

# Due Diligence Concerns in the Paper and Pulp Sector in Indonesia

Anti-money laundering statutes and  
environmental and social impacts

The case of United Fibre Systems  
Pulp and Wood Chip Mills, Kalimantan

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## World Bank, 2006\*

- “Forest loss and forest crime dominate the [Indonesian forestry] sector.”
- “ Indonesia is losing forests at a remarkable rate, one of the fastest in the world.”
- “Industrial timber demand exceeds sustainable supply;”
- “Timber plantations are insufficient and performing poorly”

# World Bank – Indonesia 2006

“Forest conversion – an unsustainable harvest method – has been the fastest growing source of timber supply in recent years and is a major source of supply for pulp mills”

# World Bank 2006\*

- Lack of sufficient due diligence continues to lead to unsustainable demand and “the same kind of debt, risk, and overexposure that contributed to the financial crisis of the late 1990s”

## World Bank – Indonesia – 2006 \*

“Efforts to increase financing in the forest sector or to work with individual firms would have to recognize that firms may misjudge costs, underestimate environmental impacts, and use overly optimistic future projections.”

# Not just forestry, not just Indonesian companies

Yesterday's NYT - front Page - April 9 2008

- "In 2005, federal authorities concluded that a Monsanto consultant had visited the home of an Indonesian official and, with the approval of a senior company executive, handed over an envelope stuffed with hundred-dollar bills. The money was meant as a bribe to win looser environmental regulations for Monsanto's cotton crops... Monsanto was also caught concealing the bribe with fake invoices."

# Indonesia's Forest Sector\*

Without bank finance, large-scale forest exploitation projects are not commercially feasible:

- Costs of machinery, harvest, processing, transport
- In Indonesia, forest industry projects often involve crimes such as illegal logging, pollution of water and air with dangerous wastes, illegal land and forest seizures, the trafficking of women and children and other human rights violations
- Significant legal risks to banks, complexity/difficulty of accurate due diligence

# Heightened International Scrutiny\*

- Civil society organizations (NGOs) around the world are increasingly focused on the environmental and social impacts of international finance – For example, over 300 organizations signed the Jakarta Declaration on Export Credit Agency finance
- CSOs monitoring international finance are looking increasingly at the intersection of environmental/social issues with relatively new anti-money laundering statutes
- Indonesian civil society organizations and community groups are quite vocal and increasingly knowledgeable about international financial investments, rules and regulations

# Financial Action Task Force (FATF)

- Founded 1989 at G-7 summit
- Legal, financial, law enforcement specialists who investigate money-laundering

# Anti-Money Laundering Laws\*

- Strengthened around the world in last 7 years
- Indonesia, Singapore, E.U., US, many other countries including offshore centers such as Cayman Islands, BVI, etc. require financial institutions to “Know your customer”, understand investment profile, patterns of transactions

# Indonesia\*

- 2003 Law 2/2003 – landmark legislation, identifies illegal logging as “predicate offence” for money laundering
- Financial institutions supporting projects involving illegal timber harvesting are now subject to money laundering charges
- Prosecution of financial backers of illegal logging

# Transparency and “Risk-based Approach”\*

Banks must implement customer due diligence proportionally to risks involved in project or transaction;

# Politically Exposed Persons (PEP)\*

Individuals who are or have been entrusted with prominent public functions

- Current, former heads of state
- Senior politicians
- Senior government, judicial, military officials
- Senior executives of state-owned companies
- Major political party officials
- Close associates and family members of all of the above

# Heightened Focus on “Politically Exposed Persons” (PEP)\*

Focus on risk associated with providing financial and business services to gov't ministers/officials from countries with widely-known problems of bribery, corruption, financial irregularities

# PEP

- Focus on cases where “those in power illegally amassed large fortunes by looting their country’s funds, diverting international aid payments”
- Disproportionately benefiting from the proceeds of privatization
- Taking bribes in return for favorable decisions, contracts, jobs

# Corruption

- New focus on tracking the proceeds of corruption which are often transferred to other jurisdictions and concealed through companies, trusts, or foundations or under the names of relatives or close associates

# Impacts\*

- Financial institutions that handle proceeds of corruption face risk of criminal charges for having assisted in laundering the proceeds of crime, lawsuits;

# Reduce Risks\*

- Requiring detailed due diligence at beginning of project and on ongoing basis where it is known *or suspected* that there is involvement of Politically Exposed Persons

# Due Diligence\*

- Close scrutiny of any complex structures (companies, trusts, multiple jurisdictions) “bearing in mind that most legitimate political figures would expect their personal affairs to be undertaken in a more than usually open manner rather than the reverse.”

# Source of Wealth\*

- Make every effort to establish the source of the wealth, including the economic activity that created the wealth , establishing that these are legitimate – at the beginning and on an on-going basis

# Monitoring

- Develop profile of expected activity on the business relationship so as to provide basis for future monitoring
- Review at senior management or board level, decision to commence business relationship and regular review

# Close Scrutiny of Unusual Features

- Very large transactions
- Use of government or central bank accounts
- Particular demands for secrecy
- Use of cash or bearer bonds or other instruments which break an audit trail
- Use of small and unknown financial institutions in secrecy jurisdictions
- Regular transactions involving sums just below a typical reporting amount

# Indonesia's paper and pulp sector\*

Overcapacity, massive illegal logging

CGI (2003) Donor Statement on Forestry:  
Estimated annual timber harvest:

73 million m<sup>3</sup>

of which 53 million m<sup>3</sup> estimated as illegal  
and 20 million m<sup>3</sup> s legal allowable cut

# CGI Report 2003\*

Illegal logging at “epidemic proportions” with “extremely serious and deleterious effect on the forest ecosystem and the welfare of communities dependent on forest resources for their livelihoods”

# CGI Report 2003\*

- Court cases “manipulated” and “indefinitely postponed”
- “Climate of moral hazard”
- Protected forest areas open for exploitation
- Government agencies characterized by “lack of political will” and show “lack of interest and apathy regarding illegal logging.”

# International Crisis Group - 2001

- “The illegal resource industry is protected and sometimes even organized by corrupt elements in the civil service, security forces and the legislature.”
- Recommended: in addition to “tackling the perpetrators and backers of illegal resource extraction, the government needs to address the sources of demand. In the case of timber, this means downsizing the Indonesian wood products industry , which grew so big in the economic boom of the mid-1990s that it now consumes far more than can be legally supplied by Indonesia’s forests.”

# United Fibre Systems (UFS)/ PT. Marga Buana Bumi Mulia\*

- Proposed \$1.2 billion pulp mill in Satui, South Kalimantan, a wood chip mill in Pulau Laut, plans to purchase Kiani Kertas mill in East Kalimantan
- Company based in Singapore, no experience in paper and pulp sector
- Over 80% finance initially by China National Machinery & Equipment Import & Export Corporation (CMEC) – no pulp/paper experience, under sanctions by US - Chemical Biological Weapons Sanctions Law and for shipping nuclear warheads to Pakistan

# Due diligence steps\*

UFS claims that all timber will come from timber plantations “HTI” – this is a “sustainable forestry” project

- Scrutinize EIA, including
  - amount of land claimed for HTI
  - claims regarding planting rates
  - other documentation, including track record of plantation establishment
- Check for involvement of politically exposed persons
- Check for government permits

Year	Planting year	Hectares
1	1994/1995	6,116
2	95 -96	7,568
3	96-97	15,992
4	97-98	38,442
5	98-99	7,641
6	99-00	0
7	00-01	0
8	01-02	0
9	02-03	0
10	03-04	20,000
11	04-05	20,000
12	05-06	20,000
13	06 -07	20,000

By 1998 PT Menara Hutan Buana 2<sup>nd</sup> largest recipient of Dana Reboisasi. Company frequently made false claims re planting. In 1995, company reported 13,740 ha, auditors found only 6,116 ha;

Investigation into Probosutejo began 1997, amount planted suddenly increased and then plummeted. In 2003, Probosutejo sentenced to prison.

UFS EIA written 2002/03 (?) claims 20,000 ha annual plantation.

# GK Goh

- Singapore investment house, detailed analysis of Poh Lian (UFS)
- Based on interviews, found over 44,000 ha of mixed tropical hardwoods would initially be logged to “yield the cash needed to resume planting”
- Proposed mill requires 2.7 million m<sup>3</sup> of wood/year to produce 540,000 tons pulp
- Plantation needs 22,500 ha planted/year ongoing basis
- Needs more than available land

# GK Goh

- “We believe that it may have to import woodchips to avoid allegations of using illegal logged wood and enable it to sell its pulp in Europe.”
- Cost difference between “internally grown and externally sourced wood” = \$118.5/ton, a cost which “is not justified now as pulp prices are low”
- Significant challenge of soil nutrient depletion to allow second harvest of timber after first harvest made.

# Field research

- Local groups found that many of the plantation lands claimed by UFS are already used or planned for use by palm oil companies, mining companies or reclaimed by local communities (victims of forced land seizures)

# DTE: Hutan Rindang Banua

One of three plantations claimed to supply UFS chip mill, found to overlap with 11 palm oil plantation concessions, a coal mining company and small-scale mining sites used by local people; this does not include indigenous/customary land ownership;

- 2004 Jaakko Poyry report estimating that of 295,000 ha concession, maximum exploitable area found to be 93,566
- 2005 UFS Annual Report admits plantation area declined to 46,000 ha
- Current estimates indicate that as little as 15,000 hectares of HRB actually has timber plantations in "good condition"

*This is only enough for 1.5 years of the wood chip mill's operation*

- Proposed pulp mill's production line of 600,000 tonnes/yr
- Normal to add additional lines once mill becomes operational

# UFS plans to purchase Kiani Kertas

- Since 2005, UFS has been informing shareholders about imminent purchase of Kiani Kertas mill owned (at the time) by former General Prabowo Subianto
- UFS has begun operating the mill while waiting for the purchase to be finalized

# Politically Exposed Persons

Probosutedjo – General Suharto's half brother, former owner of Menara Hutan Buana pulp plantation until his conviction (and sentencing to four years in prison) for lying to the Indonesian government about the extent of plantation establishment at this site and using highly exaggerated plantation figures to obtain interest-free Reforestation Funds which were deposited into his personal bank account instead of being used for plantation establishment.

# “Probosutedjo Admits to Bribing Judges”

- Jakarta Post (10/12/05)
- Gave \$600,000 to his attorney to give to Supreme Court Chief justice and other officials during appeal of conviction for abusing reforestation funds
- Sentence was reduced from 4 years to 2 years

# PEPs continued

## Wisanggeni Lauw

- Largest individual shareholder of UFS
- Close associate of Probosutedjo
- Former member of Indonesian legislature
- Reported to have gained control over Probosutedjo's shares in plantation company PT. Menara Hutan Benua during Probo's trial for felony fraud
- Reported owner of Kingsclere Finance Ltd (British Virgin Islands)

# Kingsclere Finance Ltd (BVI)

Entered into two separate agreements to:

- (1) Purchase Kiani Kertas from owners
- (2) Resell Kiani Kertas to UFS where Lauw is largest individual shareholder

The Lauw-owned Kingsclere purchase and resale of Kiani Kertas to UFS has raised questions in financial circles regarding the lack of arms-length transaction

# PEPs (continued)

## Prabowo Subianto

- President Director of Kiani Kertas
- Reportedly principal owner of Fayola Investment Inc (Republic of Maritius) = majority shareholder in Kiani Kertas
- Former head of Indonesia's dreaded Kopassus special forces
- Reported to be first person denied an entry visa to US under the provisions of UN Convention against Torture ("Prabowo denied US visa under torture agreement", Straits Times)

# Prabowo (continued)

- Son-in-law (former) of Suharto
- Brother of Hashim Djojohadikusumo
  - President of Board of Merrill Lynch Indonesia
  - Hashim and Prabowo's then wife (Suharto's daughter) played important roles in notorious Paiton power plant scandal – refused to sign statements stating no participation in corrupt activities
  - Reported to have purchased 50% of shares in Kiani Kertas from brother Prabowo

# Mohammad "Bob" Hasan

## AKA The Kian Seng

- Close associate of General Soeharto and other military officials
- Former Minister of Trade and Industry
- Former International Olympic Committee member (expelled 2004)
- Partnered with Georgia Pacific
- Convicted felon, corruption, burning forests in Sumatra (2001)
- Founder of Kiani Kertas – Prabowo took over most shares after Hasan's conviction; Hasan appears to be minority shareholder
- Notorious for logging operations

# PEPs (continued)

## Luhut Pandjaitan

- Former Kopassus General
- Former Ambassador to Singapore
- Former Minister of Industry and Trade
- President Kommissioner of Kiani Kertas

## Kang Hwi Wah

- Owner over 10 million shares of UFS
- Former managing director of Amcol Holdings (Singapore)
- Convicted of bribery in Singapore

# Complex, untransparent off-shore shell companies

- Kingsclere Finance Ltd (BVI) – reportedly owned by Wisanggeni Lauw, contracts to buy and sell Kiani Kertas; arms' length transaction concerns.
- Fayola Investment Inc (Maritius), reportedly owned by Prabowo Subianto, controlling interest in Kiani Kertas

# Offshore...

- P.T. Metra Tujuhdua – reportedly owned by or closely associated with “Bob” Hasan, minority shareholder of Kiani Kertas
- Langass Offshore Inc (BVI), reportedly entered into agreement to sell approximately \$150 million in KK bonds to Kingsclere. Unknown ownership.
- Tektronix Industries, Ltd. (BVI), reportedly owned by major shareholders of Swedish CellMark Holdings with a 10 year purchase agreement with UFS

# Finance

- Initially World Bank Group's MIGA was considering provision of guarantee for UFS
- Environmental Impact Assessment provided to MIGA

# MIGA

- In January 2004 65 NGOs from 19 countries wrote to MIGA and presented due diligence research results on EIA calling into question claims about sustainability of company plantation plans
- MIGA had initially considered coverage based on claim of 100% plantation grown wood

RESULT: MIGA plans cancelled; UFS “withdrew” request

# Europe

- Azko Nobel pulls out
- OECD ECAs refuse to provide support for UFS

# Private Banks

- German groups hang banner on Deutsche Bank
- Indonesian groups document problems with UFS field operations at chip mill, reef destruction, community conflicts
- Groups document anti-money laundering laws, “politically exposed persons”
- Expose shell companies in British Virgin Islands, Maritius, involvement of generals, convicted felons
- 93 NGOs from 27 countries endorse letter describing environmental, social and AML due diligence concerns to private investors
- Deutsche Bank, Merrill Lynch pull out of project

- UFS returns to World Bank, seeks IFC and potentially MIGA support, again
- WB officials state flatly that they will not finance UFS projects
  - “the IFC would have to be crazy to support this project.” [\[1\]](#)

# Alternative Investments

Having failed to obtain support from MIGA/World Bank, European ECAs, Deutsche Bank and other private banks, in July 2007, UFS turned to a newly-created Hong Kong based hedge fund, Abax Global Capital

# Abax Global Capital

- described in the financial press as “one of the biggest launches ever witnessed in the Asian hedge-fund industry.”
- Touted as a “hedge fund affiliate of Morgan Stanley” and financed primarily by North American institutions, pension funds, investors, funds of funds, family offices and European and Asian sources, typical Abax involvement is projected to be “\$30 million to \$150 million in notional bite-size across credit, equity, and equity-linked structured transactions”.[\[2\]](#)
- The prime brokers for Abax are Merrill Lynch and Goldman Sachs.[\[3\]](#)

# Abax announces

They will purchase “\$25 million worth of zero coupon convertible bonds that mature in 2012. The conversion price is S\$0.355 per share and the bonds represent 4.4% of United Fiber's share capital. The second component comes in the form of equity. United Fiber says it has executed a memorandum of understanding that will see Abax invest \$200 million in equity in its Indonesian subsidiary PT Marga Buana Bumi Mulia. It is expected that the ultimate financing package will be announced in the next couple of months.” [\[1\]](#)



[\[1\]](#) *United Fiber enters \$225 million financing with Abax, Asianinvestor.com, 7/25/07*

# Research findings

- Money comes from US, Europe
- Morgan Stanley + Merrill Lynch/Goldman Sachs as prime brokers;
  - MS, GS: “consider environmental issues in all aspects of our business”, “robust due diligence processes”, pledge to use Equator Principles “where there are significant environmental risks”;
  - “Will not knowingly finance companies that collude with or are knowingly engaged in illegal logging”
  - Define “high risk countries” for illegal logging as countries where “greater than 50% of annual harvest is illegal”
  - ML: “considers important environmental and economic consequences as part of its ‘due diligence’ procedures.
  - Many aspects of the UFS investment appear to represent apparent violations of environmental policies as well as key triggers for application of anti-money laundering due diligence

# Abax Global Capital

FT article highlights problems, reporters begin to contact investors

- Regulator queries – MS, GS, ML
- Letter to investors in Abax Global Capital from 74 NGOs in 18 countries
- Pension funds – CALPERS indicates no current or planned investment in Abax
- \$200 million equity deal not completed as of April 08

# Lessons Learned from UFS

- Significant legal, financial, reputational risks even with projects advertised as “100% plantation timber” from Indonesia
- Climate of moral hazard
- Proper due diligence is complex/difficult and must address:
  - Need for strong AML / PEP analysis: investors, officers, shell companies, offshore companies
  - Need for strong ground truthing – i.e. how many hectares, how many trees, audit of existing plantations, veracity of plantation records – difficult if depend on third party reports
- Current lack of appropriate levels of due diligence
- Danger of “step-wise” implementation of standards under these conditions

# Illegal logging causes trafficking

The Jakarta Post , Jakarta | Fri, 04/04/2008

Illegal logging is causing more than the destruction of forests -- it is destroying human lives through trafficking of girls to logging camps.

Roostien Ilyas of the National Commission for Child Protection (KPA) said recent cases of women and children trafficking had been uncovered in illegal logging spots **in West Kalimantan**.

"We found around 150 girls aged between 14 and 16 who were being forced to provide sexual services for illegal loggers," Roostien said Thursday in a discussion during the second Asia-Pacific Congress for the International Council of Women in Jakarta.

The non-governmental organization investigating the case, Nanda Dian Nusantara Foundation, failed to get cooperation from local police because some police officers and local government officials were allegedly involved in the crime, said Roostien, who is also the foundation chairwoman. "We had to ask the National Police and the Social Services Ministry to help with this," she said, adding that these cases were just some of the many children trafficking cases that have never been reported to the public.