million in the BII Cook Islands subsidiary (also owned by the Sinar Mas Group). IBRA only became aware of these assets, when newspapers revealed that the group had other banks in the Cook Islands and the Cayman Islands (Webb, 2001). It was also reported that the Sinar Mas Group transferred its profits from forestry businesses in Indonesia to China. The profits from its Asia Pulp and Paper (APP) units in Indonesia including Indah Kiat Pulp and Paper, Pabrik Kertas Tjiwi Kimia, and Pindo Deli Pulp and Paper, were transferred to APP units in China in anticipation of more favorable economic conditions there.[51] The Raja Garuda Mas Group also conducted a similar strategy to those applied by the Sinar Mas Group.

4.2 The environment-based debt covenant

IBRA's leadership might not have been interested in taking environmental precautions, such as requiring forestry debtors to perform log-tracking audits. However, as a result of continuous dialogues with and pressure from civil society, IBRA agreed to establish an environment-based debt covenant in 2002. This required that forestry sector debtors sign a technical covenant when signing their debt restructuring agreements. IBRA and the civil society group had discussed at least three possible versions of the technical covenant and IBRA chose the simplest form. This debt covenant required each forestry company, especially the wood processing companies, to have a sufficient supply of raw materials to service its debts and to promise not

to use illegal logs. In principle, these covenants were an integral part of the debt restructuring agreements between IBRA and debtor companies. In the event that a debtor failed to comply with either of these points, IBRA could declare the debtor to be in default. IBRA chose a simple technical covenant for two reasons. First, IBRA considered that technical forestry issues were the responsibility of the Ministry of Forestry and related departments and would have been properly addressed in forestry regulations. Second, it would have been much more difficult to reach an agreement with a debtor if IBRA had used a strong technical covenant. This, in turn, could have caused delays in the sale of the restructured loans.[52]

One of the other proposed technical covenants was much more demanding and included a requirement for debtors to provide plans for sustainable forest management and for protecting the environment. The covenant would have required them to have long-term plans (RKPH and RKL) and an annual plan (RKT) for harvesting timber. They would also have to provide a government letter supporting their plan to protect the environment (AMDAL).[53] Debtors would have been required to perform forest rearrangements based on a compartment approach and to follow all forestry regulations. The companies in debt under this plan would have been required to fulfill their obligations with regard to IHPH (timber concession license fees), PSDH (forest royalty fees) and DR (reforestation funds). The companies would also have been required to support the development of local communities around forested areas. The companies would have been prohibited from participating in illegal logging and would have to adhere to Indonesian Accounting Standard No. 32 (PSAK No.32) that requires disclosure on forest resources. They were also required to provide performance bonds and to plant at least 50% of the HTI timber plantation concession within five years of the issuance of a HPH license.[54]

Measures could have been taken by IBRA if debtors failed to fulfill their obligations as specified by the covenant. Failure to abide by the technical covenant was considered a default on the restructured loans. IBRA expected the Ministry of Forestry to monitor the implementation of the technical covenant. If there were no reports from the Ministry of Forestry about the failures of the company to follow the technical covenant, IBRA or the new owner of the loans considered the company to have fulfilled the technical covenant. IBRA expected non-governmental organizations (NGOs) concerned with forestry issues to report to the Ministry of Forestry if the company failed on the technical covenant, and then hoped the minister would take action accordingly.[55] Unfortunately, IBRA had not included these parties in the debt covenant discussion.

4.3 The debt restructuring process

The IBRA debt restructuring process followed seven stages and another four stages for settlement of the debt. Table 4.4 shows the procedures that should have been followed by debtors in the debt restructuring and debt settlement processes, according to these stages.

In the first stage, IBRA and a debtor entered into the initial negotiation stage, in which the debtor was put into a debtor category and

Table 4.4 Debt Restructuring and Settlement Processes

Stage	Restructuring Process	Settlement Process
1	Initial negotiation	Initial negotiation
2	Stand still creditor’s agreement	
3	Advisory assignment	
4	Due diligence process	
5	Start negotiation	
6	Finalizing debt restructuring proposal	
7	Signing debt restructuring agreement	
8		Fully paid in installments
9	Disposal of restructured debts	
10		Legal process/litigation
11		Appropriate legal action in progress

Source: IBRA Loan Work Out System

required to sign a letter of commitment. IBRA then conducted a preliminary assessment, held a discussion with the debtor, and came to an agreement with other creditors regarding all debts owed by the debtor.

In the second stage, after the debtor signed a letter of commitment, IBRA granted a standstill creditor agreement, whereby the debtor was allowed to postpone the payment of principal and interests until after signing a debt restructuring agreement with IBRA. (It was left unclear as to whether the unpaid interest would be added to the principal amount. When IBRA sold most of its forestry debts in June 2002, the total debt of each debtor was equal to, or close to, the amount of the debt when it had been transferred to IBRA).

In the third stage, if the debtor's loans were larger than IDR 250 billion, the debtor was required to hire third party independent financial and legal advisors, as well as an auditor. The advisors and the auditor were hired to help the debtor in submitting a debt restructuring proposal to IBRA, as well as to help IBRA to assess the proposal. Debtors were to pay for this advisory assignment.[56] This last aspect raised questions about potential conflicts of interest of the consultants. In practice, the consultants hired by forestry debtors rarely collected information from independent forestry experts. Rather, their assessment of the financial and legal condition of the debtors mostly depended on information provided by the debtors themselves.

In the fourth stage, the advisors and the auditor hired by the debtor conducted due diligence of/on the financial, commercial, and legal aspects of the debtor company. This stage included activities such as acquiring preliminary data and information regarding financial, operational, and legal aspects of the debtor's firm, and developing a debtor's initial debt restructuring proposal.

In the fifth stage, IBRA and the debtor entered into the restructuring negotiation for the debt. During this negotiation, debtors and IBRA developed alternative scenarios to restructure debts and to ensure the continuity of the debtor's operation.

In the sixth stage, IBRA discussed and circulated the final debt restructuring proposal to other creditors for approval. When the proposal was approved, IBRA and the debtor then signed a memorandum of understanding.

Finally, in the seventh and last stage of the debt restructuring process, IBRA prepared legal documentation for the debt restructuring agreement which had been drafted in stage six, and signed a debt restructuring agreement with the debtor.

It took some time from the signing of the Memorandum of Understanding to the signing of the Debt Restructuring Agreement, due to difficulties in translating the financial language into legal terms. This problem contributed to significant delays in the sale of the restructured debts. Once the debt restructuring agreement had been signed, the company started paying interest every three months.[57] The restructured debts then were transferred to IBRA's Corporate Loan Sales Unit to be sold to the financial community.

4.4 The due diligence process

Due diligence is a process conducted to assess the possible risks involved in financial transactions. The FSPC required that IBRA perform due diligence in covering the financial, commercial, and legal aspects of debt restructuring. The due diligence process was to be conducted by independent third parties, when the debt restructuring resulted in debt conversion into quasi-equity, equity, or loan discounts, or accounting write-offs.[58] The due diligence process gave IBRA information regarding the level of the cash flow available for serving all creditors, including IBRA. The process also gave information on the availability or unavailability of assets unimportant in supporting a debtor's operation, the value of the firm's assets, and the value of the firm itself.

Based on the above information, IBRA developed debt restructuring terms with the following principles:

- Determine the level of debt that could be supported by a debtor's available cash flow (sustainable debt);
- Use assets unimportant to supporting a debtor's operation, to reduce debt;
- Require shareholders to increase their equity in the firm to reduce debt;
- Use assets of debt guarantors to reduce debts;
- Convert the rest of the debts into quasi-equity or equity after taking into account all above measures and considering a good exit strategy for quasi -equity or equity;

- Reduce debt at first with interest in arrears and then later with principal as a final solution for debt restructuring.

The proposed debt restructuring deal between IBRA and forestry debtors, as described earlier, shows how IBRA failed to adopt the spirit of the above due diligence principles effectively. In practice, IBRA failed to use debtor's core assets or to require the owners of the companies to supply new capital to reduce the debts.

4.5 Debt settlement policy

The aim of the debt restructuring process was to settle the debts of companies. Once the debtor and IBRA had signed a debt restructuring agreement, the debt was transferred to IBRA's Corporate Loan Sale (CLS) Unit. The restructured debt was then offered for sale to the financial community, using an open tender mechanism. The sales process started with IBRA inviting financial institutions and investors to participate in the bidding process. IBRA distributed a sales memo to potential buyers. The memo contained, among other information, details about the loan portfolios and the company for sale, a tender timetable, and an invitation for financial institutions and investors to participate in the tender. Indonesia-based investors interested in the sales program were required to hold licenses in banking or finance. Foreign entities had to be authorized, and meet requirements of their home country in order to acquire loans. The financial institutions were allowed to form a consortium with other investors of their choice. Interested financial institutions and investors were required to pay an administration fee and sign a confidentiality agreement. Committed buyers were given an Info Memo, which contained more detailed information about the loan portfolio for sale and the terms of reference. IBRA then operated under a specific timeline during which it requested that committed buyers submit their indicative offers.

IBRA specifically prohibited debtors or their affiliates from buying their own debts. Indeed, the potential buyers had to sign a letter of non-affiliation with the debtor before entering the financial bidding. However, there was no mechanism in place that could guarantee the owners would not buy their own debts with a large discount after the debts were in the possession of the new buyers.

The sealed bids submitted by the committed buyers were opened in front of a notary public and a representative from IBRA's internal audit division. The corporate debt sales needed FSPC approval before the winners of the tender could be announced.[59] An international financial consultant, such as Goldman Sachs or Pricewaterhouse Coopers, was present to assist the whole process of the corporate loan sales (CLS) program.

Forestry debts were sold through the CLS II program. The first CLS program sale had what appeared to be a good recovery rate of 71%. At the CLS II program, of the twenty-six corporate debts on sale, there were only four forestry sector debts: Arindo Trisejahtera, Riau Andalan Kertas, Riau Andalan Pulp and Paper (RAPP), and Sumalindo Lestari Jaya. Only Arindo Trisejahtera and Riau Andalan Pulp Paper were sold completely. The loan of PT. Arindo Trisejahtera (a forest-related industry company) with a book value of IDR 145.4 billion was sold for IDR 122.7 billion, (a recovery rate of 84%) to Bank Mandiri. There were no forestry debts in the CLS III and IV programs.

When the CLS program was unsuccessful, IBRA introduced the Direct Selling Program (DSP), where buyers could buy the restructured debts without open tender. A buyer could enter the DSP if it submitted an offer above 70% of the original loan principal amount, and/or if the offer was higher than IBRA's internal valuation.[60] Out of seventy-nine debts sold in the DSP, six were forestry sector debts. These six debts included RAPP, which had reportedly already been sold in CLS II. Its presence in the DSP suggested that the sale of RAPP had not been finalized, and that the buyer had withdrawn from the purchase agreement.

4.6 Second default

After enjoying the benefits of the first debt restructuring (continuing with normal operation without paying any interest), some debtors wanted more. Two forestry debtors defaulted again after signing their debt restructuring agreements with IBRA. Forestry debtors under the flag of the Raja Garuda Mas Group (RGM) and Sumalindo Lestari Jaya (SLJ) failed to service

their restructured debts. These two groups requested a second debt restructuring for the same reason: the price of wood-based products (plywood or pulp) had fallen.[61] The debt of SLJ originated from debts of Surya Hutani Jaya (SHJ). The latter debt was transferred to SLJ (another subsidiary of Astra International Group) due to the inability of SHJ to pay its debt of IDR 40.30 billion (this included accrued interest and penalty charges). Riau Andalan Pulp and Paper (RAPP), a subsidiary of RGM Group received a similar debt restructuring deal as the one SHJ received. All obligations of SHJ and RAPP were rescheduled for a second time and there was no discount on principal and interest. Both restructured debts remained unsold following the second CLS program.

The two cases above illustrate the volatility of the debt restructuring process in the forestry sector. The second default of the companies was reportedly due to declining export prices of wood-based products in the second half of 2001. However, maintaining and even expanding current mill capacities causes a widening of the gap between the supply and demand of wood. As previously discussed, the volume and quality of the Indonesian forests are rapidly diminishing, a fact that is already responsible for a major drop in the wood supply. Coupled with increasing forestry stakeholder concerns over environmental and social issues, it is conceivable that these factors could again cause debtors to default even in restructured debt at some point in the future.

4.7 IBRA's debt fire sale

As discussed previously in Chapter Three, the FSPC ultimately decided to speed up the sale of assets under IBRA's portfolios. There were several reasons for the government to introduce the debt fire sale program. First, there was a decreased recovery rate of the disposed restructured debts. It decreased from 71% in July 2000 to 41% in July 2001. IBRA attributed the decreasing trend to unfavorable macroeconomic conditions and higher investment risk in Indonesia.[62] Secondly, IBRA faced difficulties in restructuring non-performing loans. IBRA had only been able to sign a debt restructuring agreement for about 2% of the total corporate debt under its control. There were sixty-six restructured debts on sale in open tender for the preceding two years, or 55.46% of the total restructured debts by December 31, 2000. Only five of the total forestry sector debts on offer were sold during this two-year period. Indeed, IBRA was only able to sign debt restructuring agreements with seven forestry sector debtors out of a total of 126 during this period.

Third, the ability and willingness of the debtors to serve the restructured debts were doubtful. Even though the sale of Arindo Trisejahtera by the Surya Dumai Group gave IBRA an outstanding recovery rate of 84%, this case was not representative of the recovery rate of all the forestry sector debts. The sale of the Fajar Surya Wisesa debt was not reported under forestry sector debts and there was no record of the results of its debt restructuring and disposal. The debts owed by Riau Andalan Kertas and Sumalindo Lestari Jaya remained unsold. Both companies were considered to have good repayment and business prospects and were totally rescheduled (their original debts were regarded as sustainable). Sumalindo Lestari Jaya was considered one of the best plywood companies in the country and it was a member of Astra International Group. The inability to sell the 'gem' of the forestry sector debt suggested that the financial community saw the forestry sector as too risky.

By December 2002, IBRA had reported that it controlled debts of 234 forestry companies, worth IDR 22.54 trillion (book value of debt at IBRA records), and that it had sold more than seventy-five percent of them (or 176 debts worth IDR 19.78 trillion) to banks and non-bank institutions, through the fire sale program known as *Program Penjualan Aset Kredit* (PPAK) or Loan Asset Sale Program. The largest bank buyer was Bank Mandiri, which is Indonesia's largest bank and is owned by the government. With a joint venture with non-bank financial institutions, Bank Mandiri bought forty debts with a total value of IDR 10.82 trillion. Most of the debt bought by Bank Mandiri and its partners was debt originating from state banks that had since merged to form Bank Mandiri (See Chapter Two). There were two large buyers from non-bank financial institutions. Asia Securities bought seven debts of the Raja Garuda Mas Group worth IDR 1.36 trillion, and Florida Commerce bought three debts of the Surya Dumai Group worth IDR 1.02 trillion. Table 4.5 provides a summary of the PPAK results for forestry debts as of December 31, 2002. IBRA did not publish the recovery rate of the PPAK for forestry debts.

Table 4.5 Results of the PPAK for Forestry Debts, as of December 31, 2002

No	Buyers		No. of Firms	Total Debt per 31.12.02 (IDR million)	Main Debtors
	Bank	Non Bank			
1	Bank Danamon		6	80,294.14	Rimba Karya Indah
2	Deutsche Bank		1	207,480.75	Fajar Surya Wisesa
3		Mahanusa Kapital	2	130,701.65	Wono
4		Inter Global Enterprise	3	305,382.16	Ceka
5		Cipta Dana Sekuritas	2	342,813.40	Sumatera TUD
6		Florida Commerce	3	1,017,355.18	Surya Dumai
7		Asia Securities	7	1,357,967.51	RGM
8		Victoria Securities Int.	3	98,483.63	Hutan Raya (Alex Kor)
9		Fontienne Capital Ltd.	1	314,889.51	Andatu Lestari Plywood
10	Bank Mandiri		1	231,093.25	Surya Dumai
11	Bank Mandiri	Mahanusa Kapital	10	708,620.09	Barito
12	Bank Mandiri	Batavia Prosperindo Sc	3	382,413.74	Hargas Industries
13	Bank Mandiri	Prime Capital	1	372,157.34	Batasan
14	Bank Mandiri	Jasabanda Gatra	8	2,656,949.53	Djajanti
15	Bank Mandiri	Bhinneka Makmur Inve	2	184,815.79	Hutan Raya (Alex Kor)
16	Bank Mandiri	Anugra Cipta Investa	14	6,205,227.00	M. Hasan
17	Bank Mandiri	Woka International	1	73,848.19	Suryamas Lestari Prima
18		Zealous Overseas Tradi	4	907,997.18	Sumatera TUD
19	Bank Bukopin		3	49,113.03	M. Hasan
20		Other	101	4,156,314.24	
	Total transactions closed		176	19,783,917.33	
	Total debt		234	22,535,854.81	
	Debts unsold (Still under IBRA/PT PPA)		58	2,751,937.49	
	Debts bought by Bank Mandiri consortium		40	10,815,124.929	

Source: List of Forestry Debtors per December 31, 2002

Debt Settlement of Major Forestry Debtors

5.1 Sinar Mas Group

IBRA and the Indonesian government allowed the Eka Tjipta Widjaja family to remain in control of APP Indonesia companies, even though they had not fully repaid their debts to the government. The sale of APP debts reduced the debt amount owed by the Eka Tjipta Widjaja family to the government. Based on information available to the public, the family still owed USD 634 million to the Indonesian government. APP paid USD 225 million cash in June of 2002 and transferred the ownership of 18% of BII worth USD 177 million. IBRA sold APP Indonesia debts worth USD 880 million for only USD 213 million after the APP debt had been restructured.[63] Table 5.1 shows the breakdown of APP debt repayment and the balance owed to IBRA (the Indonesian government).

Table 5.1 APP Debt Repayment

APP Debt to IBRA	USD million
Hedged Bond	1,059
Unpaid Interest	190
Total Debt	1,249
APP Debt Repayment:	
Cash (June 2002)	225
Value of 18% share of BII	177
Sale of Debt	213
Total repayment	615
Remaining Debt	**634**

Debt Restructuring Agreement

In June 2002, IBRA reached an agreement with the Sinar Mas Group on how to settle its debts. First, the group paid 20% of its total debt, or USD 250 million, and agreed to pay unpaid interest of USD 60 million by June 30, 2002. The payment method was as follows: APP paid USD 90 million to an IBRA controlled account at BII. It then transferred 16% of the shares owned by the Eka Tjipta Widjaja family in BII, or 15 billion shares worth IDR 405 billion (USD 58 million). Sinar Mas also gave up its Certificate of Entitlement, and made a provision for selling other assets or providing cash from non-APP groups should the rest of the transactions be insufficient for repaying the debt. Second, the Sinar Mas Group pledged shares to act as collateral for remaining debt balances following the government sales.[64] Third, the family of Eka Tjipta Widjaja, including Eka Tjipta Widjaja himself, gave personal guarantees to repay all remaining debts to IBRA.[65]

In December 2003, IBRA announced that Orleans Investment, a United States company, had won the bid to buy APP Indonesia's debts. These debts, despite having a book valued at USD 880 million, were purchased for only USD 213 million, at a recovery rate of only 24 percent. As the winner, Orleans Investment had obligations to support the Master Restructuring Agreement proposed by IBRA and APP, and not conduct hostile and legal actions against APP.[66]

The Master Restructuring Agreement (MRA) divided the total APP Indonesia debt of USD 6.7 billion into three categories: (i) Sustainable debt (Tranche A); (ii) Refinanceable debt (Tranche B), and (iii) Unsustainable debt (Tranche C). The Sustainable debt category involved term loans worth USD 1.2 billion, with a tenor of ten years and an interest rate of SIBOR, EURIBOR, TIBOR, or SBI plus premium. The premium was set at 1% with a cap of 6% for the first three years, 2% for the fourth and fifth years, and 3% for the remaining years. The Refinanceable debt category (Tranche B) accounted for USD 3 billion, with a tenor of thirteen years, and was to be refinanced at the end of the thirteenth year. The same interest rate applied to the sustainable

debts was also applied to the refinanceable debt. The unsustainable debt (Tranche C) was established as an instant convertible bond, worth the remaining debts of APP Indonesia (approximately USD 2.5 billion) as agreed upon by APP and the creditors.

The MRA was favorable for APP but unfavorable for the creditors, especially international creditors. Out of APP Indonesia's USD 6.7 billion debts, APP cash flows were only required to account for USD 1.2 billion or 18% of the total debt, plus interest in ten years and interest payments on just USD 3 billion. The remaining debt (Tranche C debt) was to be converted into bonds that paid interest at the very low rate of 1%. This interest was to be paid thirteen years later, after APP refinanced its USD 3 billion debt. To secure payments for the MRA, APP Indonesia was required to pay Monthly Mandatory Debt Service (MMDS) to repay Tranche A and interest on Tranche B. The MMDS was set at USD 30 million per month for the first to third years, and USD 35 million for the fourth and fifth years. For all subsequent years the price was set at USD 40 million. The required MMDS was calculated based on a pulp price (CIF) equal to or above USD 400 per metric ton.[67]

The MMDS did not apply much pressure to APP cash flows since it was proportionally divided among APP Indonesia companies, based on EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Indah Kiat was responsible for paying 55% of the MMDS, or USD 198 million per annum, within three years of the date that the creditors agreed on the MRA. This figure represents just 17% of the USD 1.2 billion that Indah Kiat earned in net sales in 2002. Tjiwi Kimia paid USD 64.8 million, which was 18% of the total MMDS. It represented only 8% of the USD 779 million that Tjiwi Kimia made in sales in 2002. Pindo Deli paid USD 48.6 million, or 13.5% of the total MMDS. This represented 7% of its USD 743 million in sales in 2002. Lastly, Lontar Papyrus paid 13.5% or USD 48.6 million; an expenditure of 19% of its USD 251 million in sales in 2002.[68]

5.1.1 Related party transactions and transfer pricing

Despite getting support from the government, the Eka Tjipta Widjaja family did not seem to have good intentions in repaying their debts. From 1999 through 2001 the family used Indah Kiat Pulp and Paper to engage in highly speculative transactions in the amount of USD 1.2 billion. Indah Kiat had provided PT. Arara Abadi, an affiliated company, with non-interest bearing loans of USD 300 million. The family also provided trade credits to affiliated shell companies located in the Cayman Islands and the British Virgin Islands, as well as to affiliated companies in Singapore, Hong Kong, Malaysia, Japan, Spain, the United Kingdom, Belgium, China, the United Arab Emirates, and India. The total trade credit given to these affiliated companies by December 2001 amounted to USD 310.86 million. The majority of that credit - USD 195 million - was provided to APP International Trading Limited, in the Cayman Islands. Two different public accountants auditing Indah Kiat Pulp and Paper's financial statements in 2000 and 2001 were both uncertain about the recoverability of the advance given to Arara Abadi and the trade credits given to affiliated international trading companies. Due to the size of the amount, the public accountants withheld their opinion on the fairness of the company accounts for the years 2000 and 2001.[69] If there were an economic reason for the advance given to Arara Abadi, a reason such as aggressively expanding its acacia plantation, the accountant should have been able to calculate the recoverability of the advance made by Indah Kiat. The inability of the accountant to estimate the recoverability of the advance suggests that the money invested in Arara Abadi and Indah Kiat was highly speculative and had unclear benefits. Indah Kiat had provided trade credits to high-risk customers represented by 'special vehicle' companies in the British Virgin Islands and other offshore jurisdictions. By December 2000, the company had provided trade credits to of USD 498 million. Out of this total, by December 2001 the company had written off USD 414.34 million or 83 percent of the trade credits.[70]

5.1.2 Creative accounting

As with other forestry conglomerates discussed later, the Sinar Mas Group also derived as many benefits as they could from the crisis. The financial crisis gave them an opportunity to subtract charges related to the crisis from the operating profits of their pulp and paper business. This strategy allowed them to report losses, not pay taxes and even get tax benefits. Table 5.2 provides a summary of Indah Kiat's

Table 5.2 Indah Kiat's income strategy during the financial crisis (USD million)

No	Items	1999	2000	2001	2002	2003
1	Net Sales	1,311.52	1,544.27	1,100.23	1,197.71	1,345.84
2	Gross Profit	542.80	532.55	195.83	168.72	152.70
3	Expenses:					
	Operating expenses	109.02	144.40	123.71	108.46	138.01
	Provision for doubtful acc	-	413.32	1.02	-	-
	Interest expenses	181.52	282.86	294.27	259.88	260.73
	Loss on foreign exchange	-	-	-	77.27	75.50
	Asset Write-off	148.62	32.54	-	-	-
	Tax expenses	-	42.52	-	-	-
	Other		94.05	59.97	25.21	17.48
	Total	439.16	1,009.68	478.96	470.81	491.73
4	Net Profit (loss)	4.03	(400.68)	(182.39)	(266.31)	(286.63)
5	Tax benefits	3.49	-	63.68	30.58	49.73

Source: INKP Financial Statements per 31 December 2000, 2001, 2002, and 2003

income strategy during the period from 1999 to 2003. Before declaring a debt payment standstill in March 2001, Indah Kiat reported gross profits from pulp and paper operations of USD 542 million and USD 532 million in 1999 and 2000 respectively. The gross profit then fell to less than USD 200 million during the next three years. This drop in the gross profit was caused by the fall of pulp prices and the increase in the cost of production (this included the cost of sourcing pulpwood supplied by Arara Abadi). Whether or not the fall of the gross profit was fair is not considered within the scope of this study. However, it is sufficient to say that Indah Kiat reported several 'suspicious' expenses which reduced its net profit, allowing it to pay little or no tax, or even receive tax benefits. The company recorded asset write-off expenses of USD 148 million in 1999 and USD 32.54 million in 2000. As discussed earlier, the company recorded bad debt expenses involving trade credits, about USD 414.34 million; USD 413.32 million in 1999 and USD 1.02 million in 2000. From 1999 to 2003, the company paid expenses related to marketing efforts by affiliated companies. These expenses were listed as 'other expenses'.

Despite not paying interest to its creditors, the company continued charging interest expenses and financial charges to its profit from pulp and paper operations. By recording various suspicious expenses along with their regular operating costs, such as salary and administration expenses, the company was able to report a net loss and secure tax benefits in 1999 and again in the three years following 2000.

5.1.3 Debt settlement of APP China

Foreign countries were consistently able to obtain more favorable debt restructuring agreements than those obtained by the Indonesian government when dealing with Indonesian companies. Chinese and Japanese institutions were both able to negotiate better debt resolutions with Indonesian companies than the resolutions worked out by Indonesian institutions such as IBRA and the FSPC. Although China did not have a powerful institution like IBRA, the Chinese government still managed to achieve a better debt restructuring deal with the Eka Tjipta Widjaja family. Through its state-owned banks, the Chinese government had forced the family to transfer the control of APP China operating units, or APP China Group Limited (ACGL). By threatening to expropriate ACGL assets, the Chinese state-owned banks received (and are still receiving) interest payments on their loans, in the amount of USD 1.6 billion. The Widjaja family also agreed on a debt-to-equity swap scheme for debts about USD 600 million to be swapped with 99.99 percent of the equity of ACGL. This scheme will split ACGL from the rest of APP and leave the APP holding company in Singapore with APP Indonesia as one entity. The APP holding company in Singapore does not have its own source of income and will depend on income from APP Indonesia. On the other hand, ACGL is considered the most valuable part of APP, with 2002 net sales of USD 1.46 billion and earnings of USD 200 million (Yuxin He, 2003).

On paper, Eka Tjipta Widjaja only had a 0.01 percent equity share in ACGL. However, there was speculation that the Widjaja family was probably

still the *de facto* controlling shareholder of ACGL. The creditors involved in the debt-equity swap scheme included the Widjaja family bank in the Cook Islands that owed about USD 256 million to ACGL and unidentified bondholders that owed USD 344 million to the company. Through the Cook Islands bank the Widjaja family was able to control a 23.1 percent stake in ACGL after the debt-equity swap. Depending on the relationship of the unidentified bondholders to the Widjaja family, the ACGL may have, in actuality, still been fully controlled by its former owner. There was also a report suggesting the Widjaja family bought ACGL bonds in distressed debt markets; however the Widjajas have denied these claims.[71]

Although the Chinese government was not as generous as the Indonesian government, the Widjaja family seemed happy with the way it restructured the ACGL debt. In return, the Widjaja family plans to increase its investment in China in the next five years. It was reported that ACGL had ordered the purchase of USD 500 million worth of pulp machinery for a new pulp mill project on the Hainan islands, planned a USD 540 million expansion to produce packaging products in the eastern city of Ningbo, and invested USD 114 million in five forestry ventures.[72] It is unclear whether there is a connection between the USD 1.2 billion financial loss experienced by Indah Kiat Pulp and Paper in Indonesia and the USD 1.2 billion expansion in China.

5.2 Bob Hasan Group

As discussed in Chapter Two, IBRA received pledged shares of thirty-one of Bob Hasan's companies; shares that represented between 30% and 100% of the ownerships of those companies. Out of these thirty-one companies, seventeen were operating in the forestry sector. In turn, out of these forestry companies, thirteen had debts to IBRA, i.e. IBRA became the creditor as well as the shareholder of the companies. The IBRA-controlled debts of the thirteen forestry companies totaled IDR 5.3 trillion. Table 5.3 shows details of IBRA assets related to the Bob Hasan Group.

Table 5.3 IBRA Assets related to the Bob Hasan Group

No	Company	Equity Share (%) Pledged to IBRA	Debts under IBRA (IDR million)
1	PT. Essam Timber	60.00	101,127.35
2	PT. Jati Cahaya Cemerlang	-	25,890.44
3	PT. Jati Dharma Indah	100.00	39,178.05
4	PT. Jati Maluku Timber	100.00	15,533.73
5	PT. Kalhold Utama	37.10	203,496.23
6	PT. Kalimanis Plywood	100.00	307,540.82
7	Kiani Kertas	100.00	2,441,338.12
8	PT. Kiani Lestari	98.00	1,538,018.35
9	Kiani Sakti	-	284,213.69
10	PT. Santi Murni	82.00	230,326.22
11	PT. Wenang Sakti	100.00	41,828.85
12	PT. Sandi Furni	-	4,145.91
13	PT. Fendi Mungil	-	8,980.18
14	PT. Lakosta Indah	-	55,369.20
15	PT. Batu Penggal Chemical Ind.	-	32,854.40
16	PT. Kiani Hutani Lestari	60.00	9,943.00
17	PT. Alas Helau	70.00	-
18	PT. Gunung Gajah Abadi	n/a	-
19	PT. Prima Maluku Timber	100.00	-
20	PT. Wanagalang Utama	100.00	-
21	PT. Tanjung Redeb Hutani	60.00	-
22	PT. Belantara Pusaka	60.00	-
23	Kertas Kraft Aceh	3.70	-
	Total Debts	5,341,000.00	5,339,784.55

Source: IBRA November 19, 2001

The largest Bob Hasan Group debtor company was PT. Kiani Kertas, a pulp and paper company located in East Kalimantan with principal non-performing loans of IDR 2.44 trillion, or 46 percent of all the Bob Hasan group's non-performing loans in IBRA. The loans were secured from a number of state-owned banks, which later merged to become Bank Mandiri. Bob Hasan pledged all his equity shares in Kiani to pay off part of his debts as principal shareholder of Bank BUN, which had misappropriated liquidity support from Bank Indonesia. The second largest debtor was PT. Kiani Lestari, a company holding HPH concessions in East Kalimantan. This company's non-performing loans were IDR 1.54 trillion or 29 percent of total Bob Hasan group non-performing loans in IBRA. Bob Hasan also pledged his equity shares in this company (98 percent) to pay off part of his liability to IBRA. These two Bob Hasan companies accounted for 75 percent of total non-performing loans of the group under IBRA.

Bob Hasan received favorable treatment from IBRA in settling his debt.[73] As with other debtors, IBRA used a 'hands-off' management policy on companies pledged by Bob Hasan. Even though IBRA owned 100% of Kiani Kertas Pulp and Paper, Bob Hasan was allowed to operate the company and control decisions on the management of the company. IBRA, in contrast, only cared about the value of the shares Bob Hasan had pledged. When the value of the pledged shares dropped, IBRA decided that Bob Hasan's debts had not been settled and requested that he add new shares.[74]

Most of the Bob Hasan Group's non-performing loans ultimately were settled through the debt fire sale program (PPAK). Table 5.4 shows details of the group's debts for tender under the fire sale program. Up until IBRA's dissolution in April 2004, there was no information stating that it had sold equity shares of forestry companies pledged by Bob Hasan. However, the sale of Kiani Kertas debt to a financial consortium led

Table 5.4. Bob Hasan Group's assets tendered by IBRA in the fire sale program (PPAK)

No	Company	IDR/ USD	Nominal Debt Value (million IDR or USD)	Status	% Shares controlled by IBRA
1	Essam Timber	USD	19.80	Restructured	60.00
2	Jati Cahaya Cemerlang	IDR	26,312.26	Restructured	
3	Jati Dharma Indah	IDR	40,165.25	Restructured	100.00
4	Jati Maluku Timber	IDR	15,667.27	Restructured	100
5	Kalhold Utama	IDR	28,678.86	Restructured	37.10
		USD	34.36		
6	Kalimanis Plywood	USD	56.62	Restructured	100.00
7	Kiani Kertas	GBP	28,359.68	Restructured	100.00
		IDR	363,041.70		
		USD	414.88		
8	Kiani Lestari (B)	IDR	575,850.35	Restructured	98.00
		USD	135.22		
9	Kiani Sakti	IDR	7,814.42	Restructured	
		USD	45.53		
10	Santi Murni	IDR	17,862.72	Restructured	82.00
		USD	39.83		
11	Wenang Sakti	IDR	938.01	Restructured	100.00
		USD	7.93		
12	Sandi Furni	IDR	4,145.91	Non-restructured	
13	Fendi Mungil	IDR	9,273.57	Non-restructured	
14	Batu Penggal Chemical In	USD	6.39	Non-restructured	
15	Kiani Hutani Lestari	IDR	18,874.04	Non-restructured	60.00
16	Kabelindo Murni	USD	1.73	Non-restructured	
17	Kemgas Tama	IDR	23,828.10	Non-restructured	
18	Nusamba (B)	USD	91.85	Non-restructured	
	Total Debts	USD	854.14		
		IDR	1,132,452.47		
		GBP	28,359.68		

Source: IBRA, May 29, 2002 List of Loan Assets Offered in the PPAK Loan Asset Sales Program

by Bank Mandiri shed some light on the status of shares pledged by Bob Hasan. Kiani Kertas's non-performing loans were resold to Bank Mandiri. Meanwhile, IBRA gave no official explanation of the sale of Kiani Kertas's equity to cover Bob Hasan's personal debts. Nevertheless, PT. Anugra Cipta Investama (ACI) owned by the former Chief of the Indonesian Special Armed Forces (Kopasus), Prabowo Subianto, declared that it had bought all the Kiani Kertas equity shares transferred to IBRA, for USD 25 million.[75] This implies that the PPAK also included the pledged assets from Bob Hasan. The cost for ACI to buy the Bob Hasan Group's assets was insignificant compared to the group's total debt and personal debt of Bob Hasan, which was worth IDR 10.67 trillion or about USD 1.52 billion.

5.2.1 The fire sale

IBRA offered the non-performing loans of 18 Bob Hasan group companies totaling IDR 1.13 trillion, USD 854.14 million, and GBP 28,359.68 inclusive of deferred interest payments. This included the two companies in the Bob Hasan group with the largest loans, i.e. PT. Kiani Kertas and PT. Kiani Lestari. A non-performing loan of IDR 55.37 billion belonging to PT. Lakosta Indah, another member of the Bob Hasan of Group companies managed by IBRA in November 2001, was not included in the PPAK list. It was, however, in the list reported in the Indonesian Supreme Audit Agency (BPK) Report for Semester II 2004.

Out of 18 debtors, IBRA had restructured 11 debtors of the Bob Hasan Group including Kiani Kertas and Kiani Lestari. This means that IBRA had succeeded in dividing Kiani Kertas's and Kiani Lestari's non-performing loans into sustainable and unsustainable debt. With these debts restructured, the debtors should have paid interest on the sustainable debt to IBRA and investors buying the loan assets. However, this was not the case when restructured Kiani Kertas loans were sold. Despite having had its debts restructured, Kiani Kertas still paid no interest on the sustainable debt assigned to Bank Mandiri.

Bank Mandiri bought fourteen Bob Hasan Group loans, including those of Kiani Kertas and Kiani Lestari. These were non-performing loans previously provided by the state-owned banks that merged to form Bank Mandiri. This state-owned bank undertook the transaction with local investor, PT. Anugra Cipta Investama (ACI), which collaborated with PT. Nusantara Energy. Nusantara Energy is owned by retired Prabowo Subianto (79 %), Widjono Hardjanto (1 %), and Djohan Teguh Sugianto (20 %).

Bank Mandiri was only interested in taking over PT. Kiani Kertas's sustainable debt, as it considered the non-performing loans of other Bob Hasan Group companies in IBRA, including those of Kiani Lestari, which amounted to more than IDR 1.5 trillion, to be unsustainable. Bank Mandiri took over PT. Kiani Kertas's sustainable debts worth USD 201,242,264.98 equivalent to IDR 1.81 trillion at an exchange rate of IDR 9,000 per USD. Bob Hasan Group's unsustainable debts of USD 789,557,585.43 or IDR 7.1 trillion were taken over by PT. Anugra Cipta Investama and converted into convertible bonds issued by Bob Hasan Group companies (BPK, 2004). On the 15 November 2002, through Debt Cession Certificate (*Akta Perjanjian Hutang*) No. 30 dated 15 November 2002, Kiani Kertas's loans moved to the Bank Mandiri and ACI consortium. The total value of Kiani Kertas' non-performing loans bought by the Bank Mandiri consortium was IDR 4,097,339,382,269.39 or USD 445,259,931.36. From this amount, Bank Mandiri recorded Kiani Kertas debts of USD 193,040,362.08 and IDR 73,733,769,650 or a total sum equivalent to USD 201,233,003.15.

To obtain the Bob Hasan Group's non-performing loans above, Bank Mandiri and ACI paid IBRA IDR 190,020,428,777, GBP 8,649.70, and USD 179,517,377 or a total equivalent to USD 200,643,647.05. Accordingly, the IBRA recovery rate for the 14 Bob Hasan group loan assets was 20.25 percent. This recovery rate had been approximated beforehand.

5.2.2 Suspicious transactions

BPK, in its audit report, identified several events that could lead to state loss. PT. Kiani Kertas had not fulfilled its interest payment obligations to Bank Mandiri from the time the bank took over the company's sustainable debts from IBRA in November 2002. By June 30, 2004, Kiani Kertas had deferred on interest payments of IDR 20,897,379,211.99 and USD 31,677,555.75 or an overall total of IDR 318,153,699,925.74, or USD 35.35 million. These interest payments were 517 days in arrears and the Kiani Kertas loan had been classified non-performing since November 2003. As a result, Bank Mandiri formed a provision of 100 percent or IDR 1,885,417,567,770.80 as a

reserve for writing off the loan (*Provisi Penyisihan Aktiva Produktif* or PPAP). This reserve reduced Bank Mandiri's earnings and capital adequacy ratio (CAR) while increasing its non-performing loans. Bank Mandiri received an appraisal report from Kiani Kertas showing the value of asset collateral on these non-performing loans to be IDR 3,776,224,151,260 (Appraisal Report, December 16, 2003). However, it is unclear whether any other creditors had claims over these, or whether the Kiani Kertas assets pledged to Bank Mandiri were genuinely worth more than IDR 3 trillion. If this was the true value, then Bank Mandiri could in fact have forced the sale of these assets and need not have incurred losses from its takeover of Kiani Kertas's loans.

Overall, the government had written off all Bob Hasan Group's non-performing loans provided by national banks and amounting to IDR 8.92 trillion. About 80 percent of these loans were written off by IBRA and the remaining 20 percent by Bank Mandiri. These public losses reflect losses to the state. The Attorney General's Office is currently investigating the possibility of corruption in Bank Mandiri linked to the takeover of PT. Kiani Kertas's sustainable debt from IBRA. Ideally, the Attorney General's Office should not limit its investigation to Bank Mandiri alone, because Kiani Kertas and Bob Hasan Group loans have been subject to corruption since IBRA began managing them.

The BPK audit report reveals several suspicious transactions associated with the sale of Bob Hasan Group debt:

- Bank Mandiri considered PT. Kiani Kertas to be an export-oriented company operating as normal, with income in USD and having reasonable prospects. However, according to BPK auditors, the company had been losing money for the previous four years (1998-2001), had problems with liquidity, was insolvent, and was not generating enough cash from its operations to meet its interest payment obligations. The company used capital from its suppliers to keep operating, while deferring its debts to them for more than 329 days. It also used long-term financial sources to meet its short-term payments. BPK concluded that Kiani Kertas was in poor health when Bank Mandiri bought its debt from IBRA.
- Bank Mandiri did not choose the best option in the takeover of Kiani Kertas's loans. According to Bank Mandiri's own analysis, the best option for the bank was the first option, which produced the lowest offer price to total ATK ratio (8.34 %) and obliged PT. Anugra Cipta Investama to put USD 116,499,543.21 into the consortium. With this first option, Kiani Kertas's debts of USD 120 million to the Bank Sumitomo syndicate and USD 165 million to suppliers would have been rescheduled for 8 years without discount. Interest applied to Bank Sumitomo syndicate loans would have been SIBOR + 2 percent while credit from suppliers would not be subject to interest. With this first option based on assumptions about production, selling prices and prices of raw materials, Kiana Kertas would have obtained an EBITDA of USD 455,430,853.57 and its sustainable debt would have been USD 101,423,682.23. With an offer of USD 199,159,844.23 to IBRA, Bank Mandiri would have paid USD 82,660,301.02, with ACI paying USD 116,499,543.21. However, the Bank Mandiri Board of Directors chose an option more beneficial for ACI. With this second option, loans from the Bank Sumitomo syndicate and suppliers were rescheduled for 8 years with a discount of 60 percent. When the second option was chosen, Bank Mandiri had not secured the agreement of these other creditors to provide the 60 percent discount to Kiani Kertas. The same interest was applied with the second option as with the first. The second option also produced an EBITDA of USD 455,430,853.57 but with a sustainable debt of USD 201,242,264.98. With the same offer price to IBRA, this second option obliged Bank Mandiri to pay USD 164,012,445.96 while only requiring ACI to pay USD 35,147,398.27.
- ACI failed to fulfill its obligations in the consortium agreement it made with Bank Mandiri. According to the consortium agreement ACI had to pay USD 22,136,649.15 million in up-front fees, restructuring fees and credit provision, and pay USD 35,147,398.27 or 17.64 percent of the total offered to IBRA to ACI's escrow account with Bank Mandiri. ACI reneged on its promise and only deposited USD 30 million. ACI was also unable to fulfill its obligation to provide additional working capital for Kiani Kertas and to seek funds from parties outside Bank Mandiri.

- Calculations of Kiani Kertas's sustainable debt did not take requirements for additional operational funds into account. Bank Mandiri estimated production for the first, second and third years at 320,000 tons, 336,000 tons, and 395,000 tons respectively, followed by a further 475,000 tons annually for the forth to seventh years. To achieve a production of 370,000 tons in the first year (2002), according to an analysis by JP Morgan, Kiani Kertas would have required additional funds of USD 20 million. Without these additional funds, Kiani Kertas's production could fall below 305,000 tons. Meanwhile Bank Mandiri's own analysis in July 2002 estimated that Kiani Kertas required working capital of USD 50 million. These two sums were not included in EBITDA and sustainable debt calculations.
- No risk analyses were undertaken for the takeover of Kiani Kertas's loans, which BPK considered high-risk. This risk was related to a shortage of working capital, low production capacity, and credit syndication involving Bank BNI 46, Bank Sumitomo, and 19 foreign banks.
- Taking over Kiani Kertas's loans traversed principles of prudent banking. The Board of Commissioners at Bank Mandiri only submitted an agreement for the takeover of Kiani Kertas's loans after IBRA announced that Bank Mandiri had won the tender for Bob Hasan Group loan assets. Furthermore, Bank Mandiri did not have the approval of Bank Indonesia to take over loans with cash flows exceeding five years. Although Kiani Kertas's loans had not been performing since they were taken over from IBRA, they were handled by the Bank Mandiri Corporate Group (business unit) and not by the Credit Recovery Group, whose specific function is to manage non-performing loans. As a result, the timeframe for restructuring Kiani Kertas's loans far exceeded the consortium's promise.

5.2.3 No intention to pay

IBRA allowed Bob Hasan to remain in control of his company despite not having paid his debt to the Indonesian government. The Indonesian Supreme Audit Agency (BPK) suggested that Bob Hasan showed no intention of repaying this debt. By June 2001, out of the total debt of IDR 6.15 trillion, Bob Hasan had only paid IDR 891.2 billion, or 14.5% of the total debts. Only eight out of the thirty-one companies Bob Hasan had pledged to IBRA actually ended up transferring shares to Kiani Wirudha, the holding company for IBRA and Bob Hasan. These shares made up only IDR 1.29 trillion or 21% of Bob Hasan's total debt to IBRA. Out of these eight companies, Kiani Wirudha had sold none. According to the MSAA, Bob Hasan had to sell his shares by December 31, 1999 at the latest. It was also reported that Bob Hasan had sold his shares in PT. Kabelindo and Bank Tugu for IDR 2.9 billion without informing Kiani Wirudha or IBRA.[76]

The extent of Bob Hasan's remaining debts was unclear. IBRA failed to provide a detailed outline of Bob Hasan's MSAA, even to the official lawyer assigned by the Indonesian government to review the MSAA and MRA. IBRA also did not inform the lawyer of the decreasing value of the assets pledged by Bob Hasan.[77] When it became clear that the value of these assets was decreasing, IBRA requested that Bob Hasan hand over his 35 percent shareholding in PT. Tugu Pratama Indonesia (TPI), an insurance company also owned by the stated-owned oil company, Pertamina.[78] However, it is unclear whether IBRA succeeded in getting these shares.

The debt strategy used by Bob Hasan was adopted by the new owner of Kiani Kertas. The new owner, Prabowo Subianto, does not show good intention to pay its debt. In June 2006, Bank Mandiri declared publicly that Kiani Kertas is an uncooperative debtor.[79] Bank Mandiri, the major financial supporter of Prabowo when taking over almost all Bob Hasan's forestry companies from IBRA, failed to collect debts of Kiani Kertas worth around USD 200 million. This debt was previously considered sustainable by IBRA and Bank Mandiri. Kiani Kertas paid no interest or principal to Bank Mandiri after it was taken over by Prabowo. Bank Mandiri is eager to look for a new investor to take over Kiani Kertas and settle its debt to Mandiri.

5.3 Raja Garuda Mas Group

It is a mystery how the Raja Garuda Mas Group, with its export markets and dollar earnings, could fail to serve its debts to local banks and instead force the Indonesian government to transfer its non-performing loans to IBRA. IBRA had no difficulty in reaching a debt restructuring agreement with the group in September 1999.

The Raja Garuda Mas Group started paying off its debt until January 2001. In February 2001 however, the group once again saw an opportunity to avoid servicing its debts, when pulp prices fell to USD 320 per ton. Under the debt restructuring agreement, Deloitte Touche Tohmatsu, the consultant hired by the Raja Garuda Mas Group, estimated that pulp prices would rise to more than USD 500 per ton. The debt restructuring terms described in Table 5.9 represent a new agreement signed in June 2001 between IBRA and the Raja Garuda Mas Group. This new agreement was drafted on the assumption that pulp prices would rise to USD 400 per ton.

In June 2001, IBRA reached an agreement with the Raja Garuda Mas Group to restructure its debts of USD 343.78 million. The group's debt was divided into three groups. The largest debt, worth USD 286.08 million, was under the Riau Complex group which consisted of Riau Andalan Pulp and Paper (RAPP), Riau Andalan Kertas, and Riau Prima Energi. The second group was the Non-Riau Complex with debt amounting to USD 43.95 million. The last group consisted of the debt of Inti Indorayon Utama which was comprised of debt to foreign creditors worth USD 359.3 million and debt to IBRA worth USD 13.75 million. However, in November 2001, the group defaulted on its promise to repay the restructured debts (see Chapter Four for a discussion on this second default). In May 2002, IBRA put all Raja Garuda Mas Group debt in the fire sale program. Asia Securities, a financial institution based in Singapore bought the group debts that were held by IBRA. No public information was available on the detail of the transaction.

Interestingly, while the Raja Garuda Mas Group's debts to IBRA were sold successfully, the group also created non-performing loans with Bank Mandiri. A BPK audit report on Bank Mandiri said the state bank had had difficulty collecting its debt from the Riau Complex Group since June 2000. It was restructured three times by September 2002. Bank Mandiri provided a credit facility to the Riau Complex Group of USD 471.27 million, which was part of a syndicate loan worth USD 1.14 billion (BPK, 2004). On 20 November 2001, the Bank Mandiri Board of Commissioners agreed to write off all loan principal worth USD 471.27 million plus unpaid interest of USD 148.28 million. However, on December 24, 2002, the Board of Commissioners agreed to put USD 171.62 million of the loan principal back into Mandiri's books. In 2002, Bank Mandiri had to reduce its profit by USD 442.48 million for allocating a provision for the bad debts of the Raja Garuda Mas Group.

Table 5.9 Total Raja Garuda Mas Debts

No	Sub Obligor/ Debtor	Foreign Debts (USD million)	Local Debts (USD million)	IBRA Restructuring Terms
I	**Riau Complex**	1,300.00	286.08	Follow foreign debt restructuring term
1	PT. RAPP		30.80	Tenor 6 yrs , rate avg 3 mo-deposit plus 3.5%
2	PT. Riau Andalan Kertas		76.21	Grace period for interest 18 months
3	PT. Riau Prima Energi		179.07	Cash sweep mechanism
II	**Non-Riau Complex**			
4	PT. RGM Lestari		1.45	Transfer to PT. Asia Forestama R, tenor 7-10 years
5	PT. Asia Forestama Raya		3.26	Tenor 7-10 years
6	PT. Inter B Medan Perkasa		1.43	Tenor 3 years and 9 months
7	PT. Sola Gratia		25.95	30% tenor 8-10 years; 70% convertible bonds
8	PT. Mitra Unggul Pusaka		7.63	Tenor 6 years
9	PT. Raja Garuda Mas Sejati		1.11	Tenor 6 years
10	PT. Unimegah Utama Raya		3.12	Tenor 10 years
III	**Inti Indorayon**			
11	PT. Inti Indorayon Utama	359.3	13.75	Required Government intervention to allow operations

Source: IBRA press release, June 2001

In a bold move to rescue Bank Mandiri, Agus Martowardojo, the new President Director of Bank Mandiri declared publicly that the Raja Garuda Mas Group is an uncooperative debtor. According to Martowardojo, the group had no good intention to repay its debts. Bank Mandiri requested the group to increase the debt repayment amount from only USD 61 million annually to USD 120 million per annum.[80] The request was put forward based on the current pulp price of USD 600 - 700 per ton compared to USD 400 per ton when the group debt was restructured.

5.3.1 Expansion while not repaying debts

Sukanto Tanoto, the owner of the Raja Garuda Mas Group, gained significant financial benefits from the financial crisis. He was able to expand his pulp mills in Riau while not paying his obligation on time. Foreign and local financial institutions allowed the group to increase its mill capacities. Using its holding company, Asia Pacific Resources International Ltd. (APRIL) that controlled Riau Andalan Pulp & Paper (RAPP) and Inti Indorayon Utama, the Raja Garuda Mas Group raised RAPP's mill capacity from 850,000 tons per year in 1999 to 2,000,000 tons per year in 2001 making it the largest pulp and paper mill in the world (Barr, 2001). It was reported that the company (RAPP) plans to increase its pulp capacity to 3.5 million tons annually.[81]

Expansion of Raja Garuda Mas interests in Indonesia might not be significant compared to its international expansion. APRIL reportedly embarked on a first stage of expansion in China in 2004.[82] Through Raja Garuda Mas International, on August 2003 the group acquired an 81.7 percent stake in Klabin Bacell S.A. (Bacell), a dissolving pulp producer in Brazil. In addition, the group also acquired a 100 percent stake in Norcell S.A. (Norcell) which owns forest lands in Brazil and supplies wood to Bacell.[83]

5.3.2 Escape from responsibility

In a competition on the ability to avoid debt repayments to the Indonesian government, Sukanto Tanoto, the controlling shareholder of the Raja Garuda Mas Group would be the clear winner. Even though Raja Garuda Mas was affiliated with the frozen Unibank, he successfully avoided any liability for paying money to protect Unibank's customers. Although Unibank was under the supervision of the Bank Indonesia and the Capital Market Supervisory Agency, or Bapepam, Tanoto was able to transfer ownership while still maintaining *de facto* control of the bank. The Indonesian government could not force Sukanto Tanoto to enter a shareholder debt settlement as they did with Eka Tjipta Widjaja and Bob Hasan. (See Chapter Two for a detailed discussion).

5.3.3 Suspicious transactions

The Bank Indonesia helped in financing Raja Garuda Mas Group's expansion. Just after the group's debts were transferred to IBRA in 1998, the Bank Indonesia provided it with financial facilities by discounting the export money order time draft (issued by the Running Nepal Bank of the Cook Islands) from USD 430 million to USD 200 million.[84] This discounting facility was granted by the Bank Indonesia under a repurchasing agreement. The Raja Garuda Mas Group should have paid the Bank Indonesia right after they executed their USD 430 million export, at the time the draft was due. Under pressure from the Bank Indonesia, Sukanto eventually paid a discounted draft of USD 200 million using Unibank money rather than Raja Garuda Mas Group money from the export. This transaction led to the collapse of Unibank for repaying Raja Garuda Mas Group debts to the Bank Indonesia about USD 230 including unpaid interest. According to one analyst, the Bank Indonesia could be accused of being the main actor in wrecking Unibank or at least be blamed for imprudence (Massasya, 2001).

5.4 Djajanti Group

Burhan Uray and Soejono Varianata, the owners of the Djajanti Group, also reaped benefits from the crisis. By January 2001, the Djajanti Group failed to service its debts of IDR 5.6 trillion, equivalent to USD 793 million. IBRA had to restructure IDR 3.6 trillion (USD 541 million) worth of Djajanti Group debts.[85] This sum represented 68% of total Djajanti Group non-performing loans. Table 5.10 shows details of the Djajanti Group's debts to IBRA and others. IBRA had got these non-performing loans from state banks that had merged into Bank Mandiri. It was unclear how the export-based industries such as forestry and fisheries could have failed to service their debts. If the temporary fall in

Table 5.10 Djajanti Group Debts

No	Company	Sector	IBRA IDR (IDR million)	IBRA USD (USD million)	Others (USD million)
1	Agoda Rimba Irian	Forestry	104,593.93		
2	Artika Optima Inti	Forestry	846,795.57		
3	Budhi Nyata	Forestry	34,864.65		
4	Kamundan Raya	Forestry	52,296.96		
5	Nusantara Plywood	Forestry	1,414,532.45		
6	Nusa Prima Pratama	Forestry	81,835.85		
7	Sagindo Sari Lestari	Forestry	34,864.65		
8	Teluk Bintuni	Forestry	87,161.61		
	Total Forestry		2,656,945.66		
9	Biak Minajaya	Fisheries	31,452.88		
10	Bintuni Minaraya	Fisheries	-	17.37	52.90
11	Daya Guna Samudra	Fisheries	-	47.04	224.00
12	Djajanti Plaza	Property	97,706.09		
13	Djarma Aru	Fisheries	-	28.22	
14	Green Jaya Plantation	Agriculture	10,254.97		
15	Hasil Citra Laut	Fisheries	-	24.00	
	Total Other		139,413.94	116.63	276.90
	Total Djajanti		2,796,359.60	116.63	276.90

Source: IBRA Press Conference, Jan 31, 2001

prices was the only reason, they should have failed to service the debts every time prices fell.

5.4.1 No intention to pay

The Djajanti Group proved that, when dealing with IBRA, an uncooperative debt strategy gained more financial benefits than a cooperative one. Because it was considered an uncooperative debtor, the Djajanti Group was asked to speed up the payment of its debts to IBRA. However, the group rejected IBRA's request for a lump sum payment of IDR 295.5 billion in cash, as part of its debt restructuring deal. IBRA's threat to confiscate the assets of the Djajanti Group's plantation and fishery interests prompted a proposal from the group to repay the IDR 295.5 billion over a three-year period.[86] However, IBRA never accepted this proposal.

IBRA and the Djajanti Group also failed to complete the debt restructuring process. The Djajanti Group only agreed to a framework for a Memorandum of Understanding (MoU), but several details were left unresolved. The MoU did not specify the proportion of Djajanti Group sustainable and unsustainable debts. The extent of the Djajanti Group owners' responsibility, should they fail to pay the sustainable debts, was left unclear. The amount of additional assets requested to reduce unsustainable debts was also left unclear. The Djajanti Group failed to provide a prediction for the cash flow of its forestry division in the debt restructuring negotiation. IBRA loan officers in charge of the group reported that several companies under the timber division were either non-operational or operating at very low capacity.[87]

By December 2002, IBRA had sold all Djajanti Group debts back to the new Bank Mandiri. IBRA did not report the recovery rate of this sale. However, taking into account IBRA's general recovery rate of 20% for corporate debts, it meant IBRA wrote off about IDR 4.48 trillion (USD 640 million) worth of debt. Even this write-off was not enough for the Djajanti Group. They planned to secure even more write-offs from the new Bank Mandiri. It was reported that the Djajanti Group made an offer to the new Bank Mandiri to buy back the total debts for only 15% of their original value.[88]

The debt restructuring agreement between the new Bank Mandiri and the Djajanti group remains unclear. However, in June 2006, Bank Mandiri finally decided to make the behavior of this group public knowledge. According to Bank Mandiri, the Djajanti group was considered an uncooperative debtor; it had no good intention to pay its debts and contributed to the increase of non-performing loans in Bank Mandiri.[89] Bank Mandiri's non-performing by June 2006 were

IDR 27.9 trillion or 26.2 percent of total loans provided by the bank. While a healthy bank, according to the Bank Indonesia, has an NPL ratio of not more than 5 percent.

It is clear that the government bailout of the Djajanti Group failed either to protect Bank Mandiri or to restructure the forest industry. Part of the government funds used to rescue Bank Mandiri was used to rescue the Djajanti Group. The company is still operating with a mill capacity of more than 800,000 m^3 per year and forest concessions of more than 3 million hectares. It is doubtful that the Djajanti Group uses the funds from Bank Mandiri (by not paying its debts) for restructuring its forestry businesses.

5.5 Barito Group

Prajogo Pangestu began his business in 1977 by investing IDR 652 million (USD 100,000) to take over Barito Pacific Lumber and its 40,000 hectare forest concession in South Kalimantan. Using this company and concession, he managed, in twenty years (by the end of December 1996), to gain control of the largest forest concession in Indonesia. This concession, at 4.65 million hectares, produced annual sales of USD 404.55 million and had assets totaling IDR 2.7 trillion or USD 385 million.[90] During this time period he also used economic rent from the forests, to expand his business interests into financial institutions, plantations, property, tourism, transportation, and petrochemical, mining, and pulp and paper industries. By the end of December 1996, his Barito Group business enterprises were worth about IDR 6.7 trillion or approximately USD 1 billion and ranked eleventh among the Indonesian conglomerates (PDBI, 1997).

Although successful in developing a giant business empire in a relatively short time period, Prajogo Pangestu failed to repay most of his (Barito Group's) debts. In May 2001, IBRA reported that the Barito Group had non-performing loans of IDR 3.2 trillion and USD 835 million or a total of about USD 1.3 billion. Of the USD 1.3 billion, Chandra Asri's debt made up USD 538 million. Chandra Asri owed an additional USD 772 million to Japanese conglomerates. Prajogo, acting through PT. Inter Pertindo Inti Citra (an investment company run by Prajogo) controlled 76.19% of the shares in Chandra Asri. Inter Pertindo Inti Citra debt worth IDR 342 billion was also transferred to IBRA. Table 5.11 shows the details of Barito Group debts under

Table 5.11 Barito Group debt under IBRA

No	Debtors	IBRA Loans		JIPC Loans	Restructuring Terms
		USD million	IDR billion	USD million	
1	Chandra Asri	538.00	-	772.00	IBRA term loans USD 100 million and IBRA equity 28.72%; JIPC term loans USD 625 million and JIPC Equity 0.47%
2	Inter Pertindo Inti Citra	-	342.50	-	Convertible Bonds
3	Mitra Laras Serasi	-	83.28	-	Convertible Bonds
4	Estika Yasa Kelola	-	74.80	-	Convertible Bonds
5	Staco Arta Karya	-	24.50	-	Convertible Bonds
6	Batara Inti Gajah Perkasa	-	25.93	-	Convertible Bonds
7	Dwiyapola Karya Utama	-	25.94	-	Convertible Bonds
8	Prajogo Pangestu	-	24.50	-	Convertible Bonds
9	Pancapuri Indo Perkasa	-	120.00	-	Convertible Bonds
10	Barito Pacific Timber	4.00	133.90	-	In process
11	Barito Pacific Lumber	10.00	140.39	-	In the process
12	Barito Wood Sentosa Int'l	-	143.38	-	In the process
13	Nan Sari Prima Plywood	-	9.09	-	In the process
14	Sangkurilang Bhakti	2.97	36.79	-	In the process
15	Tunggal Setia Pratama	-	98.40	-	In the process
16	Jabar Utama Wood Ind.	3.38	-	-	In the process
17	Other companies	300.00	1,921.64	-	In the process
	Total	858.35	3,205.03	772.00	

Source: IBRA as of May 21, 2001

the negotiations with IBRA and the Japanese conglomerates.

When the local banks turned over these Barito Group non-performing loans to IBRA, they in effect, gave the Barito Group a government subsidy of USD 1.3 billion. In the meantime, the Barito Group was allowed to continue operating without paying its debts until the time it might reach an agreement with IBRA. Despite this staggering amount of debt, Projogo Pangestu avoided payment and was still able to keep his business empire running.

5.5.1 Debt restructuring of Chandra Asri

The governments of Japan and Indonesia persuaded Prajogo Pangestu to keep control of Chandra Asri despite his inability to make the company profitable. However, the Japanese government and the Japanese conglomerate, Marubeni Corp. declined to provide a favorable debt restructuring deal to Prajogo and Chandra Asri. In contrast, despite rejection by IBRA, the FSPC (having taken over IBRA's role in dealings with the Barito Group) agreed to provide a more favorable debt settlement to Chandra Asri and also to provide a large financial subsidy to Prajogo. The FSPC did this by writing off the company's debts or by converting the debts into zero value equity and/or zero coupon convertible bonds issued by unprofitable companies.

In reaching a debt settlement for Chandra Asri, the Indonesian government failed to obtain terms as favorable as the ones obtained by the Japanese conglomerate. After a hard, three-year long negotiation and political intervention by the former Indonesian President Abdurrahman Wahid, in April 2001 the FSPC finally reached an agreement with the Japanese conglomerate. The FSPC agreed to convert USD 438 million of Chandra Asri's USD 538 million debt into 25.86 percent equity shares in the company. The Japanese conglomerate only agreed to swap USD 147 million of Chandra Asri's USD 772 million debt into equity of the company. Following the equity swap, the Japanese conglomerate would then possess 24.59 percent of the company's equity shares.[91] Using a 12 percent discount rate, the enterprise value of Chandra Asri was estimated at around USD 676 million. However, if a higher discount rate had been used (that is to say, a rate more comparable to that used by new investors in Indonesia), the equity value of the company would have been equal to zero or even negative.[92] Thus, FSPC actually agreed to exchange USD 438 million in debt for shares of Chandra Asri that had either no value or even negative (book) value.

The rest of Chandra Asri's debts to IBRA (USD 100 million) and the Japanese conglomerate (USD 625 million) were restructured. The loans were set to mature in fifteen years (ordinarily sustainable loans were only given ten years to mature) at an interest rate of LIBOR plus 1.25 percent per annum. This rate was below the market rate for a sustainable loan usually about 10 percent. The FSPC argued that the debt restructuring agreement would benefit the Indonesian parties, as the majority shareholders. A lower rate and longer maturity would give the company more cash flows to pay interest to its creditors and dividends to its shareholders. However, Prajogo, as the largest owner of Chandra Asri, would certainly enjoy larger benefits than IBRA.

Getting financial subsidies for Chandra Asri was not enough for Prajogo Pangestu. For example, rather than sell part of his wealth to pay off his company debts, Prajogo swapped the debts into a convertible bond issued by an unprofitable company. This transaction was allowed by the FSPC. The FSPC agreed to swap debts of Inter Pertindo Inti Citra (IPIC), Mitra Laras Serasi, Estika Yasa Kelola, Staco Arta Karya, Batara Inti Gajah Perkasa, Dwiyapola Karya Utama, Prajogo Pangestu, and Pancapuri Indo Perkasa into a convertible bond issued by IPIC[93] (It is through IPIC that Prajogo controls Chandra Asri). IPIC issued a zero coupon bond worth IDR 5.5 trillion (USD 786 million) due in August 2014 (twelve years) with an implied compound interest of 6% per annum. Shares of IPIC in Chandra Asri were assigned as collateral for the bond. If IPIC fails to repay the bond in 2014, the bondholders can convert it to equity of IPIC or declare IPIC bankrupt.[94] Given Prajogo's track record of failing to pay up, under pressure from IBRA, it remains unclear who would be able to force Prajogo to pay when the bond matures in 2014, should IPIC fail to honor the bond.

5.5.2 Government financial subsidies

IBRA formally provided financial subsidies to the owners of Chandra Asri in October 2003 when it sold all assets related to Chandra Asri, in the amount of IDR 10.10 trillion, for only IDR 602 billion (5.96%). These assets were sold to a Thailand-based investor, Glazers & Putnam

Investment Ltd. whose ownership was unclear.[95] IBRA sold Chandra Asri's USD 100 million sustainable debt, as well as shares of Chandra Asri worth USD 417.4 million and convertible bonds issued by IPIC in the amount of IDR 5.45 trillion. The total financial subsidy provided by IBRA for the owners of Chandra Asri was IDR 9.5 trillion or USD 1.4 billion.

IBRA sold Barito forestry companies' debts to Bank Mandiri in August 2002. Bank Mandiri, acting in a joint venture with a local financial company, PT. Mahanusa Kapital, bought debts of ten of the Barito Group's forestry companies with a book value of IDR 708.62 billion or USD 101 million. It was unclear, however, how much the Bank Mandiri consortium paid for these debts.

In general, IBRA sold its debts for only 20 percent of the total debt value including accumulation of unpaid interest (in this case the total would have been about USD 21 million). Therefore, it was estimated that IBRA provided a financial subsidy of about USD 80 million to Bank Mandiri's consortium. The Barito Group was then able to seek a debt write-off with the consortium. Bank Mandiri provided 70 percent of the capital needed by the consortium to buy Barito debts. In exchange, Bank Mandiri took the sustainable part of Barito debts, about 30% of the total debt or USD 30 million, and recorded it as a new lending facility to the group. Mahanusa Kapital paid 30 percent of the capital needed, or USD 6.3 million, and got the unsustainable part of the group debts in the amount of USD 71 million. Mahanusa Kapital later swapped the unsustainable debt with equity of Barito companies. Many analysts are concerned that Mahanusa Kapital is acting as a front company for Prajogo Pangestu so that he (Prajogo) can erase Barito's outstanding debts and still retain control over the company. Bank Mandiri could also end up selling the sustainable debt to Prajogo at a further discount, or through other methods of soft financing (Barr and Setiono, 2003).

Prajogo Pangestu benefited from another financial subsidy that was given to Chandra Asri's sister company. PT. TriPolyta Indonesia Tbk. In 2001, Prajogo had shares in the company worth 8.51%. The company was, and remains, the largest buyer of Chandra Asri propylene. Supported by the FSPC, Prajogo was allowed to increase his shares in this company (the largest Indonesian producer of polypropylene resins). While his own company was fighting the bondholder lawsuit, Prajogo increased his shares in the ownership of TriPolyta to 46.46% in 2002.[96] On November 25, 1996, TriPolyta issued bonds on the New York Stock Exchange, which were set to mature in December 2003 and totaled USD 185 million. In June 1999, TriPolyta failed to serve its bonds. In October 2001, on behalf of bond holders, the Bank of New York filed a law suit in the South District Court of New York against the company to repay all bond obligations, including unpaid interest about USD 253.58 million. By December 2002, the bond obligation had reached USD 287.68 million. On April 25, 2003, The South District Court of New York found in favor of the Bank of New York. However, TriPolyta managed to gain protection from Indonesian legal authorities. On February 27, 2003 the company filed a suit in the Serang District Court of Indonesia to annul all bond transactions and agreements, based on Indonesian law. Just two months later, on April 7, 2003, the Serang District Court issued a verdict that found in favor of TriPolyta effectively overturning the ruling of the New York court. This verdict meant the New York court could not liquidate the company, despite TriPolyta's failure to pay its financial obligations.

5.5.3 Local banks

Prajogo Pangestu looked into local banks, especially state banks, for help in developing his pulp and paper industry. To tap into local bank financial facilities, he used his prime timber company, Barito Pacific Timber (BRPT). This company was actually profitable before Prajogo squeezed its cash flows to build his pulp and paper company. From 1994 to 1997, BRPT was able to pay dividends of IDR 70 billion to IDR 90 billion annually. The company reported net profits in the range of IDR70 billion (1995) to IDR 310 billion (1993) in the period between 1992 and 1996. However, in 1997, when Prajogo started the construction of his pulp mill, the company began reporting losses. From 1998 on, BRPT stopped paying dividends.

Before 1991, BRPT had borrowed USD 172.86 million from Bank Bumi Daya, a state-owned bank that later merged into Bank Mandiri. This loan was restructured in March 1992 and again in June 1996. The company also borrowed USD 286.14 million from Bank Dagang Negara (another state bank that later merged into Bank Mandiri). This loan was restructured in September 1992 and again in June 1996. In any

debt restructuring agreement, especially one involving a large sum, a debtor usually receives a financial subsidy from the creditor in the form of a write-off on principal or interest payments, or an extension on the maturity of the loans. The details concerning the debt restructuring agreement between the old Bank Mandiri and BRPT were left unclear.

IBRA reported that Bank Mandiri (the old state banks) transferred Barito Group non-performing loans of USD 100 million. These loans included BRPT debts of USD 4 million and IDR 133.9 billion (see Table 5.7). IBRA's report for 2000 also suggested that the old state banks that had merged into Bank Mandiri, had transferred USD 416 million worth of Barito Group's non-performing loans to IBRA. However, BRPT did not report any non-performing loans under IBRA in its annual reports, or in financial statements released since 1997. The company reported receiving a new working capital loan of USD 22 million in November 1997 from Bank Dagang Negara. This was the year the Tanjung Enim Pulp and Paper mill was constructed. In 2002, BRPT received new short-term loans of IDR 7.2 billion from Bank Mandiri and IDR 3 billion from Bank Danamon, a recap bank. Both loans were repaid in 2003.

IBRA's sale of Barito Group debts back to Bank Mandiri in effect caused the groups debts in the bank to be written off at the expense of the Indonesian government. As discussed earlier, IBRA sold Barito forestry companies' debts in the amount of USD 101 million. It was estimated that Bank Mandiri recorded only USD 30 million out of USD 101 million for the sustainable part of the debt.

5.5.4 Indonesian capital markets

Bullish capital markets in Indonesia prior to the financial crisis had created an opportunity for Prajogo Pangestu to find yet another source of public funds to build his pulp and paper industry. As part of his strategy to tap into the funds of international investors and creditors, Prajogo reduced huge amounts of BRPT debt by selling its shares on the Indonesian capital markets in 1993. By doing this, the company reduced its debt-equity ratio from 2.27 to 0.52 and cut its debt from IDR 1.2 trillion to IDR 936 billion. In March 1993, one year after initiating the pulp and paper project, BRPT received fresh cash flows from TASPEN, a government pension fund, to the tune of IDR 375 billion. In exchange, BRPT traded shares totaling 20.32 percent of the entire company. TASPEN received 125 million shares and paid IDR 3,000 per share, or three times the nominal value of the company. In the same year, BRPT received IDR 612 billion from the Jakarta Stock Market. In September 1993, the company sold 85 million shares to the public for IDR 7,200 per share or 7.2 times the nominal value of the company. By the first six months of 2004, the company's shares were selling for between IDR 180 to IDR 315 per share, only 2 to 4 percent of their original price.

In 1993, BRPT improved its solvability profile, as a result of having reported high profits in the amount of IDR 310 billion. By the end of 1993, the company's equity value had increased significantly from IDR 534 billion to IDR 1.8 trillion. Just before the financial crisis, in July 1997, BRPT was able to raise fresh funds by selling bonds in the Indonesian capital markets. BRPT was able to sell bonds in the amount of IDR 400 billion which were set to mature in July 2002 (five-year bonds). The bonds paid a fixed interest rate of 15% which was payable semiannually in January and July. Under the bond indenture (agreement), the company was limited in its ability to expand without permission from the bondholders. However, the company was prohibited from reducing its paid-in capital, merging with other companies, or issuing additional bonds or similar financial instruments, with some exceptions. The company also had to maintain certain key financial ratios. By the end of 1998, the company already reportedly failed to service its bond covenant.[97] The bondholders, however, did not issue a formal reaction to the company's failure to hold to the covenant. In July 2000, the bondholders agreed to restructure the bonds by extending their maturity to January 2007, thus changing them into 10-year bonds with incremental interest rate payments. The company then set up a sinking fund in order to repay the bonds. Only six months later, the company failed once again to pay interest on the bonds. The bondholders provided yet another subsidy by allowing the company to pay back the unpaid interest in installments. Yet again, the company broke its promise and failed to pay interest in January 2002. By this time the bondholders had lost their trust in the company. After the company did not respond to their subpoena to pay all bond obligations,

they filed a lawsuit against the company in the Jakarta Commerce Court in February 2002. The bondholders' demand to bankrupt the company was rejected by both the Commerce Court and the Supreme Court in 2002. Faced with an ineffective bankruptcy system, the bondholders were forced to enter yet another debt restructuring agreement with the company. The nominal bond became IDR 444.55 billion with incremental interest rates. It was still set to mature in January 2007. The bond was given a rating of CCC by a rating company, suggesting that the ability of the company to repay its bond obligations was uncertain and speculative.

5.5.5 Related party transactions and transfer pricing

With the help of the bullish Indonesian capital markets just before the crisis of 1997, BRPT had reformed itself into a healthy and profitable company. Its debt to equity ratio was only 0.34 in 1996, it paid dividends of IDR 70 billion out of an IDR 87 billion net profit, and its liquid assets totaled more than IDR 500 billion. Using this profile, Prajogo was ready to secure funds from international creditors and capital markets, for financing his pulp and paper industry.

Prajogo Pangestu used BRPT to inject capital into Tunggal Setia Pratama (TSP), a trade company of which he had almost exclusive ownership; TSP was 37 percent individually owned by Prajogo, and 63 percent owned by Barito Pacific Lumber. Prajogo, however, also owned 98% of the shares of Barito Pacific Lumber. Through his cross-shares holding, Prajogo in effect owned all of TSP. In June 1998, BRPT bought 10,000 shares or 50% of the ownership of PT. Enim Musi Lestari (EML) from TSP. The cost of this purchase was set at USD 250 million[98], with a share price set at a staggering USD 25,000 per share. This transaction effectively channeled the USD 250 million from BRPT to TSP and Prajogo.

In a similar scenario to the one just described, Prajogo used BRPT to pay off the debts of Muktilestari Kencana (MLK), a company which he owned 95 percent of. Following the aforementioned sale of EML by TSP, BRPT controlled 90 percent of EML's ownership (since prior to the transaction BRPT had already owned 40% shares in EML). This left ten percent of the shares of EML unaccounted for. This ten percent was owned by the MLK Company. Following the TSP transaction, BRPT bought the rest of the EML shares (2,000 shares) from MLK for USD 42.6 million or USD 21,300 per share. (Rather than pay the USD 42.6 million in cash, BRPT paid MLK by reducing MLK debts and Barito Pacific Lumber debts to BRPT).

BRPT borrowed short-term loans from international creditors to finance its investment in TSP. Since August 1997, BRPT had already received short-term financing in terms of a bridging loan facility which took six months to mature. By the end of December 1997, BRPT had received short-term financing in the amount of USD 195 million from international creditors such as Credit Suisse First Boston, ING Bank N.V., and Credit Lyonnais of Singapore. BRPT had also received short-term financing from local financial institutions in the amount of USD 98 million, from Makindo Sekuritas, Bank Mandiri, and Asia Kapitalindo Securitas. During the same year, BRPT received bridging loan facilities from Marubeni Europe Plc. in the amount of USD 70 million, to pay BRPT shareholder obligations in Tanjung Enim Lestari Pulp and Paper (TEL). According to the TEL shareholder support agreement, the company should have paid the remaining share of its equity investment in TEL.

By December 2002, BRPT failed to service debts about USD 511.36 million to nineteen international and two local creditors, Bank Mandiri and Asuransi Allianz Utama Indonesia (see Table 5.12). These included debts of the founding owner of BRPT and debts of Barito Pacific Lumber (BPL) for its investment of USD 56.68 million in PT. Musi Hutan Persada, a timber plantation.

BRPT financial statements over the period from 1997 to 2003 show how international funds were used to finance the construction of the USD 1.2 billion TEL mill in South Sumatra. On March 14, 1997, while the Barito Group still controlled 57% of the shares of TEL, TEL signed a turnkey project with Klockner Industrie-Anlagen GmbH of Germany to design, provide, develop, install, and operate a 450,000 ton pulp mill with a total contract of USD 779.4 million.[99] The project began in July 1997 with the goal of starting commercial production by the beginning of 2000. The project received financial facilities of USD 690.00 million (in the form of export credit and commercial loans) from export credit agencies in Germany, Canada, and Finland, and a Swedish bank. The financial facilities were set to be due in 2010 and carried interest rates between 7 and 9 percent.

Table 5.12 BRPT Debts under restructuring by December 2002

No	Creditors	USD million
1	Commerzbank International Trust, Singapore	164.96
2	Whistler Petrochemical Corporation, Mauritius	97.36
3	Marubeni Corp.	70.00
4	Bankers Trust International Plc.	46.00
5	Makindo Sekuritas	38.50
6	Lehman Brothers Investment Pte. Ltd. Hong Kong	35.63
7	Bank Mandiri	22.00
8	Techmax (Hong Kong) Ltd.	7.90
9	Credit Agricole Indosuez Hong Kong	5.00
10	JG Summit INC Filipina	4.00
11	Bank Sarasin Rabo (Asia) Ltd. Singapore	3.00
12	Morgan Stanley	3.00
13	Multisolution Inc. Hong Kong	2.00
14	Saehan Merchant Banking Corporation Korea	2.00
15	Credit Suisse Hong Kong	2.00
16	Credit Industriel et Commercial Singapore	2.00
17	Credit Suisse Private Banking Geneva Swiss	2.00
18	ING Asia Private Limited Singapore	1.00
19	Wilsica Holdings Limited Singapore	1.00
20	Bank Kreditanstalt, Wien, Austria	1.00
21	PT. Asuransi Allianz Utama Indonesia	1.00
	Total Barito Group	**511.36**

Moreover, another financial facility, about USD 300 million was provided by commercial lenders (banks), in order for TEL to pay the fixed costs and the debt service reserves. Because of all the financial facilities provided, the cost of the pulp mill construction was fully financed by external funding.[100]

BRPT sought individual debt restructuring agreements with the Marubeni Corporation of Japan, Bank Mandiri, and the Indonesian bondholders. A government agency called Satuan Tugas Prakasa Jakarta (JITF) acted with FSPC support to set up a collective restructuring agreement with BRPT. The net loans under this agreement equaled USD 419.36 million. For the debt restructuring proposal, the exchange rate was IDR 8,973 per US dollar. Therefore, the total BRPT debt under STPJ-facilitated restructuring came to IDR 3.67 trillion.

The company and its creditors agreed upon four debt resolutions (although one group of creditors with total loans of USD 48.5 million (12%) rejected these resolutions). The first debt resolution was called the debt repurchase program, and involved debts of USD 205.11 million, equivalent to 49 percent of the total debt under the collective restructuring agreement. BRPT paid a cash amount of USD 30 million (14.6%) to the creditors who joined the program. It also issued new shares to repay the remaining debts of USD 175.11 million or IDR 1.57 trillion. BRPT issued 523,764,351 shares with nominal values of IDR 1,000 per share and a conversion price of IDR 3,000 per share. The conversion rate provided the owners of BRPT with financial benefits from the debt equity swap; benefits that totaled at least IDR 1.52 trillion or USD 169.86 million. BRPT shares, however, only traded at the rate of IDR 50 to IDR 90 per share on the Jakarta Stock Exchange during 2002.

The second debt resolution involved the issuance of Senior Amortizing Loans (SAL) in the amount of USD 38.68 million (9%) or IDR 345.81 billion. The SALs were set to be due in December 2010 and carried an interest rate of SIBOR plus 2.5 to 4 percent. The principal payment was to be made in June 2005 and interest payments began in March 2003.

The third debt resolution involved the issuance of zero coupon redeemable convertible bonds in the amount of USD 54 million (12.92%). These bonds were set to mature in December 2012. This allowed BRPT to delay payment of its current financial obligation for as long as 10 years.

The final debt resolution, for settling USD 419.36 million worth of BRPT debt, involved the issuance of new shares in the amount of USD 72.91 million (17.08%), equivalent to IDR 654.22 billion. BRPT issued 654,223,765 new shares at a sales rate of IDR 1,000 per share. This final debt resolution provided the company with a financial gain of at least IDR 595.34 billion.

5.5.6 Creative accounting

The owners and/or the board of management of BRPT deliberately chose to have BRPT experience losses. In 1998, the company recorded a significant exchange rate loss of IDR 1.08 trillion, or about 59% of its net sales for the year. During this year, the Indonesian Rupiah fell from IDR 4,650 to IDR 8,025 per US dollar. By the end of December 1998, the company had more liabilities than assets in US dollars (and the drop in the value of the Rupiah also meant more liabilities in Rupiah). Under Indonesian Accounting Standard No.10 (PSAK no.10) regarding transactions in foreign currencies, in times when the value of the Rupiah depreciates greatly, companies are allowed to charge the exchange differences to the value of the assets bought using foreign debts. In the case of BRPT, foreign debt was used in part to buy shares in TSP. The company, however, chose to charge the exchange differences, in the amount of IDR 1.08 trillion, to its profit, thereby wiping out all of BRPT's operating profits for the year. Interestingly, despite making very few changes to its 1998 asset-liabilities structure, BRPT reported a gain of IDR 32.87 billion in 1999 and only recorded an exchange rate loss of IDR 176.79 billion in 2000. The values of the Rupiah per US dollar for 1997, 1998, 1999, and 2000 were IDR 4,650, IDR 8,025, IDR 7,100, and IDR 9.595 respectively. The Rupiah fell almost 35 percent in 2000, compared to 72 percent in 1998.

BRPT losses were not only due to creative accounting, but also due to bad economic decisions. BRPT entered into questionable swap contract transactions between the company and the international bankers. On August 20, 1997, BRPT entered a cross currency swap agreement with Bankers Trust International Plc. (BTI). According to the agreement, BRPT agreed to pay USD 66.67 million in July 2002 and pay a fixed annual interest rate of 4.6 percent from the date of the signing of the agreement. In return, BTI would receive IDR 200 billion (at an exchange rate of IDR 3,000 per US dollar) in July 2002 and pay a fixed annual interest rate of 15 percent. One month earlier, the company had also entered a coupon swap contract with the American Express Bank Ltd. (AEB). Under this agreement, BRPT had agreed to pay a fixed annual interest rate of 12.5 percent for nominal principal of USD 77.07 billion until July 10, 2002. In return, AEB agreed to pay a fixed annual interest rate of 15 percent for nominal principal of IDR 200 billion (at an exchange rate of IDR 2,595 per US dollar). Both contracts created greater US dollar liability and more assets in Rupiah for BRPT. As a result, the company's decision to enter into these contracts increased the company's already extremely high foreign exchange risk. Cross currency swaps and coupon swaps are financial instruments that are usually used to reduce foreign exchange risk. BRPT should have been using these financial instruments to create more foreign exchange assets, in order to reduce its foreign exchange liabilities. The company has been in default on both contracts since 1998.[101]

Conclusions and Policy Recommendations

6.1 Summary of IBRA debt policy

When it was established in 1998, IBRA was equipped with professional staff, well trained in banking, finance, accounting, and law. The staff were provided with good salaries and equipped with far-reaching authority to assure they would deliver debt policies and settlements that were most beneficial to the country. Given IBRA's lack of expertise in forestry, IWGFF attempted to provide some input on debt settlements related to forestry-based companies. This study shows not only how IBRA failed to address these forestry issues, but also how it failed in its responsibility to protect the interests of the Indonesian government and the general public on assets under its control.

IBRA's debt policy was highly influenced by the FSPC. This powerful committee worked beyond providing general guidelines for the debt settlements of major Indonesian companies and individuals. The FSPC gave its approval when IBRA created the debt settlement terms for large debtors such as the Sinar Mas Group, the Barito Group, the Bob Hasan Group, the Raja Garuda Mas Group, and the Djajanti Group. This study shows how the head of the FSPC was not interested in responding to the demands of IWGFF even though the Indonesian government had committed itself to link debt restructuring with the restructuring of the forestry industry. Despite the Indonesian government's dependence on international donors to finance the growing fiscal deficit, the head of the FSPC (who was also the head of the IDCF) was able to ignore the World Bank and the CGI request to address the forestry issues in IBRA's debt policy. It was unclear whether the IMF raised forestry issues with the FSPC and IBRA in their negotiations to draw the IMF extended fund facility; but if it did, it did so with little effect.

In significant ways, IBRA debt restructuring practices for timber-based companies undermined the forest policy introduced by the Ministry of Forestry. The Ministry of Forestry took measures, such as introducing the soft landing policy to limit the timber industries' wood usage to what the forests could support. In contrast, IBRA and other economic leaders saw timber-based industries as strategic industries for the country's economic recovery and viewed the unsustainable wood supply as a low-priority problem. These leaders and IBRA failed to concern themselves with details over the origin of the wood (i.e. whether it came from legitimate sources such as fully licensed timber concessions, plantations or imports, or was harvested illegally).

This study shows the depth of IBRA's failure in understanding forestry issues in light of its inability to even fulfill its basic mandate to obtain the maximum value of assets under its portfolio. IBRA and the government's economic team categorized timber-based industries- especially the pulp and paper industry- as strategic industries. These industries continue to maintain, and in some cases increase, wood-based product exports. They also provide important contributions to Indonesia's balance of payments and job opportunities. Forestry operations of these industries continue to provide cash flows to the companies despite fluctuations in product prices. IBRA, however, failed in its responsibility to control the cash flows of these companies. Instead of pressuring them to use their cash flows to reduce their debts or at least pay interests on the debts, IBRA left these companies in the hands of their original owners and allowed them to use the cash flows in various suspicious financial transactions. These transactions included:

- Related party transactions and transfer pricing:
  - Providing uncollectible trade credits and non-interest bearing loans to affiliated companies.
  - Providing uncollectible trade credits to companies established in high-risk jurisdictions such as the British Virgin Islands and the Cayman Islands.
  - Buying shares of affiliated companies at unreasonable prices.
  - Increasing costs to buy wood from both affiliated companies and third parties.
- Entering into unnecessary currency and interest rate swap transactions.
- Expanding company businesses in China and elsewhere without consent from IBRA and the Indonesian government.
- Reporting accounting losses in order to receive favorable tax payments and debt restructuring terms.

Not only did IBRA fail to control the cash flows of companies' forestry operations, it also provided debt write-offs to forestry industries. When forestry companies transferred their debts to IBRA, they stopped interest payments and repayments of their debts. In theory, IBRA was to tally up the unpaid interest and add it to the outstanding balances. In practice, IBRA sold the total debts of forestry companies to private and public sector financial institutions for an average of only 20 percent of their value. The same debt settlements were also provided to non-forest based companies that were owned by forestry conglomerates. Financial institutions would then negotiate new debt restructuring terms with forestry companies. The size of the financial benefits that the forestry companies received when they settled on the new debt terms is unclear.

Forestry companies saw the financial crisis of 1997 as an opportunity to gain as many benefits as possible especially for the founding owners. These companies did not stop at amassing wealth from their forestry operations and IBRA debt write-off subsidies. They pursued at least three other moneymaking schemes. *First*, with IBRA's 'protection' and the relative immunity afforded them by Indonesia's weak court system, they failed to pay debts to international creditors (and in one case even won a bankruptcy suit filed by creditors). In the end, forestry conglomerates were usually able to win favorable debt restructuring deals and force international creditors to provide huge debt write-offs. *Second*, at least in cases where financial reports were available, this study found that forestry companies did not pay corporate taxes on the operating profits earned from their operations. They chose accounting policies that could wipe out their forestry profits and even showed the companies coming out at a loss. The accounting policies they used to achieve this objective included provisions for doubtful (receivable) accounts, interest expenses on non-performing debts, loss on foreign exchanges, and asset write-offs. *Third*, they did not pay taxes on windfall profits received from debt write-offs. This facility was made possible with the support of the FSPC.

A range of local and international creditors from commercial banks, export credit agencies, merchant banks, and security companies provided billions of US dollars to finance the expansion of Indonesian timber-based conglomerates during the Suharto era. When they financed these expansions, they based their decisions on information provided by the companies and consultants hired by the companies. Information from independent forestry experts was not considered by the local and international creditors. Many creditors thought they could control the collateral and company cash flows in the event that the loans defaulted. In reality, there are wood supply problems, illegal logging, and other structural problems in the forestry sector. Besides this, many large forestry companies were able to seek protection from international creditors and bankruptcy threats by entering debt restructuring negotiations with IBRA and entering the Indonesian court system. Forestry conglomerates won favorable debt restructuring terms with both local and international creditors.

This study shows how Indonesia's state banks acted as the major local financial players in financing the timber-based industry expansion. Prior to the financial crisis, the four state banks that later merged into Bank Mandiri were the largest local creditors for timber-based industries. Not only did these banks fail to collect loans from their forestry clients, they also failed to see the threat these clients posed to Indonesia's natural forests and the people living there. Currently, Bank Mandiri and its

financial partners have bought back most of the debts of their former forestry clients (debts that were previously under IBRA control). Some of these old friends of Bank Mandiri have already created financial problems for the bank. Bank Mandiri publicly announced that the Raja Garuda Mas Group, the Djajanti Group, and Kiani Kertas were uncooperative debtors. They have no good intentions to repay their debts. The total non-performing loans of these groups were estimated at more than USD 1 billion or about 30 percent of Bank Mandiri's total non-performing loans.

6.2 Implications for financial institutions and forests

Bank Mandiri is the largest bank in Indonesia and, according to Bank Indonesia's definition, is a systemic bank. Damage to the bank's reputation and liquidity could hurt the whole Indonesian banking system. Bank Mandiri has financed the forestry sector and most major forestry conglomerates are its customers. This study shows that the forestry conglomerates, and the timber industry as a whole, pose serious threats to the bank's financial stability.

Banks face high credit risk and legal risk from their investments in forest industries. Banks help wood-based industries to continue operating without addressing illegal logging activities that have contributed to the deforestation of Indonesian forests. Shortage of wood could also force banks to enter another debt restructuring process that could lead to more subsidies for the wood-based industries. When industries are caught in illegal logging cases, banks could not only lose their investment but could also face legal suits for their involvement in money laundering. Banks involved in financing forest-based industries face legal risks from banking regulations and the anti-money laundering law. Banking regulations require that banks know their customers, manage risk, and avoid financing projects that may be harmful to the environment. Failure to address these regulations can result in banks losing their licenses, facing administrative sanctions and even being brought up on criminal charges. The Indonesian anti-money laundering law makes banks and other financial institutions liable for transactions involving forestry and environmental crimes. In October 2003, the Indonesian government enacted Law No. 25/2003 as an amendment to Law No. 15/2002. Among the changes under this new law was the categorization of forestry crimes and environmental crimes as new predicate offences for money laundering. Finally, banks involved in financing high-risk, forest-based projects could lose not just their reputations as responsible banks but also their businesses.

While Indonesian institutions such as IBRA and Bank Mandiri, and international agencies provide financial subsidies to timber or wood-based industries, we can expect more deforestation and social conflicts involving forest-dependent peoples. With this financial backing, the timber industries have greater freedom to maintain or even expand their timber production. Since the production forests are diminishing, it is natural that they would look for other sources of timber. Using the local autonomy argument, they could persuade local governments to issue forest utilization permits in areas located under existing HPH concessions, in protected areas, or in national parks. They might not be able to secure permits directly but they could buy the timber produced by the holders of local governments' forest utilization permits. Expansion of the timber industry's activities into these areas could create conflicts with people who obtain their livelihoods from these natural forests. These people depend on forest products for food, fiber, fuel wood, construction materials and medicinal plants.

6.3 Policy recommendations

The observations of this study can be used to obtain some important lessons and formulate recommendations towards future policies. *First*, both local and foreign banks are in a strategically weak position when dealing with forestry conglomerates and timber industries. They are unable to force conglomerates and timber industries to repay debts and have no control over their cash flows. Many forestry conglomerates can obtain favorable debt agreements, get away with forestry problems, and transfer profits from forestry and wood-based businesses abroad including to their non-timber businesses. Creating a well-paid, powerful administrative institution does not necessarily fix the problem. Instead of becoming an agent of change, for a new Indonesian economy with new economic players and governance, IBRA became a mere selling agent with no initiative for correcting

economic or timber industry problems. *Second*, policies for dealing with forestry conglomerates and timber industries were made by a group of top economic ministers. These policies lacked transparency, making it difficult to assign responsibility for their consequences. Although some information on IBRA was available and could have been used to hold it accountable for its actions, higher up there was no way to hold the FSPC accountable for the decisions it made. *Third*, there is a conflict of interest between forestry and economic decision makers. Indonesian Presidents have failed to reconcile the conflict of interest between reducing pressure on natural forests and extracting timber for profit. Taking into account the above lessons, the following recommendations are offered:

- Transparency and accountability in restructuring debts of forest and wood-based industries. Public participation is a must in any debt restructuring involving government budgets and state-owned companies. Public participation is even more important when debt restructuring is related to forestry issues. Forests are public assets. Since problems with forestry and the timber industries have yet to be resolved, we can expect the forestry conglomerates and timber industries to report a new crisis before long. This crisis could be caused by a lack of timber supply, an increase in social conflicts, a drop in product prices, a boycott from customers (especially abroad), or an increase in oil prices. Any one of these problems would provide the forestry conglomerates and timber industries with an excuse to avoid paying their debts and force the government to bail them out once again.
- Any policy introduced by an economic minister or a group of economic ministers should be transparent and accountable. Decisions relating to new subsidies, both direct and indirect, for forestry conglomerates and timber industries should be clearly explained to the public, and should outline the rationale and implications for sustainable forest management.
- The Indonesian government should require the Bank Indonesia and the Ministry of Finance to review the cash flows of the forestry conglomerates and timber industries that were bailed out by IBRA. They should review the cash flows of these companies for the past five years- including the years when they were under the control of IBRA. Any illegal transfer of forestry profits should be punished severely.
- The Indonesian government, or any other government, should not create another institution like IBRA in the future. No temporary organization can force politically powerful industries to follow regulations. Instead governments should provide existing institutions with incentives to enforce forestry and financial regulations, and operate more accountably and transparently.
- Banks are influential actors in timber production, timber trading, and the production of wood-based products. Banking regulations on asset quality, money laundering, and legal lending limits can be used to promote sustainable forest management as well as healthy wood-based industries.

These recommendations are offered in the hope that the Indonesian government, as well as other governments throughout the world, will make changes to regulate debt-ridden timber industries. Without these changes, the industries will continue to use powerful connections to break regulations at the country's financial and environmental expense.

Endnotes

1 The Indonesian financial crisis which began in mid-1997 caused the collapse of the banking and real sectors. As the Rupiah went into freefall hitting a low of IDR 17,000 to the US dollar, large Indonesian companies failed to service their mounting foreign debts. These companies' non-performing loans caused banks to run out of liquidity and seek government protection.
2 Every year the CGI pledges new loans to the Indonesian government, usually to finance the government's fiscal deficit.
3 Presidential Decree No.80 / 2000 concerning the Interdepartmental Committee on Forestry, June 7, 2000
4 Dollar equivalents of *Rupiah*-denominated figures are calculated at an exchange rate of IDR 7,000 per US dollar.
5 IBRA was founded with the issuance of Government Regulation No.17 in February 1999. Placed under the Ministry of Finance, the agency was assigned a broad mandate to restructure and revitalize the country's collapsed banking sector which included the implementation of the bank liability guarantee program, banking recapitalization program, restructuring of non-performing loans, shareholder liability settlements, and the recovery of state funds provided as liquidity assistance to banks known as BLBI (IBRA 2001). IBRA was responsible for implementing the government's general bank recapitalization program as defined by a joint decree from the Minister of Finance and the Governor of Bank Indonesia in December 1998 (Ministry of Finance and Governor of Bank Indonesia Joint Decree No. 53/KMK.017/1999 and 31/12/KEP/GBI regarding the implementation of the banking recapitalization program).
6 Under Article 13 of Government Regulation No. 17/1999, IBRA had the authority to take legal action over assets and/or liabilities under restructuring. The legal actions in this case were based on Article 37A of Banking Act No. 10/1998.
7 Article 14 of Government Regulation No. 17/1999 says that companies affiliated to banks under restructuring were subject to IBRA authority if there was strong indication that the companies were involved in violations of bank regulations or taking advantage of those violations.
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28 This uniform classification is implemented in stages.

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31 Presidential Decree No. 177 /1999 concerning a Financial Sector Policy Committee, December 28, 1999.

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