

Risking the forests

Identification and management of Indonesian oil palm plantation risks by financial institutions

A research paper prepared for World Wide Fund for Nature (WWF)

september 2003

AIDEnvironment

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Summary

Commissioned by WWF, this study explores the risks that financial institutions are exposed to when providing financial services to the oil palm plantation sector in Indonesia. Many of these risks are associated with the indiscriminate expansion of oil palm plantations into forest areas. If financial institutions were aware of these risks they would incorporate them in their risk policies, thereby reducing the chances they would finance irresponsible oil palm plantation expansion. For this purpose, answers were sought to the following specific questions:

- What are the main developments in the Indonesian oil palm sector?
- Which are the risks associated with providing financial services to this sector, especially those related to environmental and social impacts of oil palm plantation development?
- Which financial institutions play a major role in financing the Indonesian oil palm plantation sector?
- How do financial institutions analyze and handle these risks?
- How can existing risk policies be strengthened?

A new oil palm expansion boom

The present area planted with oil palm plantations in Indonesia, 4.1 million hectares, is set to expand considerably in the coming decade. Permits have been granted or sought for expansion up to 9 million hectares and expansion beyond that is possible:

- The Indonesian Oil Palm Research Institute (IOPRI) estimates that the country has as much as 18 million hectares of suitable land for oil palm development.
- The aggregate area that increasingly independent provincial and district governments aim to develop for oil palm plantations amounts to over 20 million hectares.
- Numerous companies remain interested in entering this profitable sector: according to the Indonesian Ministry of Forestry almost 1,900 investors had applied for permits to develop plantations in Indonesia with an aggregate area of 30 million hectares in the year 2000.

Even though economic realities may not allow for the full realisation of these aspirations, there is an unmistakable drive to dramatically expand the Indonesian oil palm sector. This development is of concern to conservation organisations such as the World Wide Fund for Nature (WWF) who fear that uncontrolled expansion of oil palm plantations will increase deforestation and the loss of High Conservation Value Forests (HCVF). Indonesia presently loses 2 million hectares of forest each year at the expense of unique biodiversity and ecological stability. Similarly, further expansion of the sector is of concern to many of the 30 to 65 million indigenous people in rural Indonesia, whose customary land and resources would come under even greater pressure from expanding plantation companies.

Financial institutions involved in the Indonesian oil palm sector

In order to identify which financial institutions play a major role in financing the Indonesian oil palm plantation sector, this study examined a sample of 27 business groups engaged in this sector. These groups together have planted an area of at least 2.1 million hectares, which is more than 60% of the Indonesian total at present. They account for an annual Crude Palm Oil (CPO) production of at least 5.9 million tonnes, which is around 65% of the Indonesian total in 2002 (9.0 million tonnes).

The total investment figure for the selected groups (US\$ 7.4 billion) is estimated to represent 75% of the total investments in the Indonesian oil palm sector (US\$ 10.0 billion) over the past decade.

The fast expansion of the oil palm plantation sector over the past decade would not have been possible without the strong financial support of numerous financial institutions from Indonesia, Europe, North America and East Asia. These financial institutions have been financing the expansion of the Indonesian oil palm plantation sector with loans, commodity trade financing, stock and bond issuances and other means. The financial analysis of the selected oil palm groups revealed the involvement of 160 financial institutions from 24 countries, including Indonesia. Together, these financial institutions invested at least US\$ 3.8 billion in the Indonesian oil palm plantation sector over the past ten years, or almost 40% of total investments in this sector.

Since the Government of Indonesia - with support from the World Bank - laid the foundations for further expansion of the oil palm sector in the 1980s, commercial and investment banks have by far become the most important financiers of the Indonesian oil palm plantation sector, providing 81.4% of total investments identified. The next important group of financial institutions are the institutional investors (asset managers, insurance companies and pension funds), which provided 10.0% of total investments. The contribution of (multilateral and national) development banks was more modest (7.2%), while export credit agencies and other financial institutions played only a minimal role. Figure 1 shows the relative roles played by different types of financial institutions in the total investment amount which was identified (US\$ 3.8 billion).

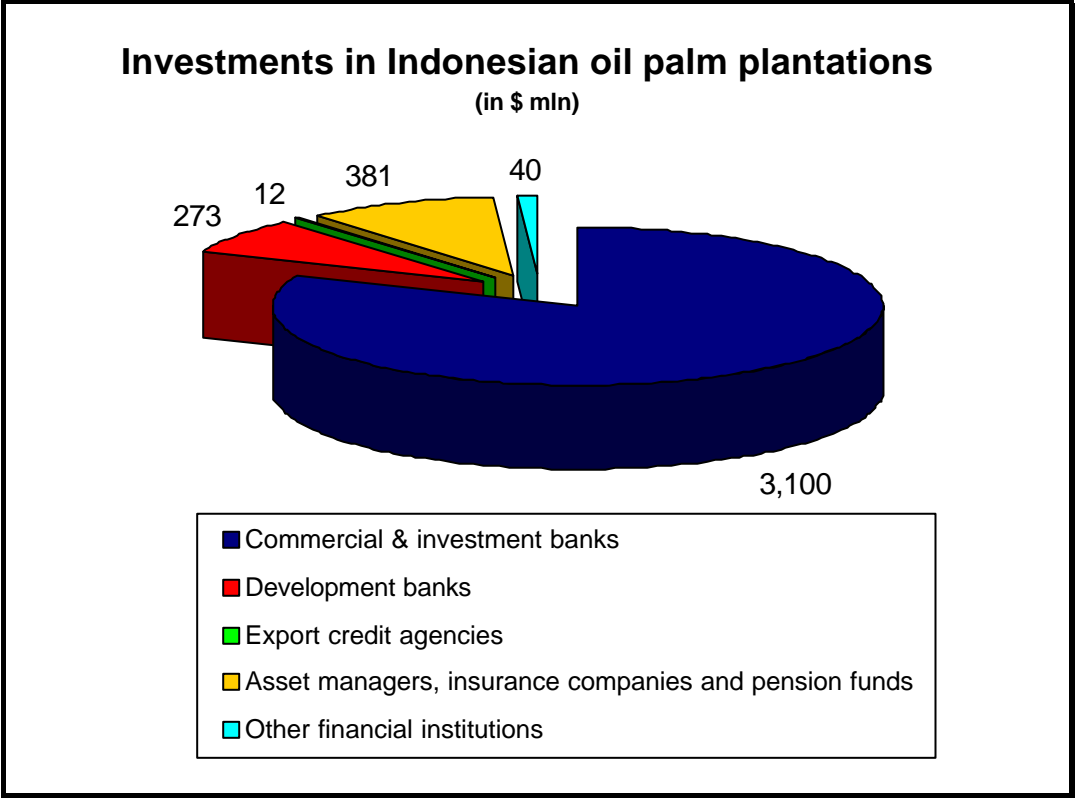


Figure 1. Investments in Indonesian oil palm plantations by type of financial institution

An analysis of foreign investment flow by country of origin of the financial institution shows that a total of 32 Indonesian financial institutions (of which 7 are closed at present) contributed US\$ 0.9 billion or 23% of total investments analyzed. Bank BNI, Bank Mandiri and Bank Rakyat Indonesia are the most important Indonesian financial institutions with respect to the financing of the oil palm plantation sector.

Grouped by country of origin Malaysian financial institutions are the most important group, accounting for 24% of total investments by foreign financial institutions. Financial institutions from The Netherlands rank second, followed by their competitors from Switzerland, the United States and Japan.

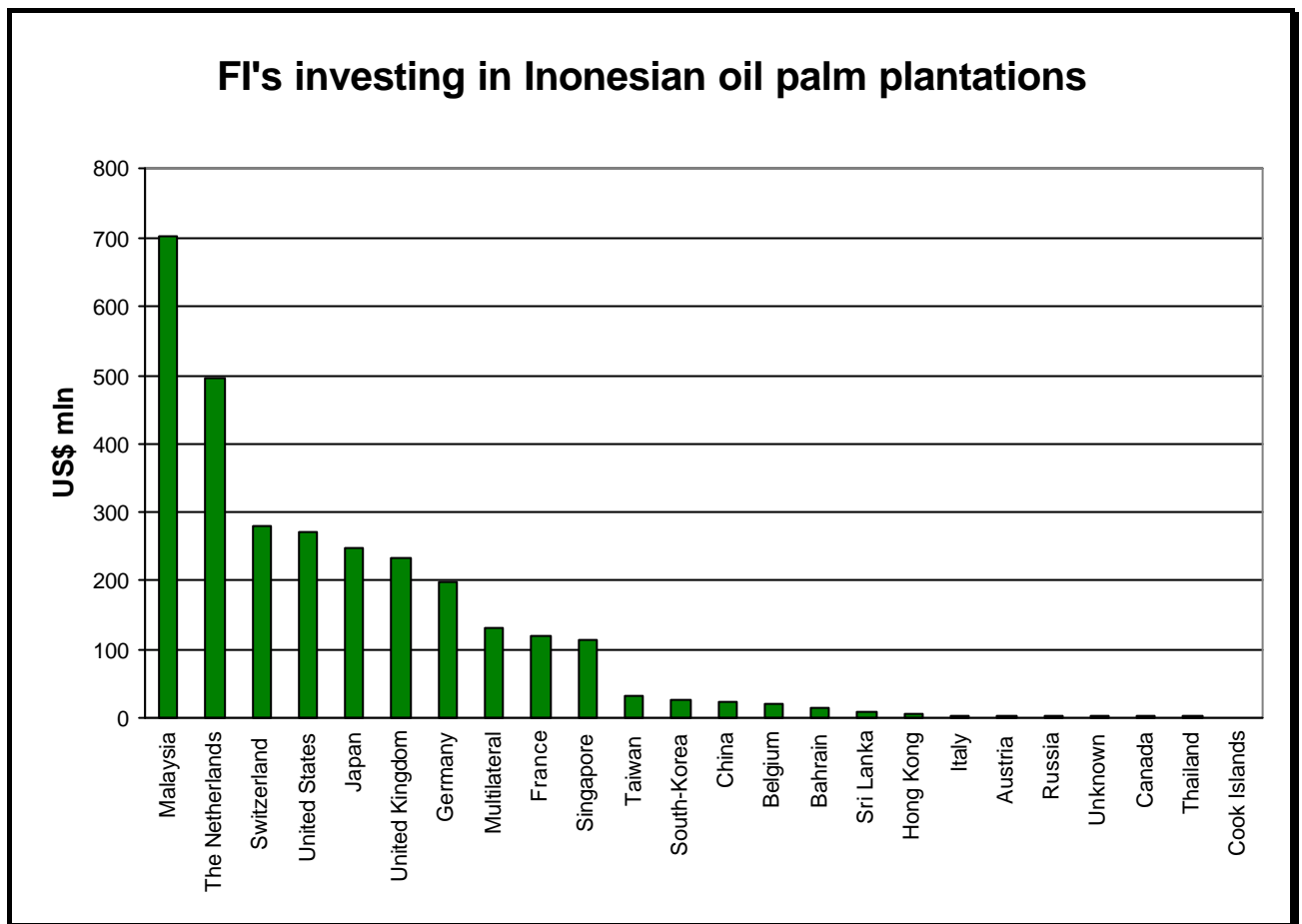


Figure 2. Investments in Indonesian oil palm plantations, by country of origin of the financial institution

In terms of total capital input, the most important foreign financial institution is UBS (Switzerland), which invested an estimated US\$ 216 million in the Indonesian oil palm groups researched. Second in rank is the Malaysian state-owned investment fund manager Yayasan Pelaburan Bumiputra, with an estimated US\$ 201 million. Other financial institutions in the top-10 are three Dutch banks (ING Bank, Rabobank and ABN AMRO Bank), two Malaysian banks (Commerce Asset-Holding and Bank Islam), and banks from the United States (J.P. Morgan Chase & Co.), Germany (HypoVereinsbank) and Japan (Sumitomo Mitsui Financial).

The largest part of the investments identified was committed in the mid-1990s, when the Indonesian oil palm plantation sector experienced an unprecedented boom. Since the Asian financial crisis of 1997/98 and the almost simultaneous drop in world CPO prices, the investment level was more moderate.

But the resurgence of the CPO price on the world market since the first quarter of 2002 improved profitability of most plantation groups and renewed the interest of domestic and foreign financial institutions in the Indonesian oil palm plantation sector. The financial market activity has not yet returned to the level of the mid-1990s but this study found that the number of financial services provided to oil palm plantation companies is on the rise again.

With global demand for oil palm products predicted to grow strongly in the medium- and long-term, and Indonesia being a low-cost producer, many investors deem high and stable returns on investments in the Indonesian oil palm plantation sector as guaranteed. This study indicates that financial institutions are failing to properly assess the risks associated with these investments and that they are therefore likely to expand their financial services to the palm oil sector in Indonesia in the coming decade.

Identification of risks

In identifying and analyzing the risks associated with providing financial services to the Indonesian oil palm plantation sector, this study focuses on four of the nine types of financial sector risks as defined by the *Office of the Comptroller of the Currency (OCC)*, which is the regulator for national banks in the United States. The following oil palm plantation risks for financial institutions were identified:

1. Credit risk and 2. Price risk	
Operational risks:	Examples:
Climatic conditions	Productivity may be affected by unpredictable extreme draught or rainfall (El Niño)
Conversion of High Conservation Value Forests	Damage caused by wildlife forced out of their natural habitats by intense forest fires or due to drier conditions associated with canopy loss
Illegal land clearing and logging	Legal action taken by government or other parties
Burning	Legal action taken by government or other parties
Management of community relations	Costs created by protests and blockades
Labour costs	Hikes in wages and costs of secondary labour conditions
Unsustainable smallholder schemes	Unequal partnerships, leading to indebtedness and poor productivity
Sub-optimal locations	Poor soils or high risk locations (e.g. flood-prone areas)
Lack of investment funds	Financial problems in the company group (e.g. due to the monetary crisis)
Poor management quality	Inexperienced estate managers may lead to low productivity
Legal and institutional risks:	Examples:
Poorly developed legal system	Unreliable governance due to difficulties in identifying and applying relevant laws and decrees
Poor sectoral policies	Ambiguous government support to the sector, including inability to address key risks (e.g. land tenure issues)
Poorly developed foreign marketing	Lack of coordination within the sector, lack of focused government support
Poorly developed security infrastructure	High risk of social conflicts and human rights violations; costs of military protection
Poorly developed transport infrastructure	Absence of roads or specialised ports
Poorly developed R&D infrastructure	Insufficient innovation
Inability to solve the land tenure issue	Ongoing conflicts with local communities, resulting in operational and reputation risks

High tax burden	Decentralisation of government taxes creates uncertainty and creates unforeseen costs
Market risks:	Examples:
Competition from other edible oils	In major markets, palm oil is easily replaced by other edible oils, notably soybean oil
Competition from other oil palm countries	Competitive advantages of newly emerging producer countries
Exchange rate developments	Disrupt market orientation and hence income
Reputation risks	Clients can become NGO campaign targets and lose markets due to exposure of links to tropical forest destruction, human rights violations, etc.
Market preference for sustainable palm oil	Clients' potential loss of market share
Food safety regulations	Clients' potential loss of market share
Risks to other clients	Corporate clients of the financial institution in other sectors may be negatively affected (e.g. timber industries)
3. Compliance risk	Examples:
Financial institutions may be held liable for their clients' acts	International legal frameworks may emerge, f.i. with regard to land tenure rights of local communities
4. Reputation risk	Examples:
Reputation of FI can be hurt	Financial institution's image can be tarnished due to exposure of its financing of tropical forest destruction, human rights violations, etc. by its clients

Environmental and social externalities

Although most risks described above relate in one way or another to the overall sustainability of the oil palm sector in Indonesia, WWF's concerns primarily relate to the ecological and social impacts of oil palm plantation expansion.

The rapid development of Indonesia's oil palm plantation sector has had substantial impacts on the environment and social stability in Indonesia's forestlands and it is expected that these will compound if the sector continues to expand freely. Some of the key impacts that translate into various risks for financial institutions include:

- **Deforestation and loss of biodiversity**

The expansion of oil palm plantations is a driver in the extremely high Indonesian deforestation rate (>2% per year), which poses a great threat to the country's unique biodiversity. The relation between deforestation and plantation expansion is complicated by forest degradation due to logging and forest fires that occur prior to complete forest clearance for oil palm development. The Indonesian Oil Palm Research Institute (IOPRI) estimates that 63% of all oil palm plantations are established in secondary forests and scrub and 3% in primary forests. A further complicating factor is that around 60 to 70% of the area cleared in the past under the banner of oil palm plantation development was not actually planted. This was partly due to a lack of funds and partly because companies were using the false promise of establishing a plantation to gain access to the timber stand.

The conversion of High Conservation Value Forests (HCVF) into oil palm plantations translates in potentially major reputation risk to the financial institutions involved.

- **Forest fires and haze**

In Indonesia, burning has for many years been considered the most practical, quickest and cheapest land clearing technique. Even though the Indonesian government has incrementally prohibited its use, many plantation companies continue to burn illegally, thereby increasing chances of repetition of the devastating forest fires in 1997 and 1998. The vast ecological, social and economic costs of these fires were, and continue to be, transferred to society at large but public and policy pressure to stop burning is mounting. Plantation companies that continue to burn or fail to extinguish fires expose themselves and their direct stakeholders to reputation and legal liability risks.

- **Conflicts with local communities**

Indonesia's forestlands provide livelihoods to millions of indigenous people and other rural communities. Because these communities are not given legal rights to the forests and other lands they are traditionally tilling, licensed palm oil companies have taken over large tracts of customary lands. This has nurtured numerous persistent and often violent conflicts. These conflicts have sometimes prevented companies from operating altogether and in response, some have mobilised and paid the police, army or government officials to suppress unrest resulting all too often in gross human rights violations. Poor community relations bring about significant additional operational cost and reputation risk.

Existing risk policies

To date, most financial institutions involved in the oil palm plantation sector in Indonesia reviewed investment proposals against standard risk assessment parameters including agronomic, legal and business management criteria. These do not adequately assess potential impacts of oil palm sector activities on tropical forest ecosystems and local communities.

Some financial institutions have begun to realise that such impacts can translate into serious risks. At the end of 2001, four Dutch banks (ABN AMRO Bank, Rabobank, Fortis Bank and ING Bank) adopted a set of principles that would apply to their new investments in the oil palm plantation sector. They did so largely in response to a joint campaign of Friends of the Earth and Greenpeace in the Netherlands. The NGOs had requested the banks to ensure that their oil palm plantation clients would:

- Not clear tropical rainforest (or High Conservation Value Forest);
- Not be involved in burning forestland;
- Respect the rights and wishes of local communities;
- Respect Indonesia's law and relevant international conventions.

Although the precise wording of the scope and implementation procedures varies, all four banks committed to these basic investment criteria after consultation with their clients and other stakeholders.

Case study of ING Bank and Indofood Sukses Makmur

The four Dutch banks adopted their new risk policies during the 1998-2002 investment pause in the Indonesian palm oil sector. The first significant test of these policies arose in April 2002 when ING Bank took a lead role in a transaction that was described as "the largest offshore loan financing for an Indonesian corporate since the start of the Asian financial crisis in 1997". The two-year syndicated US\$ 100 million loan was arranged by ING Bank for the Indonesian food company PT Indofood Sukses Makmur.

ING Bank stated it subjected the transaction to its adjusted risk assessment policy and found it to comply. To verify this claim, a case study was conducted into the field level practises of a full subsidiary within the Indofood Sukses Makmur group, PT Gunung Mas Raya in Riau province. During field visits, it was found that PT Gunung Mas Raya:

- Introduced some Better Management Practises in its existing plantations;
- Was clearing High Conservation Value Forest at least up to March 2003;
- Appeared to be burning logging debris and made no effort to extinguish these fires as required by law;
- Faces land tenure conflicts with indigenous communities;
- May be expanding beyond its concession boundaries;
- Facilitated access to the forest area to illegal loggers.

The question whether or not the company is in default with the ING policy could be subject to a detailed semantic debate. More importantly the case study concludes that ING policy on 'sustainable deforestation' is too vaguely worded and lacks ambition to ensure that the key NGO-concerns and investment risks are adequately tackled. Key issues identified, among others, are:

- The scope of the policy is too narrow. ING's policy does not require performance beyond legal compliance, a requirement that does not stamp out risk prone practices in Indonesia;
- Popular terminology (such as High Conservation Value Forests, illegal logging and local communities) is used in the policy but is not operationalised into performance requirements *additional* to legal compliance. Similarly, ING claims to take into account the "Forest Policy" of the World Bank but how this is done remains unclear;
- ING's loan conditions on financing holding companies are unclear but appear to allow clients to internally reshuffle budgets and thereby allocate group funds for subsidiaries' expansion activities.¹

The case study leaves open questions with regards to the procedure by which the bank applied its policy. ING stated that its credit committee was convinced the Indofood deal was in line with the policy but it remains unclear whether or not the committee was aware of the client's field level practises prior to its decision. If not, then the bank's risk assessment procedure was inadequate; if so, then ING did not seriously enforce its policy.

Strengthening risk policies

It is recommended that financial institutions with exposure to the oil palm plantation sector adopt a risk management strategy that encompasses at least the following four elements:

- **Increasing internal risk awareness**
Each financial institution should carefully decide if it wants to remain or become active in the oil palm plantation sector. When a financial institution decides to remain or become active in the sector it should foster knowledge of relevant issues as well risk awareness for all employees dealing with the oil palm plantation sector. This will require internal education, training and sector monitoring.
- **Formulating and implementing a risk policy**
An oil palm risk policy is needed to make sure that financial services provided do not generate unacceptable risks for the financial institution. An effective policy would involve:
 - Consultation with other stakeholders in the formulation of the risk policy

- Clear definition of the policy scope, taking into account the variety of financial services provided to a variety of activities in the full palm oil chain-of-custody
 - Guidelines for impact assessments before financing
 - Tight conditions in loan and other agreements (legal compliance is insufficient!)
 - Client reporting and periodic monitoring
 - Transparent reporting of results to internal and external stakeholders.
- **Requiring comprehensive development and management plans**
Oil palm plantation companies should enable their financiers to conduct more efficient risk assessment procedures by developing company level plantation development and management plans that take into account the risk areas defined in the risk policies of financial institutions.
- **Encouraging an oil palm sector development plan**
Financial institutions willing to stay involved in this sector should work with the Indonesian government, nature conservation organizations and representatives of local communities to develop a sector plan that pro-actively addresses risks at the level of the sector as a whole.

Chapter 1 Introduction

This report provides a summary of the findings of a research project undertaken by AIDEnvironment and Profundo, on behalf of WWF. The aims of this project were to:

- What are the main developments in the Indonesian oil palm sector?
- What are the risks associated with providing financial services to this sector, especially those related to environmental and social impacts of oil palm plantation development?
- Which financial institutions play a major role in financing the Indonesian oil palm plantation sector?
- How do financial institutions analyze and handle these risks?
- How can existing risk policies be strengthened?

In Chapter 2, this report first gives an overview of the Indonesian oil palm plantation sector in the context of the global market, discerning three main development stages. Special emphasis is given to the slackening growth in the period 1998-2002 and its underlying causes. Starting in 2002, a renewed interest in investments in the sector is observed.

Chapter 3 examines the risks posed to financial institutions providing financial services to Indonesian oil palm plantation companies, based upon the data gathered in the preceding chapters. The analysis distinguishes between four types of risks: *credit risks* and *price risks*, which could have an impact on the client's ability to service its debts, and *compliance risks* and *reputation risks*, which could have a direct impact on the financial institution. Chapter 3 highlights the main ecological and social externalities brought about by the oil palm plantation sector in Indonesia: deforestation, burning and social conflicts. These impacts heighten the risks associated with investments in this sector.

Chapter 4 comprises a review of the financial structure of a representative sample of business groups engaged in the Indonesian oil palm plantation sector. This selection includes the largest business groups operating in this sector as well as a number of smaller business groups which have secured foreign financing during the past ten years. Based on this analysis, the importance of various types of financial institutions in financing this sector during the past ten years is determined. Within the categories of foreign and domestic financial institutions, the ten most important players are identified.

Chapter 5 elaborates briefly on existing risk policies adopted by several commercial banks in the Netherlands.

Chapter 6 is a separate case study report of a particular financial transaction by a Dutch bank, ING Bank. That transaction was arranged *after* it had committed to introduce new risk assessment standards and procedures for investments in Indonesia's oil palm industry. The study compares the field level practises of a Riau-based oil palm plantation company, PT Gunung Mas Raya with the investment policy as laid down by ING Bank. Based upon this case study, lessons are drawn regarding due diligence, loan conditions, monitoring, enforcement and transparency.

In Chapter 7 lessons are drawn on how financial institutions can set up, implement and monitor effective risk assessment screens when dealing with clients in the Indonesian oil palm plantation sector.

In the final Chapter 8 some options for further research are listed.

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Chapter 2 Overview of the Indonesian oil palm plantation sector

2.1 Introduction

This chapter provides a general overview of the development of the Indonesian oil palm plantation sector, in the context of global market developments. After a brief overview of the global oil palm sector, the three main development stages of the Indonesian oil palm plantation sector are described and analyzed. Special emphasis is given to the stagnating growth in the period 1998-2002 and its underlying causes. Starting in 2002, a renewed interest in investments in the sector is observed.

2.2 The global oil palm sector

2.2.1 Oil palm production

The oil palm (*Elaeis guineensis*) originates from the coastal regions of West Africa and can only be grown in lowland areas near the equator. In the beginning of the 20th century the first oil palm plantations were established in Southeast Asia, which at present is the most important production region in the world. Malaysia (48%) and Indonesia (36%) together account for 84% of global output and Thailand and Papua New Guinea add another 3%. Production countries in Africa (Nigeria, Ivory Coast) and Latin America (Colombia, Ecuador) play a far more modest role.²

When the oil palm tree reaches maturity after three to four years, bunches of palm fruits (each fruit is the size of a small plum) grow in the armpits of the palm leaves. These "Fresh Fruit Bunches" (FFB) are cut and transported to a processing mill. After the flesh of the palm fruit is separated from the kernel, it is pressed to extract the Crude Palm Oil (CPO), a yellow-red liquid. CPO is first processed into refined, bleached and deodorized palm oil (RBDPO), a major ingredient in margarine, shortenings, and ice cream.

RBDPO is further fractionated to produce RBD olein and RBD stearine. At normal temperatures, RBD olein is liquid and RBD stearine is solid. In its pure form, RBD olein is sold as unbranded cooking oil. RBD olein is used mainly in the manufacture of cooking oil and margarine and is used in industrial frying or processed foods like potato chips, french fries, instant noodles and other snack foods. RBD stearine is primarily used in the manufacturing of soaps, detergent, beauty creams and lipsticks and in the manufacture of margarine and shortenings for food.

Apart from CPO, the oil palm fruit also yields palm kernels. These kernels are crushed into Palm Kernel Oil (PKO) and Palm Kernel Meal (PKM). Palm kernel oil is used mainly for margarine and as shortening for producing bakery, pastry and confectionary, as well as for luxury toilet soap and powdered soap. Palm kernel meal is processed and blended into compound feed for the livestock industry.³

One hectare of oil palms thus yields three different basic products: CPO (3.2 tonnes per hectare in Indonesia), PKO (0.34 tonnes), and PKM (0.42 tonnes). The oil yield of the oil palm is much higher than that of any other oil crop in the world, the average oil yield for soybeans is only 0.5 tonnes per hectare.⁴

2.2.2 Consumption of oil palm products

Global palm oil consumption increased 70% since 1995. The main palm oil consuming regions are India (14%), the European Union (13%), Indonesia (12%) and China (10%). Global palm kernel oil (PKO) consumption increased with 59% since 1995, with Malaysia (31%), the European Union (18%), Indonesia (7%) and Nigeria (7%) being the main processing and consuming regions.⁵

Palm oil and PKO compete globally with various other (vegetable and animal) edible oils. For many products, one edible oil ingredient can easily be substituted for another, when availability and prices make this attractive. Since 1995 global palm oil consumption has shown the strongest growth of all edible oils and palm oil now holds a 21% share of the global edible oils market. When the market share of PKO (3%) is added to that of palm oil, the oil palm derived oils near the market share of market leader soybean oil (25%). Together palm oil and palm kernel oil is accounted for almost 40% of the global growth in the consumption of edible oils since 1995.⁶

Palm oil is expected to further strengthen its market position. The principle authority in global trends in edible oil consumption - Oil World - forecasts that demand for palm oil will rise yet another 50% in the coming five years. By 2012, palm oil will be the most produced, consumed and internationally most traded edible oil in the world.⁷

Global palm kernel meal (PKM) consumption increased 56% since 1995. Palm kernel meal is mostly used by the feedstock industry and therefore its geographical consumption pattern differs distinctively from those of palm oil and PKO. The European Union is by far the largest PKM consuming region in the world, with a 64% share of global consumption. South Korea (8%) and Nigeria (4%) follow far behind. The consumption of PKM is growing faster than that of other oilmeals, but still only has a 2% market share on the global oilmeals market.⁸

2.3 Development of the Indonesian oil palm sector

2.3.1 1848-1985: Gradual development

The development of the oil palm sector in South East Asia started in 1848, when four seedlings were transported from Africa to the botanical garden in Buitenzorg (the present-day Bogor) in Java, which was at that time under Dutch colonial control. Dutch traders set up the first large-scale Indonesian oil palm plantation in 1911 in Deli, North Sumatra. During the colonial period the planted acreage of oil palm plantations gradually expanded.⁹

After Indonesia gained independence in 1945 the plantation system partly collapsed as Dutch plantation owners no longer had the backing of the colonial government and labour migration was no longer undertaken with government help. In 1957 the colonial plantations were nationalized and subsequently suffered a period of declining production. In 1967 the Indonesian oil palm plantation sector covered no more than 106,000 hectares, including 65,573 hectares of state-owned plantations.¹⁰

From 1968, the New Order government under former President Suharto started to reinvest in state-owned oil palm plantations and since 1979 the government provided incentives for the development of private plantations as well as smallholder estates, partially with World Bank aid. Under the so-called PIR/NES schemes (*Perkebunan Inti Rakyat* or *Nucleus Estate and Smallholder Scheme*) private developers (known as *Inti* or *Nucleus*) planted plots of land with oil palms on behalf of smallholders located nearby. Most of these smallholders were migrants from other areas. As the oil palms matured the plots were transferred to the smallholders (known as *Plasma*), who developed the plantations under the supervision of the *Inti* (private or state owned companies). These companies purchased the FFB from the smallholders, process them into CPO and sell this CPO on the market.

Since the PIR/NES scheme started, smallholder plantations further expanded under the *PIR-Transmigration* scheme (1986-1994) and the later *KKPA* scheme (1995-1998), both of which stimulated smallholder developments in transmigration areas. The planted area held by smallholders grew to 1.1 million hectares in 1999. Presently, most smallholder estates are found in Riau, South Sumatra, North Sumatra, Jambi and West Kalimantan.¹¹

2.3.2 1985-1998: The oil palm boom

To profit from its lower labour costs and abundant land area, the New Order government aimed to overthrow Malaysia as the world's largest palm oil producer by 2000. To achieve this, large forest areas were handed out to Indonesian business groups and to foreign investors. Greater private sector involvement in the oil palm sector was also encouraged between 1986 and 1996 when the Government of Indonesia granted access to credit at concessionary rates for estate development, new crop planting and crushing facilities.¹²

In the early 1990s, the government allocated 5.5 million hectares, mainly covered with forests, for conversion into oil palm plantations but by 1995 so many private plantation companies had applied for permits that they would jointly need 20 million hectares of forestland to realise their proposals. Part of this tremendous demand was believed to come from companies primarily in search of cheap wood supplies instead of having serious investment plans for oil palm development.¹³

By early 1997, Indonesia's Investment Co-ordination Board (BKPM) had approved 612 oil palm investment projects representing a total value of US\$ 23.6 billion. If realised these projects would have covered a total area of 8.7 million hectares. Of these proposals Indonesian investors submitted 526 proposals with a total area of 6.6 million hectares. Foreign companies proposed 93 projects covering 2.1 million hectares; 71% of these were Malaysian companies.¹⁴

To accommodate this huge demand for land to be converted in oil palm plantations, the Indonesian government released forestlands outside Sumatra and West Kalimantan where the oil palm plantation sector is concentrated. In 1996 the BKPM allocated 9.13 million hectares of land for oil palm plantations in the eastern part of the country, including 5.56 million hectares in West Papua, 1.70 million hectares in East Kalimantan and 1.80 million hectares in Maluku.¹⁵ In early 1998, the Ministry of Forests and Estates sanctioned the BKPM plan and released another four million hectares of forestland for oil palm conversion until 2000.¹⁶



Figure 3. Development of oil palm plantation acreage in Indonesia

The area planted with oil palm in Indonesia increased considerably since the mid-1980s. Starting from about 600,000 hectares in 1985, the total area reached approximately 2.8 million hectares in 1998 and 4.1 million hectares in 2003. Private plantations, which covered just 145,000 hectares in 1986, experienced the strongest growth during the 1990s and now cover 2.0 million hectares.¹⁷

As a consequence of the tremendous increase of the oil palm acreage, the production and export of Indonesian oil palm products has also grown rapidly, as is shown in Figure 4. Over the past seven years production growth in Indonesia (114%) was stronger than in any other producing country, bringing CPO production to 9.0 million tonnes in 2002. But export growth was even stronger (244%) and in 2002 almost 6.4 million tonnes (71% of total production) was exported. The development of the Indonesian oil palm sector, in other words, is increasingly export-driven.¹⁸

For the year 2003, the Indonesian Palm Oil Producers Association (Gapki) expects CPO output to increase to 9.6 million tons.¹⁹



Figure 4. Indonesian CPO production and export since 1995

The strong growth of the oil palm plantation sector brought significant benefits to the Indonesian economy. In 1997, when CPO and PKO prices were at their top, the export earnings of the oil palm sector were valued at US\$ 1.7 billion. In 1998 they tumbled to US\$ 940 million, but in 2002 they had recovered to US\$ 2.1 billion. Indonesia’s oil palm industry is also an important employer, with over 800,000 people employed directly and another 2 million people employed indirectly.²⁰

To realise these benefits, significant investments were needed. Developing a new oil palm plantation often involves building a CPO mill as well, and it takes a number of years before the plantation starts producing. On average, developing a new plantation costs between US\$ 2,500 and 3,500 per hectare. A CPO mill with a processing capacity of 30 tons of FFB per hour is estimated to cost US\$ 5 million.²¹

We estimate the total investment figure for the Indonesian oil palm sector as a whole at US\$ 10.0 billion over the past ten years (see Chapter 4).

2.3.3 1998-2002: Investment pause

Between 1998 and 2002, the expansion of the Indonesian oil palm sector was much slower than during the preceding decade. During this period many oil palm groups ran into financial trouble and lacked sufficient funds to invest much more in existing plantations and opening up new ones.²²

The following figure shows how the oil palm planting rate slowed down in this period.²³

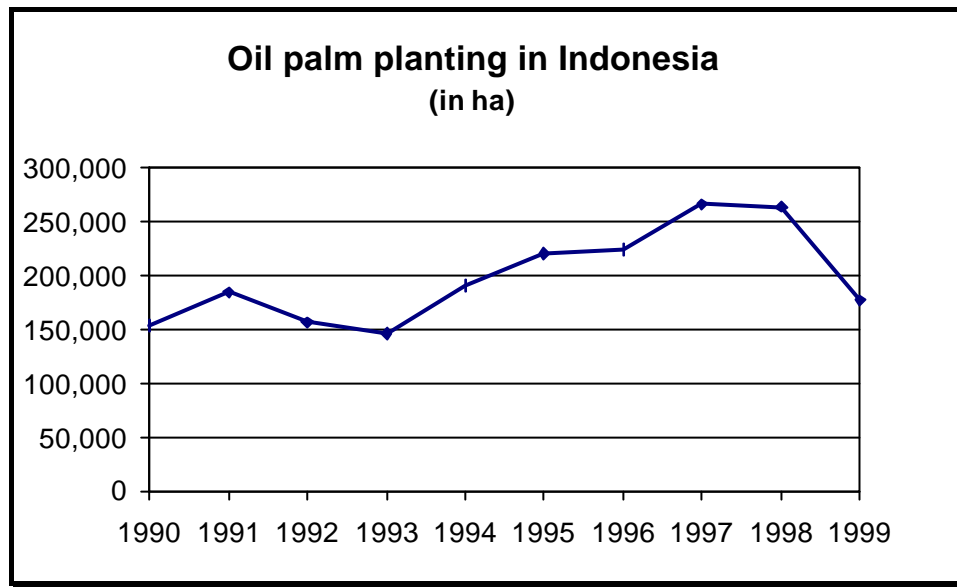


Figure 5. Annual planting of oil palms in Indonesia (in ha)

The main reasons why many oil palm plantation companies ran into financial problems in the period 1998-2002, are discussed below:

- **The Rupiah exchange rate**

The so-called *Asia Financial Crisis* of 1997/1998, resulted in a strong devaluation of the Rupiah since the end of 1997 (a US dollar equalled 2,432 Rupiah in June 1997 as compared to 14,925 per dollar in July 1998). The present rate is 8,358 per dollar.²⁴ The financial crisis had mixed consequences for the Indonesian oil palm companies. Companies exporting a large part of their production saw their Rupiah-income rise substantially while for instance labour and land compensation costs did not rise significantly or even dropped. However, companies that had borrowed large sums from foreign banks needed far more Rupiahs to pay interest and repay their debts. Those companies that exported most of their production did not suffer too much but many of those who produced mainly for the domestic market and had borrowed heavily from foreign banks ran into severe financial trouble.

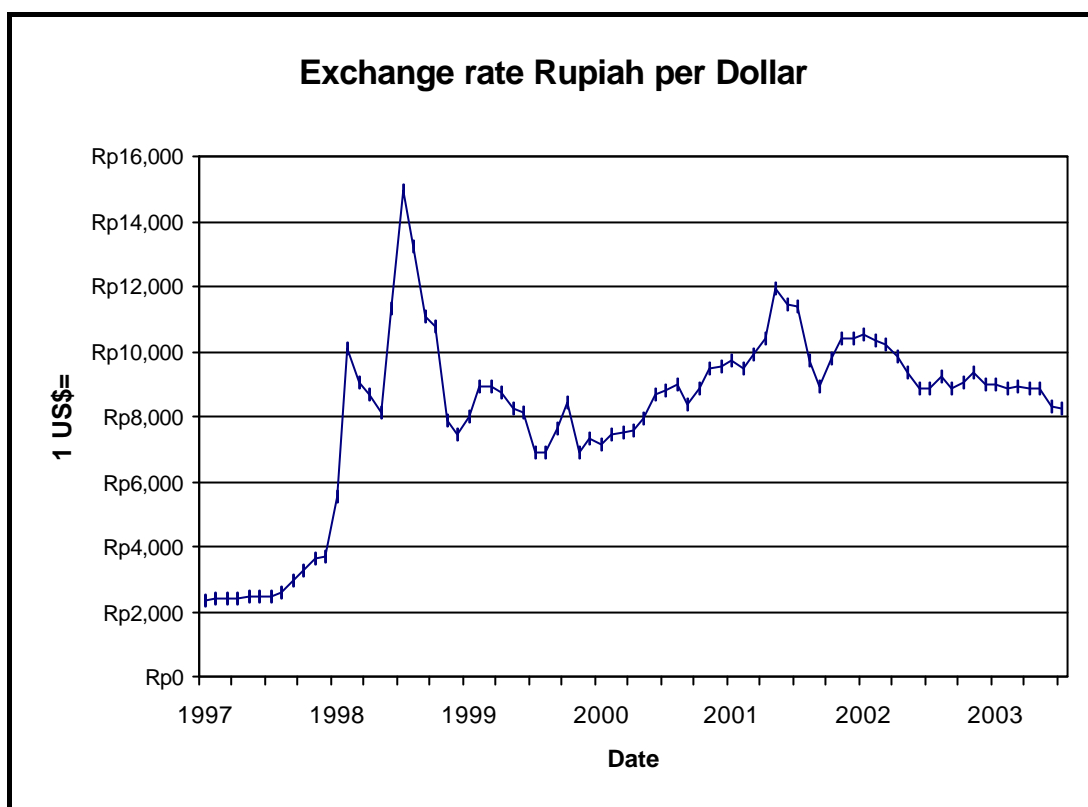


Figure 6. Development of the Rupiah-Dollar exchange rate since 1997

- **The CPO export ban and export tax**

As the devaluation of the rupiah and the high CPO prices on the world market offered very high returns most Indonesian oil palm companies tried to export as much of their production as possible from mid-1997 onwards. This resulted in domestic cooking oil shortages and accompanying price hikes so to diminish social unrest, the New Order regime temporarily banned the CPO export.²⁵

Oil palm plantation companies that had borrowed large sums from foreign banks, were thereby deprived from the possibility to earn foreign currency to pay interest and repay their debts.

In April 1998, the CPO export ban was replaced by a CPO export tax of 40 percent, to compensate the price difference for CPO on the domestic and world markets. Since then, this export tax was first raised and then reduced gradually to the present level of 3%.²⁶

- **Prices on the world market**

Since the beginning of 2000 the CPO and PKO prices on the world market were very low. This price trend was partly caused by the rapid expansion of CPO and PKO export from Indonesia. But for the individual Indonesian producer it meant that export earnings were much lower than expected in 2000 and 2001.

In 2002 CPO and PKO prices however recovered and in 2003 they are rising further. Export earnings and profits for the Indonesian oil palm companies are rising accordingly.²⁷

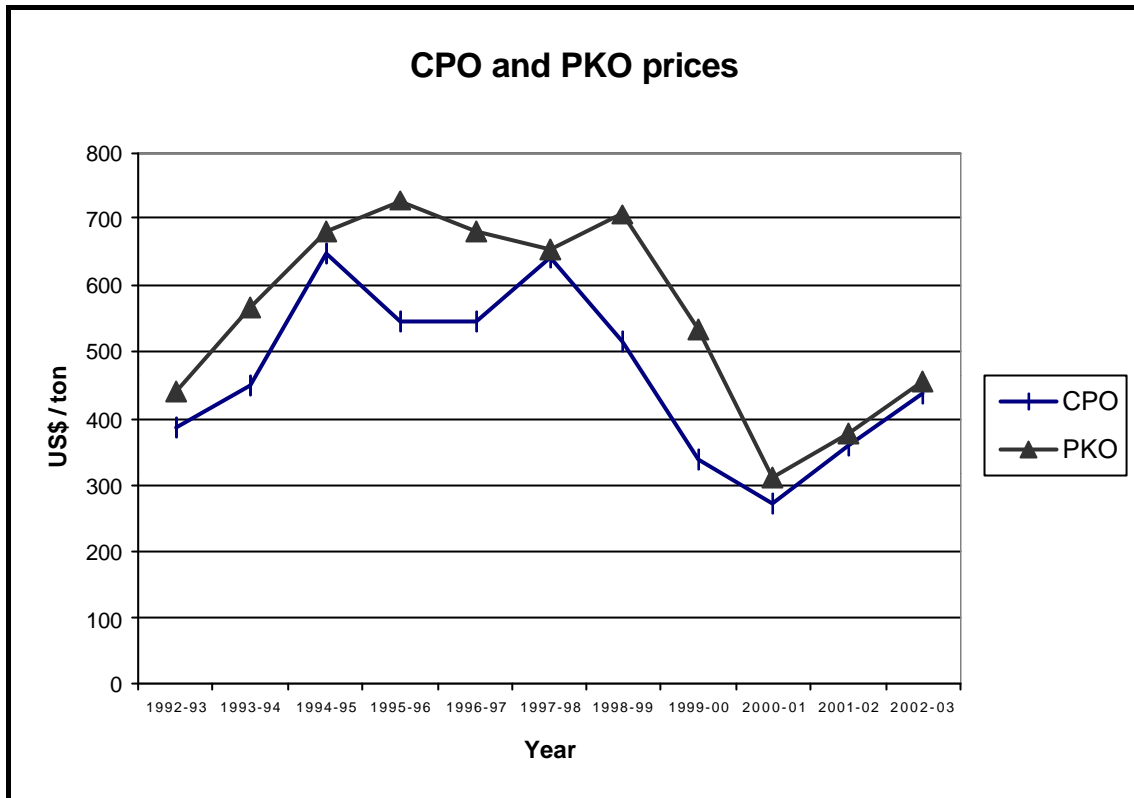


Figure 7. CPO and PKO prices on the world market (in \$ per ton)

- **Policy changes in Indonesia**

After President Suharto stood down in May 1998, the new Habibie government was under a great deal of pressure to reform the forest sector and rid Indonesia of corruption, collusion and nepotism (KKN). The reforms introduced, also by the subsequent Wahid government, deterred investment in the oil palm sector:

- In early June 1998 the Ministry of Forestry and Estate Crops instructed all provincial forestry and plantation offices to revoke the forest use and conversion permits of estate crop companies that failed to develop their estates after logging.²⁸
- In March 1999, the Ministry of Forestry and Estate Crops released a regulation that limited plantation concession sizes. In this regulation, tree crop plantation development for a given company was limited to 20,000 hectares in any one province, and at 100,000 hectares in the whole country. Plantations are furthermore required to have their own CPO-mill.²⁹
- During 1998 and 1999 frequent changes were made to the domestic CPO distribution system as well as to the CPO export system. CPO distribution used to be dominated by Bulog, the National Logistics Agency, but the national government now retreated from direct intervention in the sector through Bulog. The government policy now is not to intervene in CPO price setting as long as there is adequate oil supply.³⁰
- In January 2001, the Indonesian government pledged to a moratorium on further forest conversion to the donor community (CGI).

- **Social unrest**

The relative political liberalisation that took place in Indonesia since the end of 1998 provided room for local communities to step up protests against further oil palm expansion. Local communities sought to reclaim land previously taken from them by force or with minimal compensation during the New Order era when oil palm plantation companies were given concessions to vast areas of land. In this era any attempt to reclaim land the army or mobile brigade (Brimob) suppressed any looming protest. However, when the *reformasi* was introduced, local authorities became increasingly reluctant to side with the private sector and for some time vast areas of forestland were inoperable to investors as local communities obstructed access to the area.³¹ Looting of FFB also increased on estates because estate workers and local communities began to experience increased living costs after the rupiah depreciated against the dollar. Some resorted to looting to supplement their incomes.³²

- **Foreign reluctance to invest in Indonesia**

From 1998 until recently, foreign companies and banks have been reluctant to invest in Indonesia and especially so in the oil palm sector. The general reluctance was caused by the economic and political instability facing the country since the financial crisis of 1997/1998. Many Indonesian companies collapsed under their debts in that period, exposing the large loans extended to them by local banks (which often belonged to the same business groups).

The oil palm sector in particular was not very popular with foreign banks between 1998 and 2002, as the loans extended in the mid-1990s had not generated the returns expected. Many Indonesian oil palm companies were not able to pay interest and repay their debts in time and entered into a painful debt restructuring process, which often forced foreign banks to accept write offs on their outstanding loans.

At the same time, foreign banks faced NGO-criticism on their role in converting the Indonesian forests into oil palm plantations.³³

Indonesian banks and the Indonesian capital market offered some relief during this period and domestic companies which were not in big financial trouble themselves sought local capital input as a limited alternative to (cheaper) foreign capital.

- **Financial problems of sister and mother companies**

Sometimes exacerbating the financial problems of some oil palm plantation companies in the period 1998-2002 were the financial problems of their sister and mother companies. For instance, Golden Agri-Resources of the Sinar Mas Group is still unable to use the cash deposits it deposited at a bank in the Cook Islands, which belongs to the debt ridden Sinar Mas Group itself. And PP London Sumatra Indonesia was unable to retrieve considerable loans that it extended to its mother company Pan London Sumatra Plantation.

2.3.4 Since 2002: Renewed expansion

During 2002 and certainly during the first half of 2003, the tide seems to have turned for the Indonesian oil palm sector. CPO and PKO prices on the world market recovered and the rupiah appreciated relative to the dollar. Almost all oil palm groups are making profit again and most have succeeded in restructuring their debts.

Now they have more financial room to manoeuvre, many oil palm companies are resuming their expansion plans. Early 2003 the Indonesian Agriculture Ministry announced it had licensed 74 companies to open new oil palm plantations covering an additional 672,977 hectares. These companies pledged a total investment of Rp 17,300 billion (US\$ 2.1 billion). With the addition of these new oil palm plantations Indonesia's CPO production is expected to outstrip Malaysia's in two to three years' time, according to the Ministry.³⁴

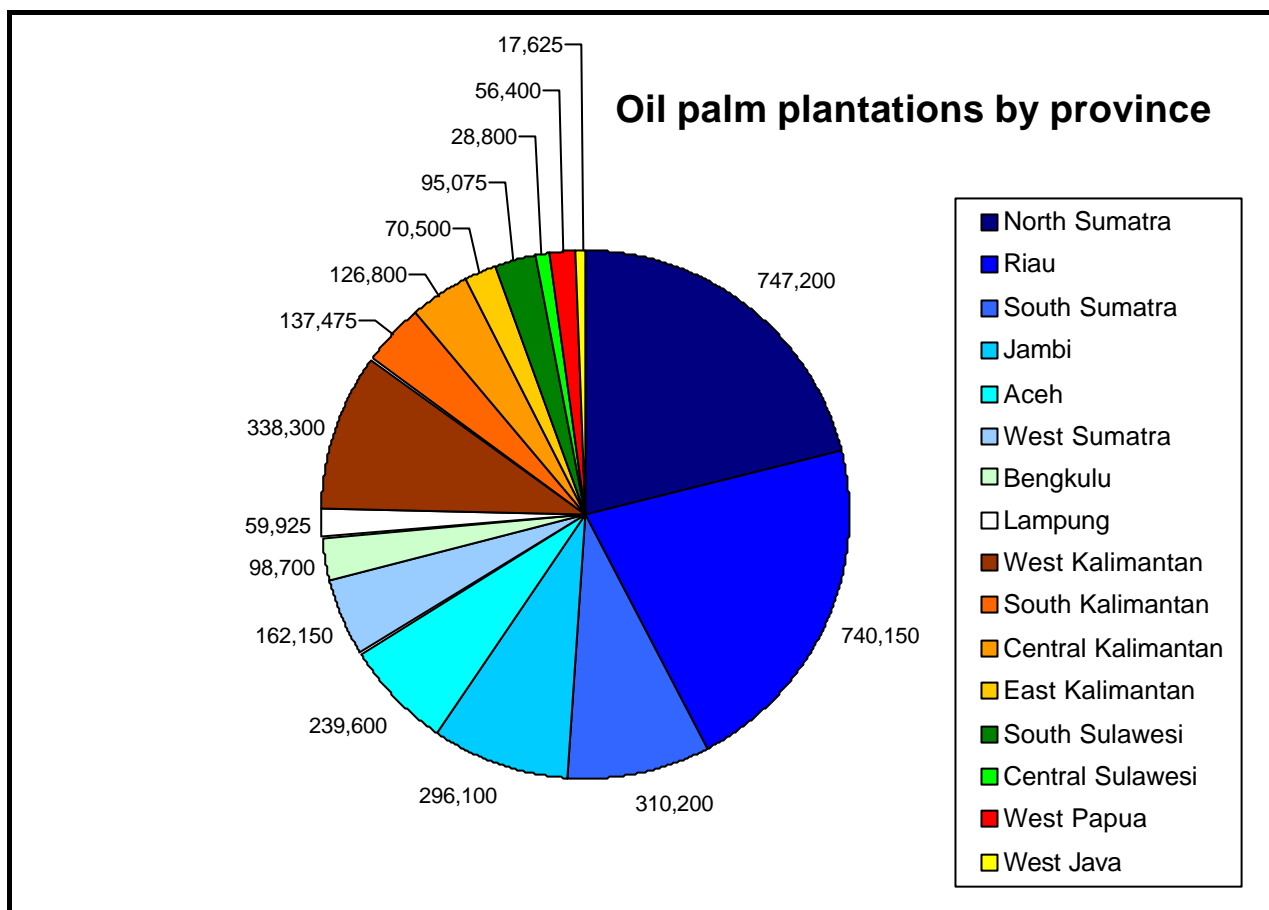
Private sector interest to expand the industry remains as strong as pre-crisis levels. In a letter dated 22 May 2000, the Indonesian Ministry of Forestry and Estates stated that no less than 1,896 investors had applied for permits to develop plantations in an aggregate area of 30,167,594 hectares.³⁵ Most of these applications (~90%) involve oil palm development. Local governments, who have a greater say in land use decisions since early 2001, too have announced to develop large new areas for oil palm. The estimated aggregate area that provincial and district governments would set aside amounts to some 22.5 million hectares.³⁶

Whereas these figures represent aspiration rather than commercial viability it is evident that further expansion of the oil palm sector can be expected. In January 2001, the Indonesian central government pledged a moratorium on further forest conversion to the donor community (CGI) but decentralisation policies have led to confusion over land use decision making. Meanwhile, many local governments have begun to allocate new forest areas for oil palm development.³⁷

In terms of agronomic suitability, the Indonesian Oil Palm Research Institute (IOPRI) estimates 18 million hectares of land in Indonesia are suitable for oil palm plantations (the presently planted area is 4.1 million hectares).³⁸ If the path of spatial expansion is followed, then questions arise with regard to where these new plantations would be developed. There are few remaining uncommitted forestlands available in Sumatra and Kalimantan although there may be considerable areas that have been cleared but not developed.³⁹ In addition, a growth in oil palm development in West Papua is likely to occur. Whether or not operating oil palm estates in this province is commercially viable remains to be seen but it is not unlikely that the forest rich province will attract investors who aim to gain access to forest resources.

Apart from spatial expansion there is also a growing need for investment in existing estates. Between 1998 and 2002, many plantation companies were forced to postpone the building of CPO mills due to a lack of funds. Meanwhile, areas planted with oil palms before 1998 have become mature. As a consequence, at least one million tons of FFB were wasted last year due to a lack of milling capacity because FFB has to be processed within 24 hours to avoid the rapid build-up of free fatty acids. This equals 0.2 million tonnes of CPO which was lost. Indonesia has nearly 300 mills spread over some 16 provinces. About 240 of these are located in Sumatra and nearly 40 in Kalimantan. But especially South Sumatra and Kalimantan still face a capacity shortage, particularly in the peak production months. South Sumatra province alone needs at least 22 new CPO-mills, its governor said in January 2003.⁴⁰

The following figure shows the geographical distribution of the Indonesian oil palm plantations at present, as provided by the Ministry of Agriculture. More than 75% of all oil palm plantations is located in Sumatra and another 19% in Kalimantan. Oil palm plantation development in Sulawesi and West Papua has only just started.⁴¹



Further expansion of the Indonesian oil palm sector requires substantial additional investments, for which the support of financial institutions is needed. We will discuss this further in Chapter 4.

With the economic prospects for the sector improving and with some of the major foreign banks apparently overcoming their reluctance to invest in the Indonesian oil palm sector, a new expansion phase is clearly gaining momentum. This poses further pressure on Indonesia's already battered natural environment and rural economy, as will be explained in Chapter 3.

2.4 Export markets for the Indonesian oil palm sector

Over the past decade the Indonesian oil palm sector became increasingly export-driven and palm oil exports increased 244% in the past seven years. Despite a volume growth of 60% since 1995, the European Union lost its position as the most important export market for Indonesian palm oil to India. The share of the EU declined from 50% to 23%, while India now accounts for 28% of Indonesian palm oil exports. Some other Asian markets, especially China, Malaysia, Pakistan, Bangladesh and Hong Kong are quickly expanding their palm oil imports from Indonesia.

Indonesian palm kern oil (PKO) exports increased 137% over the past seven years. Different from the palm oil market, the European Union still is the most important export destination by far for Indonesian PKO. Exports to the EU doubled in the past seven years and its share in total Indonesian PKO exports slipped only slightly from 71% to 61%. As is the case with Indonesian palm oil, Malaysia, India, China and Turkey are also strongly expanding their PKO imports from Indonesia.

Indonesian palm kern meal (PKM) exports increased 109% over the past seven years. Even more than is the case for Indonesian PKO, the European Union is the dominant export market for Indonesian PKM. Indonesian PKM exports to the EU increased 93% over the past seven years and its share of Indonesia's PKM exports only slipped slightly from 94% to 87%. Apart from the EU, only South Korea and Singapore seem to be stable (although much smaller) export markets for Indonesian PKM.

Chapter 3 Indonesian oil palm risks for financial institutions

3.1 Introduction: What is risk?

This chapter examines the risks posed to financial institutions providing financial services to Indonesian oil palm plantation companies. Risk is generally defined as “exposure to uncertain change”⁴² or as “the uncertainty of whether events, expected or otherwise, will have an adverse impact.” In this last definition, the adverse impact is usually a quantity of return (income) or value at risk.⁴³

In a definition tailored to the banking industry, the *Office of the Comptroller of the Currency* (OCC), which is the regulator for national banks in the United States, defines risk as “the potential that events, expected or unanticipated, may have an adverse impact on the bank’s capital or earnings.” According to the OCC nine different types of risk can be discerned in the financial sector, which bank risk management systems should identify, measure, control and monitor:⁴⁴

- Credit risk
- Interest rate risk
- Liquidity risk
- Price risk
- Foreign exchange risk
- Transaction risk
- Compliance risk
- Strategic risk
- Reputation risk

Providing financial services to Indonesian oil palm plantation companies incurs most of these types of risk, partly depending on the type of financial service offered. As some of these types of risk (such as interest rate risk, foreign exchange risk and transaction risk) are not typical to the Indonesian oil palm plantation sector, we will not elaborate on them here. This chapter will focus on the following types of risk:

- Credit risk
- Price risk
- Compliance risk
- Reputation risk

In the following paragraphs each of these types of risk will be defined and for each type of risk the specific risks related to the Indonesian oil palm plantation sector will be analyzed.

3.2 Credit risk

According to the OCC, credit risk is “the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed.”⁴⁵ By some sources this type of risk is also called *default risk*, which “refers to the probability that interest or principal will not be paid on the due date and in the promised amount.”⁴⁶

Credit risk therefore includes all possible events that can substantially impact the client’s profitability and therefore its ability to service its debts. These events can be further divided in three categories:

- **Operational risks:** Risks which are directly related to the operational and management activities of the client;

- **Legal & institutional risks:** Risks which are related to the legal and institutional framework within which the client is operating;
- **Market risks:** Risks which are related to the development of the markets on which the client is operating.

We will elaborate on each of these three types of risks below.

3.2.1 Operational risks

- **Conversion of High Conservation Value Forests (HCVF)**

Indonesia's tropical rainforests are of especially high conservation value: whereas Indonesia's land surface represents only 1.3% of the globe, it harbours 10% of all plant species of the world, 12% of mammals, 16% of reptiles and amphibians and 17% of birds. Most of these species depend on the lowland rainforests, which are also home to the key stone species such as orang-utan, proboscis monkey, Sumatran rhinoceros, tiger and elephant, rhinoceros hornbill, clouded leopard, sunbear, and several species of crocodile.⁴⁷

High Conservation Value Forests

The concept of High Conservation Value Forests (HCVF) was developed by the Forest Stewardship Council (FSC) as a means to ensure that the world's most important forests are adequately maintained under FSC certification. The FSC provide a generic definition (below) which must then be adapted to reflect the realities in each country.

HCVFs are those that possess one or more of the following attributes:

1. Forest areas containing globally, regionally or nationally significant concentrations of biodiversity values (e.g. endemism, endangered species, refugia).
2. Forest areas containing globally, regionally or nationally significant large landscape level forests, contained within, or containing the management unit, where viable populations of most if not all naturally occurring species exist in natural patterns of distribution and abundance.
3. Forest areas that are in or contain rare, threatened or endangered ecosystems.
4. Forest areas that provide basic services of nature in critical situations (e.g. watershed protection, erosion control).
5. Forest areas fundamental to meeting basic needs of local communities (e.g. subsistence, health).
6. Forest areas critical to local communities' traditional cultural identity (areas of cultural, ecological, economic or religious significance identified in cooperation with such local communities).

Moreover, these tropical forests still provide livelihoods to vulnerable and isolated indigenous communities and deforestation would most likely wipe out their culture. The loss of the Indonesia's tropical rainforests is of grave concern to many environmentalists, scientists, local communities, consumers and account holders and the tropical timber trade. Tropical forest loss has been subject to intense media campaigns and public and policy debates in Indonesia and western countries for many years. Many governments have acknowledged the need to preserve and sustainably manage tropical forests.

Even though forest conversion for plantation development is highly controversial, oil palm plantation companies have a preference to establish new plantations in forested areas. This is for several reasons:

- Forest areas are (perceived to be) less densely populated and developing estates in these areas brings about fewer costs for compensation for lost crops;
- The fertility of forested land is generally higher;
- The timber yield from forest areas represents an attractive one-time financial value of about US\$ 2,100 per hectare.⁴⁸ The proceeds are realised in the first years of estate development and do not require outside financing. It is conceivable that without the timber value, many plantations would not be developed and, indeed, many plantation areas remained undeveloped *after* the standing timber was harvested.

The extent to which tropical forests are cleared for oil palm plantations is presently under debate in the sector. The Indonesian Palm Oil Research Institute (IOPRI) estimates that 63% of all oil palm plantations are established in secondary forests and scrub, 3% in primary forests and the remainder 34% in other vegetation and land use types.⁴⁹

Although converting High Conservation Value Forests (HCVF) in many cases is not illegal, it does incur serious market risks (see paragraph 3.2.3) as well as operational risks. The number of incidents with elephants and tigers attacking oil palm plantations, buildings and workers is increasing strongly. In Riau alone, the largest palm oil producing province, the losses due to elephant damage of oil palm plantations and timber estates reaches a total of about Rp 950 billion (US\$ 105 million) per year, according to an estimate of WWF.⁵⁰

- **Unpredictable climatic conditions**

As for many agricultural crops, precipitation levels are a main determinant of oil palm harvest levels. In 1997 the El Niño phenomenon resulted in a long drought, forest fires and caused harvest failures in the country. Although it is certain this type of climatic development will return, it is very hard to predict when.⁵¹

- **Illegal burning**

Even though the Indonesian government incrementally prohibited the practise, burning continues to be perceived as the most practical, quickest and cheapest land clearing technique as opposed to mechanical clearing which is not considered cost-effective especially in peat swamp areas.⁵²

Oil palm plantation companies have as a result been associated with the heavy smog that regularly blankets large parts of rural Indonesia, Singapore and parts of Malaysia. Especially during the 1997/1998 El Niño draught, a vast area of forestland (over 11 million hectares) burnt to various degree. Between 46% to 80% of all larger fires occurred in plantation company concessions. Most of these fires were lit for land clearing purposes, while some resulted from arson in connection with conflicts between communities and the companies or other causes.⁵³

The costs of these fires and haze are enormous. WWF estimated that the 1997/98 haze alone affected the health of 70 million people while CIFOR recently estimated the total economic costs of these fires and haze at US\$ 5.1 to 6.3 billion.⁵⁴

Forest burning has been illegal since 1985, when Government Regulation No. 28 on Forest Protection prohibited forest burning practices with exception for special cases approved by the legal authority (Article 10, Paragraph 1).⁵⁵

In the past five years, various new laws, governmental decrees and guidelines on burning have been released. The 1997 Environment Management Act No.23 first recognised corporate liability for environmental crime, including the crime causing forest and land fires. Thus, that every concession or plantation company is responsible for fire outbreaks in its concession area.⁵⁶

As of February 2001, Government Decree No. 4/2001 Act on Environmental Pollution related to Forest Fires and/or Land Burning explicitly prohibits all persons and their businesses to cause forest fires and use fire for land clearing in their locations. They are obliged to extinguish all fires and take fire prevention measures including monitoring of fire outbreak and reporting (based on satellite images) on a half-yearly basis to the Governor's Office, District Head, the mayor and other relevant technical institutions (Art. 13-15).⁵⁷

Violations are subject to sanctions specified in the Environment Management Act. Article 41 states that offenders found guilty of causing haze and damaging the environment can be sentenced to a maximum of 10-year jail sentence and a fine up to 500 million rupiah (approx. US\$ 58,000), or more depending on the impact of the pollution caused.⁵⁸

Alternatively, the Indonesian Forest Act could be applied. Article 50d prohibits the use of fire for land clearing. Article 78 (ad. 4) specifies that offenders may be penalised Rp. 1.5 billion and imprisonment for a maximum period of five (5) years.⁵⁹

Despite strengthened laws, forest fires in plantation concessions are still a common phenomenon in Indonesia to date.



Forest fires caused by oil palm development on the Dumai coast, March 2003

Few companies have been sued and ultimately prosecuted, but pressure to apply the law is increasing. Last year, a local government team in Riau investigated several companies that were suspected for burning such as PT Sindora Seraya, PT Cibaliung Tunggal Plantation (an Indofood subsidiary, see 6.3), PT Tribakti Sari Mas, Kawasan Industri Dumai, and PT Jatim Jaya Perkasa. Recently, the local administration in Riau came to a settlement with the oil palm plantation company PT Adei Plantation, part of the Malaysian Kuala Lumpur Kepong group, amounting to US\$ 1.1 million in compensation for burning forest areas in several of the company's plantation areas.⁶⁰

Burning for land clearing can result in juridical persecution, fines and the withdrawal of concessions, which can harm the profitability of the client. Burning can also cause unforeseen damage to assets of the company.

- **Illegal land clearing and logging**

When clearing their concession area, oil palm plantation companies frequently clear more land than the area specified in the permits they have obtained. It is also not unusual for companies to commence with land clearing prior to obtaining all required permits.⁶¹ Furthermore, there is a large grey area in Indonesian legislation with regards to the issuance of land clearing permits and logging activities.

Illegal land clearing and logging can result in prosecution, fines and the withdrawal of concessions, which can seriously harm the profitability of the client.

- **Land tenure conflicts**

Indonesia's forestlands provide livelihoods to some 30-65 million indigenous people and other rural communities. Because these communities rarely have formal rights, licensed palm oil companies have taken over large tracts of, what communities perceive as, customary rights (*adat*) lands. The Indonesian Legal Aid Foundation (YLBHI) found that in 1998 alone, in 14 provinces, people lost over 800,000 hectares to private companies and investors. In the process, more than 200,000 households lost their sources of income. Such developments nurture numerous, persistent and often violent conflicts. These conflicts have sometimes prevented companies from operating altogether and in response, many have mobilised and paid the police, army or government officials to suppress unrest, which often translate in gross human rights violations.⁶²

Apart from dispossession of their customary rights land, community resistance to oil palm is also based on the lack of economic benefits. Local communities are the primary producers of agroforestry and agricultural commodities (such as rattan, coffee, tea, rubber, cacao and rice) in Indonesia. Unlike some alternative land uses such as oil palm, An in-depth study in a village in East Kalimantan found that such production systems are relatively resistant to market shocks, and do not require long time horizons or large initial investments to realise returns. From the local perspective, customary forest management may ultimately provide a greater return to labour than oil palm.⁶³

Some companies have encountered so much social unrest that they are inclined to return part of their estates to local communities and there are a few cases in Indonesia where an informal arrangement has been made. Companies are, however, very reluctant to see any form of formal recognition of traditional land claims as this would set a precedent that could affect many plantation companies throughout the country.

Although the Indonesian government does not recognise indigenous peoples' ownership of forestland, which legally is state-owned, the cause of marginalised communities is recognised by several international conventions and covenants.⁶⁴ Local communities' land and forest use rights and claims are also an integral component of the High Conservation Value Forest definition, a concept that is increasingly recognised in the market place. Plantation companies that poorly manage their community relations and are associated with human rights violations and the marginalisation of local communities face direct operational risks, because of damages done to their assets and operations. In the longer term they face the legal risk of losing part of their land base as well.

- **Rising labour costs**

Labour costs, which make up a crucial part of the total costs of cultivating oil palms and processing its fruits, are set to rise as a consequence of labour unrest, trade union activity, etc. Many oil palm plantations have been paying their workers below the minimum wage level⁶⁵, but with the relative political liberalisation of the past few years labour unions have more possibilities to force employers to respect the minimum wage. Wage increases of 15% per year in the Indonesian oil palm plantation sector are still exceptions, but an upward trend is visible.⁶⁶

Other labour related issues include gender issues and health risks related to agrochemical (pesticide) use.

- **Unsustainable smallholder schemes**

Smallholder schemes are usually promoted as an alternative to recognition of existing land claims (smallholder schemes guarantee rights to 2 hectares of land per family head). But the Indonesian smallholder credit schemes tend to make smallholders prone to indebtedness and poor management of oil palm plantations. A WWF study in West Kalimantan found that, with some exceptions, oil palm does not appear to provide smallholders with sustainable livelihoods. Smallholders are often awarded the poorer sites within the area, resulting in below average yields. Moreover, the credit schemes make smallholders highly dependent on the Nucleus company and they often end up with bad debt.⁶⁷

Plantation companies that poorly manage their smallholder relations face direct operational risks.

- **Sub-optimal locations**

In their endeavour to expand their planted acreage as quickly as possible, many oil palm plantation companies plant oil palms in locations which are not particularly suited, either because they are prone to flooding, unfertile, or otherwise not suited. These kind of sub-optimal locations incur the risk of lower than projected output levels and production losses.

- **Liquidity drain from related indebted companies**

Oil palm plantation companies in Indonesia often experience a lack of investment funds, either because the company itself runs into financial trouble, or because available investment funds are drained towards mother and sister companies within the same business group, or because the company's banks run into financial trouble. As a consequence of such a lack of investment funds, a large number of Indonesian oil palm companies in the past years reduced expenditure on fertilizer, which of course risks lower yields.

Another consequence of a lack of investment funds is that between 1998 and 2002 many plantation companies were forced to postpone planting of their estates for which permits were obtained. Many companies subsequently saw their licenses withdrawn by provincial governments.

The building of CPO mills was also postponed while areas planted with oil palms before 1998 in the mean time have become mature. As the oil palm fruit has to be processed within 24 hours after harvesting to avoid the rapid build-up of free fatty acids, at least one million tons of FFB were wasted last year due to a lack of milling capacity. This equals 0.2 million tonnes of CPO which was lost.

- **Poor management quality**

The expansion of the Indonesian oil palm plantation sector has proceeded so fast, that the general management quality level throughout the sector is very low. Many companies without background in agriculture entered the sector in the past decade.

Poor management quality leads to poor technical management of the production process, but also to poor management of social relations with workers, communities and other stakeholders. Poor management quality also results in a short-sighted approach to the business, which is one of the reasons for the present lack of CPO mills mentioned already. The same short-sightedness is apparent in the lack of Research & Development expenses of most Indonesian oil palm plantation companies. Only four oil palm plantation companies maintain research facilities in Indonesia, including PT PP London Sumatra Indonesia and PT Socfindo, which is owned by the French Bolloré Group. These companies maintained breeding and varietal screening programs that produced seed for their own plantings and for sale to other plantations. But most Indonesian oil palm plantation companies do not invest in R&D.⁶⁸

3.2.2 Legal and institutional risks

- **Poorly developed legal system**

Indonesia has a fantastically complex and often contradicting legal system, comprising a web of laws, decrees and other regulations. Government data may in some cases be so inconsistent and unreliable that ultimately it is impossible to determine the legality or illegality of a certain activity.

Perhaps the majority of forest concessions, including community forestry operations, issued in Indonesia are of questionable legality owing to major deficiencies in the process of gazetting of forestlands. As a result of these procedural failures as much as 90% of forestlands have never actually been properly transferred to the jurisdiction of the Department of Forestry.⁶⁹

Furthermore, law enforcement in Indonesia is slack and thrives on *KKN* (Corruption, Collusion and Nepotism). In the Indonesian regulatory context, anything illegal could also easily be legalised through corruption. Even cases in which the illegality of certain operations is well documented, do not always result in prosecution. Legal charges against companies are regularly announced by state prosecutors, but this does not lead very often to verdicts with significant impact on business performance.

Companies operating in such an insecure and weak legal system, face operational, legal as well as reputation risks.

- **Poorly developed sectoral coordination**

The regulatory framework for the development of the oil palm sector is ambiguous and constantly changing. This is one of the main problems facing the Indonesian oil palm industry, according to the Indonesian Chamber of Commerce and Industry (Kadin). The industry is currently overseen by seven ministries that rarely coordinate their policies on the industry. Kadin therefore favours the establishment of a coordinating board for crude palm oil, which is expected to produce effective policies to boost the industry's competitiveness. According to Kadin, Indonesia is far behind Malaysia in handling the palm oil industry. "Malaysia has implemented integrated and comprehensive management to handle their CPO industry. Indonesia, meanwhile, has done nothing. The management is still partial and has no focus."⁷⁰

Companies working within a poorly developed regulatory framework can become at the mercy of random and conflicting policies, which increases operational and legal risks.

- **Poorly developed foreign marketing**

The Indonesian oil palm industry is lacking a joint foreign marketing and promotion approach, according to the Indonesian Chamber of Commerce and Industry (Kadin). In contrast, Malaysia is conducting aggressive marketing campaigns to boost CPO exports and has marketing representative offices in several countries. Kadin therefore favours the establishment of a coordinating board for crude palm oil which is expected to produce effective policies to boost the industry's competitiveness.⁷¹

Poor marketing efforts cause operational risks as the exporters may not be provided with the information they need to get the right price for their products and to address consumer needs.

- **Poorly developed security infrastructure**

Partly connected with land conflicts, many oil palm plantation companies are confronted with looting, demolition and violent clashes with local communities. State-owned plantation company Perkebunan Nusantara II, which is operating in North Sumatra, reported no fewer than 450 cases of looting and illegal logging in the period 1999-2000. These incidents caused the company to suffer a loss of Rp 111 billion (US\$ 15.6 million) in 1999 and Rp 60 billion (US\$ 6.3 million) in 2000. Most companies feel that the Indonesian government is insufficiently protecting their assets and guaranteeing their security.⁷²

As a result, many plantation companies resort to paying the police, armed forces and paramilitaries for protection. The Malaysian oil palm company Kumpulan Guthrie for instance reports proudly in its latest annual report that an Indonesian subsidiary has donated two pick-up four-wheel drives and a minibus to the Indonesian army.⁷³

Such practices potentially violate the international Human Rights Convention and the Indonesian Human Rights Act, when intimidation and violence is used to silence local communities. Companies paying officials for protection face serious reputation risks.

Another important security issue is the hijacking of palm oil tankers. According to the International Maritime Bureau (IMB) of the International Chambers of Commerce "a ruthless and determined gang is preying on valuable palm oil cargoes being towed off Sumatran coast". In September 2002 alone, three such hijacking cases were reported in the region - two in Indonesian waters, one in the Malacca Strait. The three ships were carrying millions of dollars worth of palm oil.⁷⁴

- **Poorly developed transport infrastructure**

The oil palm plantation sector is scattered over the Indonesian islands, meaning that most oil palm products have to be transported by sea to foreign as well as domestic markets. But in the rural areas where oil palm plantations are located, roads to ports are poor and ports are poorly developed. There are no deep water berths for modern ships. CPO moves long distances on small, poorly regulated, often rudimentary tanker trucks around Sumatra. From Kalimantan CPO is often loaded into old, poorly prepared barges for extended sea passages and transshipment at sea is common.⁷⁵

Poor infrastructure has resulted in high transport cost of oil palm fruits, so much so, that when the selling price of FFB was as low as Rp 200 per kilogram, some farmers were not interested in harvesting their crops at all.⁷⁶

CPO producers in Aceh also have to pay bribes to various groups to avoid trouble while transporting their goods to Belawan Port in North Sumatra.⁷⁷

- **Poorly developed R&D infrastructure**

In strong contrast to Malaysia, Indonesia does not have a strong, publicly funded R&D infrastructure for the oil palm sector. The publicly supported Indonesian Oil Palm Research Institute (IOPRI) is viewed by the large plantations as either not very effective or focused on small holders and state-run plantations.⁷⁸

The Indonesian Palm Oil Producers Association (Gapki) in December 2002 urged the government to set up a special research institute to help develop the industry.⁷⁹

- **Inability to solve the land tenure issue**

The Indonesian government fails to adequately recognise traditional land claims and is ineffective in settling community-company conflicts on land issues. Local communities are therefore often trying to reclaim, by legal and illegal means, concession areas which they consider as their property.

The National Assembly in 2001 has passed a Decree (TAP MPR IX/2001) requiring a major change in natural resource management laws which would recognise customary rights in forests and to land in general. Legal confusion presently prevails. In the meantime, as a result of decentralization, district legislatures are beginning to recognize the rights of local communities to land to a measure of autonomy and to community forestry by passing local decrees.⁸⁰

The inability of the Indonesian government to act decisively in the land tenure matter poses an important risk for the companies in the present situation (prolonged conflicts) as well as in the possible future (potential loss of developed plantation land).

- **High tax burden**

The Indonesian Palm Oil Producers Association (Gapki) has been lobbying the government for a long time to abandon the export tax on CPO. This export tax was lowered to only 3% in February 2001, but Gapki argues that in Malaysia no export tax exists at all. The Indonesian government has not responded to this demand, however, and in stead is regularly threatening to increase the export tax as to secure the supply of cooking oil to the domestic market. CPO producers also complain that none of the tax proceeds is used by the government to stimulate the industry.⁸¹

When the government would increase export taxes again, it would become very profitable again to smuggle palm oil to neighbouring places like Malaysia. This smuggling was widespread in 1998-2000, when CPO export was first banned and then levied with a heavy export tax. Some industry sources mentioned that there were several occasions when the palm oil sold in the domestic market was collected by some parties and then shipped out of the country.⁸²

In December 2002, Gapki also started to complain about the poor implementation of the autonomy law by regional administrations. The new autonomy law which gives greater power to local governments in managing their affairs was launched in 2001. But following criticism from many businesses, the government is now planning to revise the law. According to Gapki the provincial and district governments are too aggressive in collecting revenue by imposing various levies, which in turn have placed a heavy burden on CPO producers. The levies have increased the price of fresh fruit bunches and are discouraging new investors from entering the industry.⁸³

High taxes and insecurity on future tax levels, pose strong institutional risks to oil palm plantation companies. Smuggling obviously poses legal risks.

3.2.3 Market risks

- **Competition from other edible oils**

One of the main determinants of global PKO and CPO price developments, is the competition with other edible oils. Although global edible oils consumption is still increasing strongly, palm oil probably will be more under pressure from other edible oils, especially soybean oil. The soybean sector in the main production countries (United States, Brazil and Argentina) is strongly integrated and controlled by only a handful of international commodity traders (Cargill, ADM, Bunge and Dreyfus). Together with the national governments in the production countries, these companies invest strongly in Research & Development, transport infrastructure and processing infrastructure. While the oil palm plantation sector, especially in Indonesia, will face rising production costs which are not offset by productivity gains, the global soybean sector will be able to further reduce production costs. As a consequence lower soybean oil prices will exert a downward pressure on CPO and PKO prices.⁸⁴

- **Competition from other oil palm countries**

The economic success of the Indonesian oil palm plantation sector has not gone unnoticed to other production countries. Among others Papua New Guinea, Nigeria and some Latin American countries are stepping up efforts to increase their output.

- **Exchange rate developments**

Changes in the exchange rate of the rupiah versus the dollar can have severe consequences for Indonesian oil palm plantation companies, which have borrowed large sums in dollars. The strong depreciation of the rupiah in 1997/98 did mainly impact oil palm companies selling on the domestic market, of which many were not able to service their debts anymore.

The present (much more gradual) appreciation of the rupiah in contrast mainly impacts companies exporting their oil palm products, at a time when a much larger percentage of Indonesian oil palm products is being exported in comparison to 1997/98.

- **Market preference for sustainable palm oil**

Environmental and conservational NGO's, consumers, investors and governments in foreign oil palm product markets are becoming increasingly concerned about the demise of Indonesia's biodiverse ecosystems (lowland and peat swamp forests) as well as about the plight of many local Indonesian communities. The awareness about the connections between the Indonesian oil palm plantation sector and the loss of High Conservation Value Forest (HCVF), forest burning, illegal logging, and land right conflicts is increasing. The public pressure on companies buying oil palm products to switch to other edible oils or to palm oil produced in a sustainable way, is increasing especially in Europe. Important buyers of oil palm products such as Migros (Switzerland), Unilever (Netherlands-UK), Nestlé (Switzerland) and others have responded to this pressure and have begun to develop, adopt and implement sustainability guidelines for their (palm oil) suppliers.⁸⁵ Oil palm plantation companies which can not adhere to the guidelines of some of their buyers, face the risk of losing market share.

- **Food safety regulations**

Foreign buyers of oil palm products are increasingly insisting on food safety issues, spurred by governments and retail chains. The European Union is working on food safety regulations, demanding from food companies that their products do not contain traces of pesticides anymore from 2005. In the oil palm plantation sector around 25 different pesticides are being used, but as usage is not controlled and documented control is very difficult. Demands on food safety, animal welfare, environmental protection and worker welfare are formulated by a cooperative body of European retail chains and food suppliers, *EurepGAP*, which is defining *Good Agricultural Practice (GAP)* procurement guidelines.⁸⁶

Indonesian oil palm plantations should adapt their management practices to these kind of food safety regulations or face the risk of losing market share. To qualify for *EurepGAP* oil palm plantation companies must meet three criteria: ensuring minimal damage to the environment, sustaining crop productivity and fulfilling social obligations to workers and the surrounding community. In June 2003 the Malaysian oil palm company Kumpulan Guthrie announced it was adapting its palm oil mill in Labu, Negri Sembilan, to manufacture products that would meet the *EurepGAP* certificate standards. According to Kumpulan Guthrie the company would be the first in Asia to meet these standards.⁸⁷

3.2.4 Risks to other clients

It should be noted many of the credit risks associated with the Indonesian oil palm plantation sector, could also cause credit risks for other clients of the financial institution. Timber and pulp & paper industries in Indonesia, as well as their trading partners and export markets, are increasingly exposed to operational risks because Indonesia's tropical timber resources are dwindling fast. Oil palm plantation companies are to a large extent responsible for the demise of these resources. Financial institutions with clients in both industries, therefore face the risk that the activities of their clients in the oil palm plantation sector reduce the ability of their clients in the timber and pulp & paper sectors to service their debts.

3.3 Price risk

Price risk is defined by the OCC as “the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. This risk arises from market-making, dealing, and position-taking activities in interest rate, foreign exchange, equity, and commodities markets.”⁸⁸

This type of risk is not only relevant for commercial and investment banks (for instance when involved in commodity or currency swaps, or when helping a client to issue shares or bonds), but also for institutional investors investing in the shares or bonds of Indonesian oil palm plantation companies. For these financial institutions, price risk includes all events which could possibly reduce the value of shares, bonds and other financial instruments issued by Indonesian oil palm plantation companies. These events are very similar to those analyzed under “credit risk” in paragraph 3.2 and therefore we will not elaborate on them any further here.

3.4 Compliance risk

According to the OCC compliance risk is “the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank’s clients may be ambiguous or untested. Compliance risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts.”⁸⁹

Compliance risk is clearly related to providing financial service to Indonesian oil palm plantation companies. Indonesian authorities, local communities, nature conservancy organisations and other stakeholders can try to make financial institutions liable for illegal acts of their clients, such as illegal logging, burning or the occupation of land belonging to a community. Although the Indonesian government does not recognise indigenous peoples' ownership of forestland, which legally is state-owned, the cause of marginalised communities is recognised by several international conventions and covenants.⁹⁰

At present, the risk that such a case would lead to the prosecution of a financial institution is not very large. But liability law is developing rapidly worldwide, spurred by the desire to stem financial flows to terrorist networks as well as by an increasing awareness on *Corporate Social Responsibility* issues. Financial institutions will be increasingly held responsible for knowing what their clients are doing with the money which they have provided, to prevent the financing of illegal activities.

3.5 Reputation risk

According to the OCC reputation risk is “the risk to earnings or capital arising from negative public opinion. This affects the institution’s ability to establish new relationships or services, or to continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation.”⁹¹

Within the financial industry the importance of managing reputation risk is increasingly realised, as a financial institution's reputation is critical to its ultimate survival: “... more than any other industry, the banking system exists primarily on confidence. When it is lost, the likely immediate withdrawal of capital can quickly degenerate into panic and collapse of even the most solvent banks.”⁹²

Local communities, nature conservancy organisations, environmental organisations and others are increasingly blaming financial institutions because their clients are involved in logging HCV forests, burning, occupying community land and other non-sustainable activities. Publicly linking a financial institution to such practices of one of its clients can strongly damage its public reputation, even if the client operates within the boundaries of Indonesian law.

Chapter 4 The financing of the Indonesian oil palm plantation sector

4.1 Types of financial services

The fast expansion of the oil palm sector would not have been possible without the strong financial support of a large number of financial institutions. Indonesian financial institutions as well as foreign financial institutions from Europe, North America and East Asia have been financing the expansion of the oil palm sector in Indonesia with loans, trade financing, stock issuances and other means. Especially during the mid-1990s the Indonesian oil palm plantation groups secured large amounts of financing from domestic and foreign financial institutions.

Types of financial services most frequently provided were:

- **Providing short-term loans**

Short-term loans (including trade credits, current accounts, leasing agreements, et cetera) have a currency of less than a year. They are mostly used as working capital for day-to-day operations: paying materials, machines, taxes, et cetera. Short-term debts are usually provided by a single commercial bank, which does not ask for substantial guarantees from the company.

- **Providing long-term loans**

A long-term loan has a currency of at least one year, but generally of three to ten years. Long-term loans are in particular useful to finance expansion plans, which only bring rewards after some period of time. Often long-term loans are extended by a *loan syndicate*, which is a group of banks brought together by one or more *arranging banks*.

- **Issuing shares on the stock exchange**

Issuing shares on the stock exchange gives a company the opportunity to increase its equity by attracting a large number of new, small and big, shareholders. When it's the first time a company offers its shares on the stock exchange, this is called an *Initial Public Offering (IPO)*. When a company's shares are already traded on the stock exchange, it can issue a *secondary offering* of additional shares.

To arrange an IPO or a secondary offering, a company needs the assistance of one or more investment banks, who will promote the shares and find shareholders.

- **Issuing bonds**

Issuing bonds is a different way of lending money. It can be best described as cutting a large loan into small pieces, and selling each piece separately. The buyer of each bond is entitled to repayment after a certain number years, and to a certain interest during each of these years. Bonds have some similarities with shares: both are *securities* traded on the stock exchange.

To issue bonds, one needs the assistance of one or more investment banks which *underwrite* to a certain amount of bonds. *Underwriting* means buying, with the intention to sell to investors.

- **Fiscal planning and trust services**

A financial institution can help a production company with facilities to plan its investments, loans, bonds, and other capital movements in a fiscal attractive way. A clear example of such a facility, is setting up, housing, and managing a financing company in a tax haven like the Netherlands.

- **Commodity and currency swap contracts**

Commodity and currency swap contracts are financial services provided mostly by commercial banks to exporting customers. A commodity swap contract guarantees the exporter a fixed price for its commodity during a certain period, independent of market and exchange rate fluctuations. A currency swap contract guarantees a company a fixed exchange rate for exchanging its export earnings from a foreign currency to the local currency.

To assess the financial importance of the services provided by each financial institution to the Indonesian oil palm sector, the total value (in US\$ million) of these services is added up. To give a more accurate result, two correction factors are applied:

- **The directness of the financial service**

Financial services can be provided exclusively for financing oil palm plantations and related activities. But they can also be provided for general corporate purposes to companies which also undertake activities outside the Indonesian oil palm sector. In this case we assume that the percentage of the assets of the company which is directly related to its Indonesian oil palm activities, corresponds with the percentage of the value of the financial service which is used to finance its Indonesian oil palm plantations.

- **The type of financial service**

To assess the value of different financial services, the following assumptions are made:

- Loans, lease agreements, etc.: 100% of the loan issued by a specific bank or 100% of the value of its participation in a loan syndicate;
- Shares and bonds acquired: 100% of the value acquired;
- Shares and bonds underwritten: 50% of the value underwritten;
- Managing a financing company: US\$ 0.1 million.
- Refinancing an existing loan by the same financial institution is not treated as a new financial service, but refinancings by other financial institutions are treated as new financial services

4.2 Selection of oil palm plantation groups

One of the objectives of this research project was to identify which foreign and domestic financial institutions have been most important in financing the Indonesian oil palm sector during the past ten years. To reach this objective a sample of 27 business groups engaged in the Indonesian oil palm sector were analysed. This selection includes the largest business groups operating in this sector - in terms of land banks and certainly in terms of planted area and CPO production - as well as a number of smaller business groups which have secured foreign financing during the past ten years. The selected business groups are listed in Table 1, including key figures on land banks, planted areas, CPO production and total assets.⁹³

Group	Country of ultimate ownership	Land bank (ha)	Planted area (ha)	CPO production (tons)	Total assets (US\$ mln)
Perkebunan Nusantara	Indonesia	770,000	561,126	2,094,364	1,400.0
Sinar Mas	Indonesia	591,000	282,000	1,105,000	1,285.2
Raja Garuda Mas	Indonesia	543,000	317,850	600,000	1,000.0
Kumpulan Guthrie	Malaysia	215,973	162,213	329,524	728.9
Salim	Indonesia	230,000	161,973	775,651	597.1
Napan & Risjadson	Indonesia	340,000	40,534	259,492	330.0
Astra	Hong Kong	290,621	189,970	543,635	277.5
Lyman	Indonesia	160,000	n.a.	n.a.	160.0
Tirtamas and Maharani	Indonesia	270,000	105,282	n.a.	150.0
Incasi Raya & Metro	Indonesia	200,000	n.a.	n.a.	150.0
Benua Indah	Indonesia	180,000	n.a.	n.a.	150.0
Cargill	United States	27,000	27,000	100,000	150.0
Kuala Lumpur Kepong	Malaysia	52,000	31,808	n.a.	106.0
Sungai Budi	Indonesia	62,015	12,000	n.a.	102.9
Duta Palma	Indonesia	65,800	25,450	n.a.	100.0
Surya Dumai	Indonesia	154,133	23,975	n.a.	95.0
Anglo-Eastern	Malaysia	33,692	18,389	63,240	92.1
Johor	Malaysia	140,000	19,622	n.a.	90.0
REA	United Kingdom	125,000	13,209	28,557	82.2
Bakrie	Indonesia	80,000	34,681	55,401	71.9
Oriental	Malaysia	43,900	n.a.	n.a.	66.7
CDC	United Kingdom	45,400	n.a.	100,000	60.0
Sipef	Belgium	65,000	29,364	127,003	53.0
Carson Cumberbatch	Sri Lanka	15,934	12,557	26,570	48.8
Bolloré	France	37,467	37,467	182,628	42.3
Rowe Evans	United Kingdom	35,304	25,136	0	36.6
Hasko	Indonesia	8,000	n.a.	n.a.	8.0
<i>Double-counting</i>		<i>(220,000)</i>	<i>(20,000)</i>	<i>(500,000)</i>	
Total		4,561,239	2,111,606	5,891,065	7,434.2

n.a. = no data available

As Table 1 shows, these 27 oil palm groups and their subsidiaries hold a total oil palm land bank of 4.6 million hectares, which exceeds the official total area of oil palm concessions issued in Indonesia (about 4.2 million hectares). This is caused by the fact that the figures in Table 1 include land banks allocated in the Suharto-era by provincial governors, for which no concession is granted (yet).

The selected oil palm groups together have planted an area of at least 2.1 million hectares, which is more than 50% of the Indonesian total (4.1 million hectares) at present. And they account for an annual CPO production of at least 5.9 million tonnes, which is around 65% of the Indonesian total as of 2002 (9.0 million tonnes). As we could not find CPO production figures for many of the researched groups, the actual percentage will be considerably higher. Their share in CPO production will exceed the share of these business groups in the planted acreage, as the FFB produced by smallholders and most of the FFB produced by smaller plantation groups is processed at the CPO mills of the larger plantations.

We assume that the total investment figure for the selected groups (US\$ 7.4 billion) represents 75% of the total investments in the Indonesian oil palm sector, as smaller groups usually have not invested in CPO mills of their own. Therefore we estimate the total investment figure for the Indonesian oil palm sector as a whole at US\$ 10.0 billion.⁹⁴

4.3 Types of financial institutions involved

The financial analysis of the selected oil palm groups revealed the involvement of 160 financial institutions from 24 countries, including Indonesia.⁹⁵ Together, these 160 financial institutions have invested an estimated US\$ 3.8 billion in the Indonesian oil palm plantation sector over the past ten years. This equals 38% of our estimate for total investments in the Indonesian oil palm sector (US\$ 10.0 billion). The actual percentage will be higher, as we have not identified all investments by (especially Indonesian) financial institutions in the Indonesian oil palm sector.

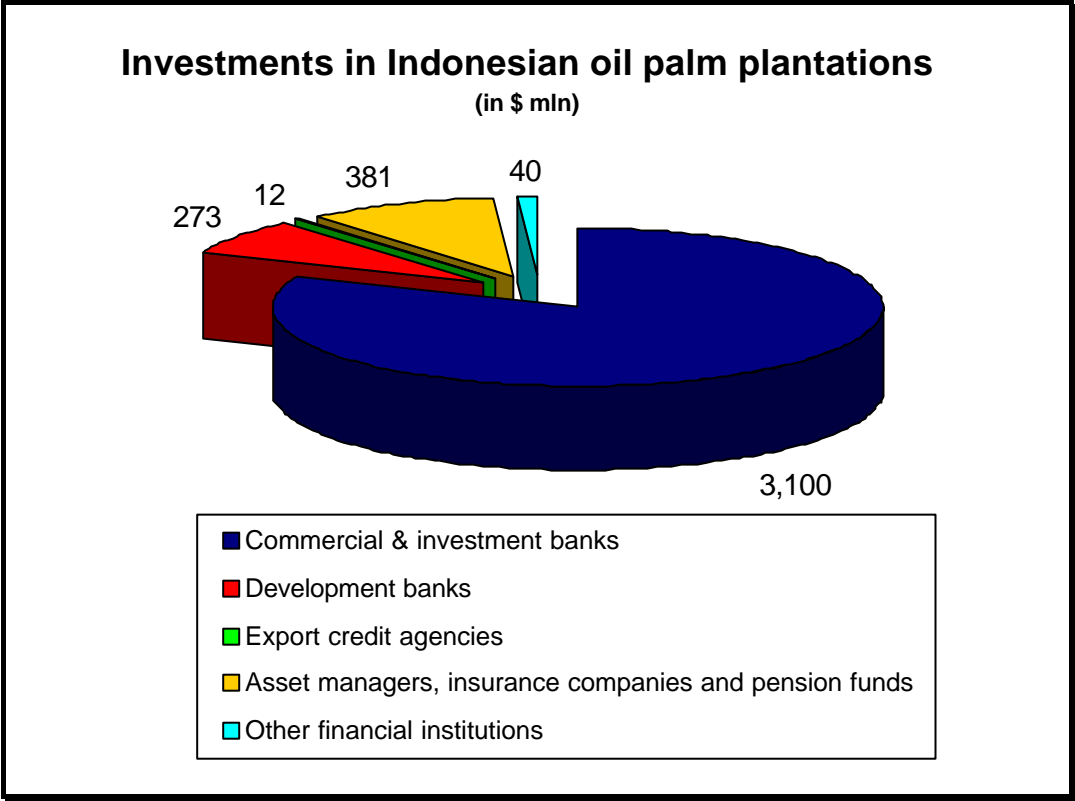


Figure 8. Investments in Indonesian oil palm plantations by type of financial institution

As is shown in Table 2, commercial and investment banks are the most important financiers of the Indonesian oil palm plantation sector by far, providing 81.4% of total investments identified. The next important group of financial institutions are the institutional investors (asset managers, insurance companies and pension funds), which provided 10.0% of total investments. The contribution of (multilateral and national) development banks was small (7.2%), while export credit agencies and other financial institutions played only a minimal role.

Type of institution	Number of FI's	Number of countries	Total investment (US\$ mln)	%
Commercial & investment banks	110	22	3,100	81.4
Development banks	9	7	273	7.2
Export credit agencies	4	4	12	0.3
Asset managers, insurance companies and pension funds	20	8	381	10.0
Other financial institutions	17	8	40	1.1
Total	160	24	3,807	100

4.4 Financial institutions by region and country

In Table 3, the total investment flow is divided by the region of origin of the financial institution. A total of 32 Indonesian financial institutions (of which 7 are closed at present) contributed US\$ 0.9 billion or 22.9% of total investments attracted by the 27 business groups analyzed in this report. (With regard to the entire Indonesian oil palm plantation sector, this figure is significantly higher).

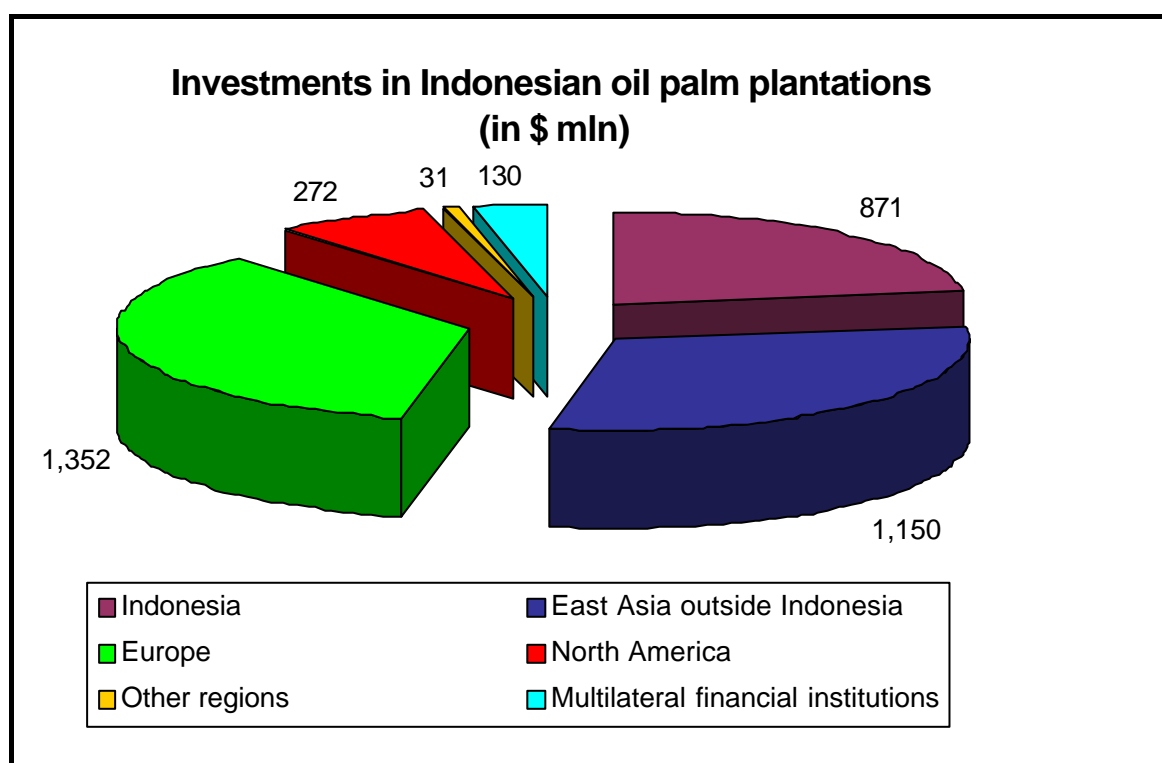


Figure 9. FI's involved in the Indonesian oil palm plantation sector, by region of origin

A total of 54 financial institutions from eight other East Asian countries contributed US\$ 1.2 billion (30.2%), but the 42 financial institutions from eight European countries took the largest share (35.5%) by contributing US\$ 1.4 billion. The contribution of 22 North American financial institutions is more modest (US\$ 0.3 billion), and the capital inflow from other regions was very low (US\$ 0.03 billion). Multilateral financial institutions contributed the remaining US\$ 0.1 billion (3.4%).

Region of origin	Number of FI's	Number of countries	Total investment (US\$ mln)	%
Indonesia	32	1	871	22.9
East Asia outside Indonesia	54	8	1,150	30.2
Europe	42	8	1,352	35.5
North America	22	2	272	7.1
Other regions	8	4	31	0.8
Multilateral financial institutions	2	1	130	3.4
Total	160	24	3,807	100

Table 4 gives a more detailed break-up of the foreign investment flow by country of origin of the financial institution. Malaysian financial institutions clearly are most important, accounting for 24% of total investments by foreign financial institutions. The Netherlands ranks second, followed by Switzerland, the United States and Japan.

Country of origin	Number of FI's	Total investment (US\$ mln)	%
Malaysia	13	702.4	23.9%
The Netherlands	7	495.7	16.9%
Switzerland	3	278.8	9.5%
United States	19	270.4	9.2%
Japan	15	247.1	8.4%
United Kingdom	14	231.5	7.9%
Germany	7	196.6	6.7%
Multilateral	2	130.2	4.4%
France	5	119.7	4.1%
Singapore	8	112.2	3.8%
Taiwan	5	31.5	1.1%
South-Korea	7	26.3	0.9%
China	3	24.1	0.8%
Belgium	3	21.7	0.7%
Bahrain	2	14.4	0.5%
Sri Lanka	3	9.0	0.3%
Hong Kong	2	4.4	0.1%
Italy	2	4.2	0.1%
Austria	1	4.0	0.1%
Russia	1	4.0	0.1%
Unknown	1	3.8	0.1%
Canada	3	2.0	0.1%
Thailand	1	2.0	0.1%
Cook Islands	1	0.0	0.0%
Total	128	2,936.0	100%

4.5 Top-10 foreign financial institutions

As shown in Table 5, the most important foreign financial institution is UBS (Switzerland), which invested an estimated US\$ 216 million in the Indonesian oil palm groups researched. Second in rank is the Malaysian state-owned investment fund manager Yayasan Pelaburan Bumiputra, with an estimated US\$ 201 million. Other financial institutions in the top-10 are three Dutch banks (ING Bank, Rabobank and ABN AMRO Bank), two Malaysian banks (Commerce Asset-Holding and Bank Islam), and banks from the United States (J.P. Morgan Chase & Co.), Germany (HypoVereinsbank) and Japan (Sumitomo Mitsui Financial).

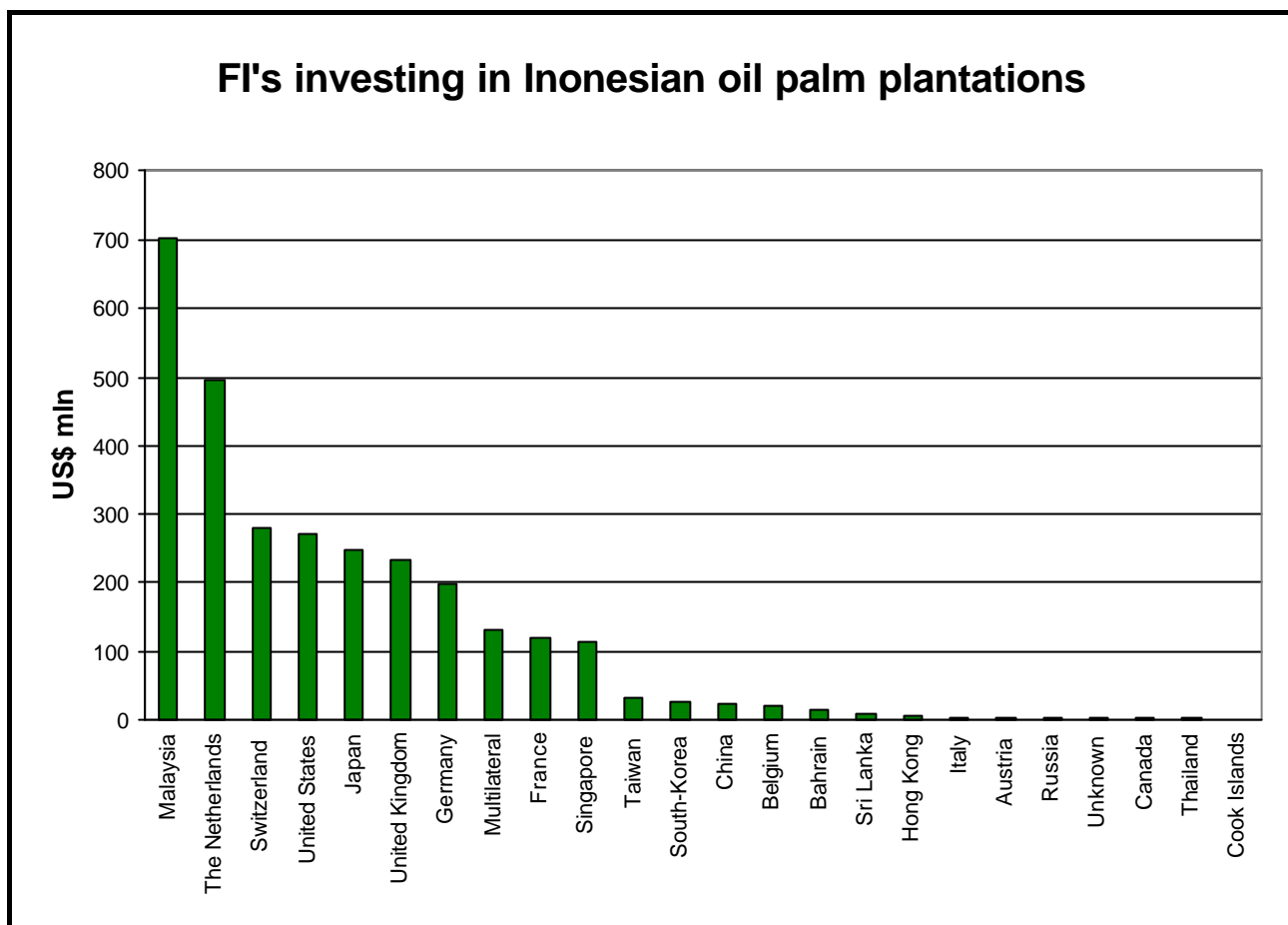


Figure 10. Investments in Indonesian oil palm plantations, by country of origin of the financial institution

Financial institution	Country	Number of oil palm groups	Amount invested (US\$ mln)	% of foreign total
UBS	Switzerland	3	216.2	7.4%
Yayasan Pelaburan Bumiputra	Malaysia	3	201.2	6.8%
ING Bank	The Netherlands	6	166.4	5.7%
Rabobank	The Netherlands	9	125.5	4.3%
Commerce Asset-Holding	Malaysia	8	123.0	4.2%
ABN AMRO Bank	The Netherlands	5	104.0	3.5%
J.P. Morgan Chase & Co.	United States	5	100.5	3.4%
Sumitomo Mitsui Financial	Japan	5	96.9	3.3%
HypoVereinsbank	Germany	3	92.3	3.1%
Bank Islam	Malaysia	2	91.5	3.1%

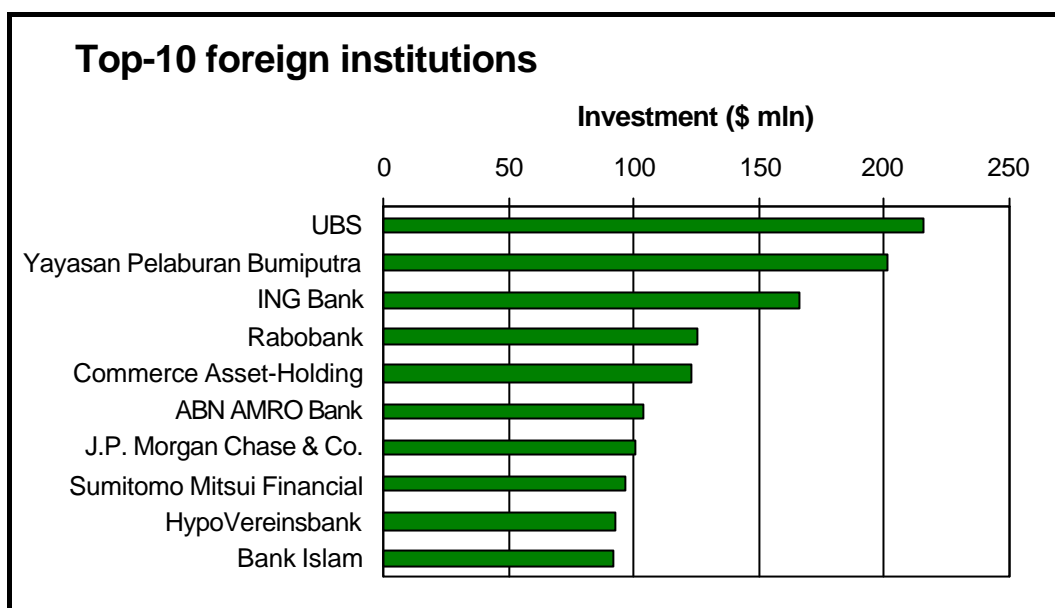


Figure 11. Top-10 foreign financial institutions investing in Indonesian oil palm plantations

4.6 Top-10 Indonesian financial institutions

Based upon the financial analysis of the 27 oil palm groups we also ranked the Indonesian financial institutions with regard to their investments in the Indonesian oil palm plantation sector. It should be noted that actual investments in the sector by these banks are underestimated here, as we did not analyse the numerous mid-sized and small business groups active in the sector which are mainly financed by Indonesian financial institutions. However, we do believe that these figures would not significantly change the ranking as presented in Table 6. Bank BNI, Bank Mandiri and Bank Rakyat Indonesia clearly are the most important Indonesian financial institutions with respect to the financing of the oil palm sector.

Bank	Country	Number of oil palm groups	Amount invested (US\$ mln)	% of Indonesian total
Bank BNI	Indonesia	15	284.2	32.8%
Bank Mandiri	Indonesia	18	206.3	23.8%
Bank Rakyat Indonesia	Indonesia	10	51.6	6.0%
Asuransi Jasindo	Indonesia	1	50.0	5.8%
Bank Central Asia	Indonesia	8	49.2	5.7%
Bank Mega	Indonesia	3	37.6	4.3%
Bank Danamon	Indonesia	9	36.4	4.2%
Danareksa Sekuritas	Indonesia	3	30.1	3.5%
Bank Internasional Indonesia	Indonesia	3	28.9	3.3%
Bahana Securities	Indonesia	2	14.7	1.7%

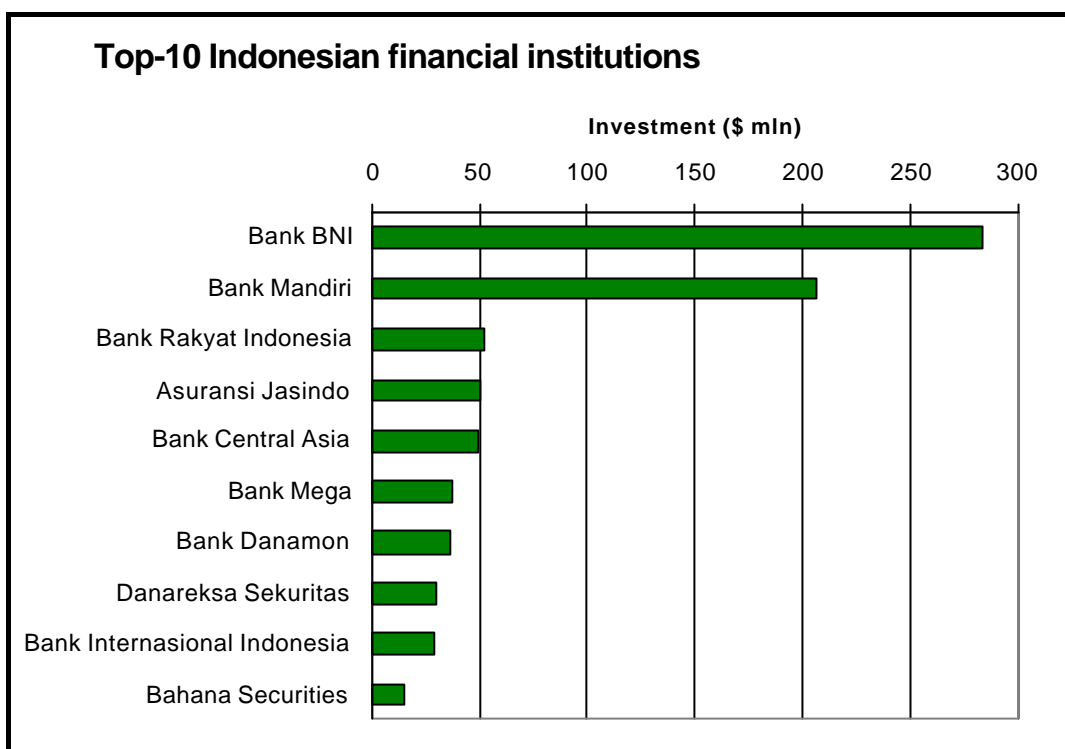


Figure 12. Top-10 Indonesian financial institutions investing in Indonesian oil palm plantations

4.7 Recent financial services to the Indonesian oil palm sector

Most of the financial services discussed in the previous paragraphs were extended before the *Asian Financial Crisis* of 1997/98. But the resurgence of the CPO price on the world market during the past year has improved profitability of most plantation groups and has renewed the interest of domestic and foreign financial institutions in the Indonesian oil palm sector, as described in paragraph 2.3.4. The financial market activity has not yet returned to the level of the mid-1990s, but the number of financial services provided to oil palm plantation companies clearly is rising again since the first quarter of 2002.⁹⁶ Some examples:

- Since the beginning of 2002, Kumpulan Guthrie Bhd. has been planning to issue additional international Islamic bonds worth US\$ 245 million, to repay the rest of its December 2000 loan. The issuance now is scheduled for somewhere in 2003.⁹⁷
- In March 2002, Kuala Lumpur Kepong Bhd. started trading of American Depository Receipts (ADRs) of its shares in the United States. Under the ADR programme a maximum of 3% of KLK's current issued and paid-up share capital will be traded in ADRs in the USA in the ratio of one ADR to ten KLK shares. **J.P. Morgan Chase & Co.** (United States) is the sponsor of the programme.⁹⁸
- **Rabobank** (The Netherlands) extended a working capital facility with a maximum value of US\$ 15.0 million to PT Astra Agro Lestari in 2002.⁹⁹
- In 2002 PT PP London Sumatra Indonesia obtained a Rp 90.0 billion (US\$ 10.1 million) long-term bank loan from **Bank Mandiri** (Indonesia) to finance its plasma programme.¹⁰⁰

- In April 2002, **ING Bank** (The Netherlands) arranged a syndicated two-year US\$ 100 million loan for PT Indofood Sukses Makmur, which was described as “the largest offshore loan financing for an Indonesian corporate since the start of the Asian financial crisis in 1997”. The loan will be used for working capital and will mature in April 2004. We estimate ING Bank’s own participation at US\$ 20 million.¹⁰¹ This loan is central to the case study in Chapter 6.
- In June 2002, PT Indofood Sukses Makmur issued five-year bonds worth US\$ 280 million on international capital markets. This was the largest offshore bond issue since the 1997-98 Asian financial crisis. 72% was distributed in Asia as a whole, 8% in Europe and 10% with offshore US accounts. The bonds were used to repay the US\$ 250 million syndicated loan of June 1997. The bond issuance was managed by **Crédit Suisse** First Boston (Switzerland).¹⁰²
- **Rabobank** was appointed by PT Astra Agro Lestari in February 2003 to help it sell stakes in 10 non-oil palm plantation subsidiaries to potential investors.¹⁰³
- In April 2003, PT Indofood Sukses Makmur announced it will issue five year bonds worth Rp 1,000 billion (US\$ 125 million) in the first week of June 2003. The bond issuance is to be managed by **Bahana Securities** (Indonesia), **Danareksa Sekuritas** (Indonesia), **ING Bank** (The Netherlands) and Mandiri Sekuritas, which is part of **Bank Mandiri** Indonesia).¹⁰⁴
- In July 2003 the IFC, which is part of the **World Bank** (Multilateral), agreed to provide a US\$ 14 million loan to Verdaine Investment Limited, an investment vehicle created in June 2000 to acquire, rehabilitate, and further develop Indonesian palm oil plantations. IFC also agreed to provide a US\$ 12 million loan to PT Sahabat Mewah dan Makmur, a 12,000 hectare oil palm plantation acquired by Verdaine in February 2003.¹⁰⁵

The financial market activity has not yet returned to the level of the mid-1990s but this study found that the number of financial services provided to oil palm plantation companies is on the rise again.

While global demand for oil palm products is invariable predicted to grow strongly in the medium- and long-term and Indonesia is still a low-cost producer, many investors deem high and stable returns on investments in the Indonesian oil palm plantation sector as guaranteed. As this study indicates that the risks associated with these investments are assessed only poorly by financial institutions, we expect that in the coming years financial institutions will provide a much larger number of financial services to the palm oil sector in Indonesia.

Chapter 5 Existing oil palm risk policies

5.1 The need for oil palm risk policies

Up to date, financial services to the oil palm plantation sector in Indonesia have primarily been reviewed against standard risk assessment parameters (such as availability of greenfields, labour force, expected yield, pests & diseases, price developments, legality of operations and national level political and economic risk assessments) and procedures. These risk assessments do not sufficiently prevent clients from causing negative impacts on tropical forest ecosystems and local communities. The financial sector is increasingly aware that such impacts can translate into serious risks. Although most financial institutions have yet to translate this into concrete risk policies, first steps have been made by a number of banks in the Netherlands.

5.2 Oil palm risk policies of the Dutch banks

Dutch banks play an important role in financing the Indonesian oil palm sector, as is outlined in the previous paragraphs. As a group, the Dutch banks rank second behind the Malaysian banks and provide 17.1% of foreign financing of the Indonesian oil palm plantation sector (see Table 4). Three Dutch banks rank among the top-10 of foreign financial institutions, as provided in Table 5. And Rabobank and ING Bank are among the banks involved in new lending activity recently (see paragraph 4.7).

The four biggest Dutch banks (ABN AMRO Bank, Rabobank, Fortis Bank and ING Bank) were the first foreign banks to adopt a set of principles which would apply to their *new* investments in the oil palm plantation sector. These commitments were made at the end of 2001 and early 2002 and followed a joint campaign of Friends of the Earth and Greenpeace in the Netherlands.¹⁰⁶

The NGOs had requested the banks that when providing significant financial services to oil palm plantation companies, they would assure that their clients should:

- Not be clearing tropical rainforest (High Conservation Value Forest);
- Not be involved in burning forestland;
- Respect the rights and wishes of local communities;
- Respect Indonesia's law and relevant international conventions.¹⁰⁷

Although there is some variation in the precise wording, the scope and implementation procedures, all four banks committed to these basic investment criteria after consultations with their Indonesian clients and other stakeholders.

This sector specific initiative of the Dutch banks has not yet been followed up by other financial institutions but an increasing number of financial institutions are beginning to review current approaches to risk, sustainability and multi-stakeholder issues. A prominent example are the Equator Principles adopted in June 2003 by ten major international banks (among which ABN AMRO Bank and Rabobank), which will guide their project finance activities.¹⁰⁸

In this light, it is useful to evaluate the experiences of the Dutch banks with applying their oil palm policies. In Chapter 6 a case study is presented which focuses on a recent US\$ 100 million loan by ING Bank to the Indonesian company PT Indofood Sukses Makmur, which operates a number of oil palm plantations. The case study examines if and how ING Bank has applied its oil palm risk policy and if the policy was effective in limiting risks for the banks as well as for other stakeholders involved.

Chapter 6 Case study ING Bank and Indofood

6.1 Description of the case

Against the background of the expected new investment flow into the Indonesian oil palm plantation sector, banks can expect their lending activities to be scrutinized in two ways: the policy content and the success of implementation.

This case study¹⁰⁹ aims to draw lessons from one particular financial transaction by a Dutch bank that was arranged *after* it had introduced new criteria and procedures for investments in Indonesia's oil palm industry. As such this case study goes beyond reviewing the need for such standards in general and evaluates the content and effectiveness of an existing oil palm risk policy.

The case study looked into a syndicated two-year US\$ 100 million loan arranged by ING Bank (The Netherlands) for PT Indofood Sukses Makmur in April 2002. The deal was described as the largest offshore loan financing for an Indonesian corporate since the start of the Asian financial crisis in 1997.¹¹⁰

In December 2002, ING Group stated that the transaction was subject to its new policy that its credit committee was convinced that Indofood had complied.¹¹¹

The case gained even greater relevance when it was announced that ING Bank would co-manage the issuance of five-year bonds worth US\$ 125 million for Indofood in the first week of June 2003.¹¹²



Figure 13. Burning peat swamp forest for oil palm plantations, habitat of the endangered Sumatran tiger and subject to land disputes with the Orang Sungai Kubu: the PT Gunung Mas Raya area (March 2003)

Indofood Sukses Makmur is a large company group that owns dozens of plantation estates in Riau Province. The case study focused on the management and expansion activities of a single oil palm subsidiary company, PT Gunung Mas Raya. Spread out over several blocks, this company operates a total concession area of 12,000 hectares in Rokan Hilir, northern Riau province (Sumatra).

6.2 ING's risk policy

In December 2001, a few months prior to the Indofood transaction, ING Bank adopted its voluntary policy on "sustainable deforestation / logging". ING's policy states that the Bank that its new criteria "affluently guarantee that its transactions will not lead to the destruction of tropical forest."¹¹³ The bank incorporated the guidelines for the credit commission in the credit conditions and guidebook. The bank stated that "it had thereby well adhered to the demand" (of Friends of the Earth Netherlands) "to implement the investment policy."¹¹⁴

In summary, the main criteria of ING's policy are (emphasis added):

- ING will not finance companies and projects that are guilty of illegal deforestation and / or burning of tropical rainforests (HCVF) for the development of palm oil plantations. This also applies to wood processing and sales.
- Financing is considered when:
 - there is no relationship between deforestation and plantation development (minimum 3 years);
 - compliance to relevant social, labour and other laws on deforestation and environment, as determined by the local government;
 - Sufficient respect for the rights of local communities.
- Conditions are laid down in a legal document with the client.
- Policy is not applicable to financing of holding companies as long as these are not involved in deforestation / or burning of tropical rainforest.

ING stated that the capital facility to Indofood was tested by ING against the policy even though at that time, the policy was not yet officially implemented (March 2002).¹¹⁵ Specifically for this transaction, ING stipulated that the company (Indofood) cannot use the loan for the purchase of new plantation land or acquisition of existing plantations.¹¹⁶

6.3 Risk prone activities by PT Gunung Mas Raya

6.3.1 The existing plantation area

The management of the previously developed oil palm plantation area did not appear to be subject to extraordinary risks with the notable exception of local peoples' claims over (part of) the plantation area. In environmental terms, the company introduced a number of Best Management Practises (BMPs) in its established plantations that bring about both environmental and economic benefits. These BMPs include full recycling of organic waste materials produced in the estates and by the CPO mill and Integrated Pest Control (IPC).

6.3.2 The expansion area

Since 1998-1999 PT Gunung Mas Raya embarked into an expansion program for two of its estates in the northern part of its concession area. Between 2000 and 2002, the company cleared approximately 500 hectares. The total area that the company appears to add to the existing estates is around 1,000 ha.

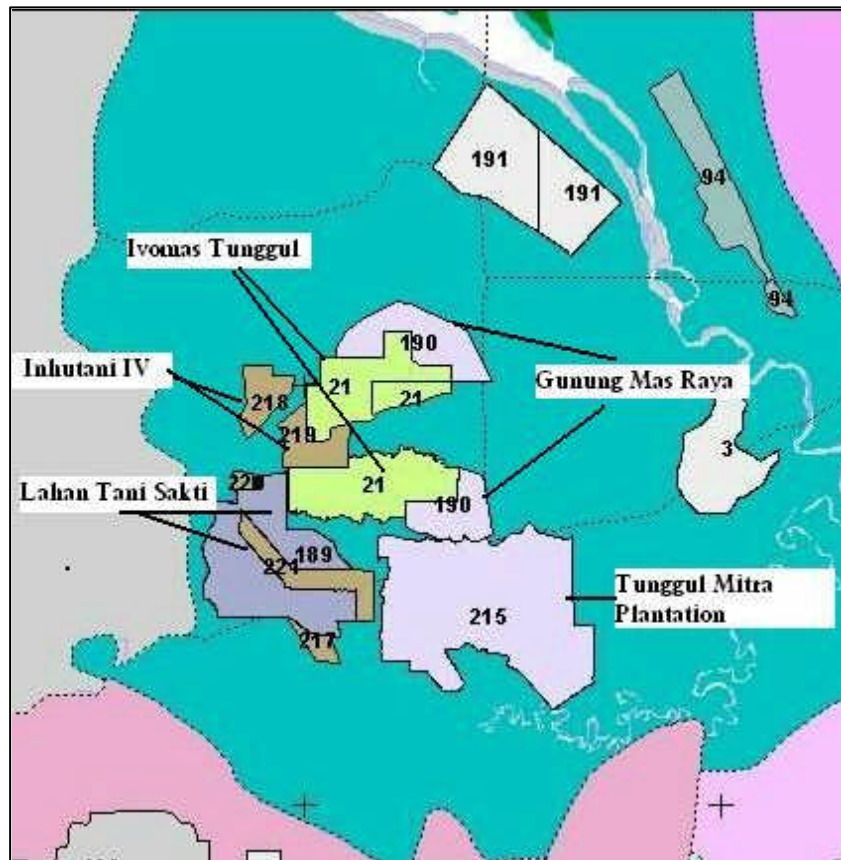


Figure 14. Oil palm concessions in Rokan Hilir, Riau (source: WWF Riau)

In summary, the case study identified the following risk prone activities (Table 7):

Table 7 Activities and risks at PT Gunung Mas Raya			
Activity	Type of risk for GMR/Indofood	Type of risk for financier	Comments
Possibly operating outside concession area	Compliance risk Reputation risk	Reputation risk	<ul style="list-style-type: none"> According to (government) concession maps overlaid with satellite images, the company appears to operate outside its concession area. The company claims the new plantation blocks are developed within its concession area and government maps may not be accurate.
Clearing of High Conservation Value Forest (HCVF)	Reputation risk	Reputation risk	<ul style="list-style-type: none"> Conversion of tiger (endangered, legally protected) habitat; impacts on watershed functions and land disputes. Forest block is limited in size and being logged-over.
Peat swamp conversion	Operational risk	Reputation risk Credit risk	<ul style="list-style-type: none"> Risk of flooding; higher cost of plantation development; dehydration of swamp forest; contribution to carbon emissions. Company addresses basic business risks.
Illegal logging	Possibly compliance risk	Reputation risk	<ul style="list-style-type: none"> Company provides road access to illegal loggers and middlemen and benefits from this activity. Company may not be able to stop these activities.

Activity	Type of risk for GMR/Indofood	Type of risk for financier	Comments
Burning	Compliance risk Operational risk	Reputation risk Credit risk	<ul style="list-style-type: none"> • Company clearly benefits from 'accidental' fires and makes no effort to extinguish fires. • Company denies using fire for land clearing.
Human-mammal Conflict	Operational risk	Reputation risk	<ul style="list-style-type: none"> • Viability of remaining tiger population is in question
Land disputes	Operational risk	Reputation risk Credit risk	<ul style="list-style-type: none"> • Local communities are frustrated with lack of interest shown by government and company to satisfactorily address their land claims. • Indigenous peoples' land claims are not (any longer) recognised by the Indonesian government.

PT Gunung Mas Raya and its mother company Indofood Sukses Makmur as well as ING Bank are exposed to various types of risks. We elaborate on these further below:

1. Overlay of the concession map and company maps with satellite images suggests that PT Gunung Mas Raya operates outside its concession boundaries (see the map below). However, government maps and data on the company's estate area and permits were hard to obtain and those available were contradictory. It is therefore not possible to claim with full certainty that the expansion activity is illegal. If the company expanded outside its concession area, this poses legal liability risk and reputation risk to Indofood and reputation risk to ING. If the company does operate within its concession boundaries, the company is still subject to risk as a result of inconsistency in government mapping.
2. Although a full stakeholder consultation process would be required, it is likely that the peat swamp forest cleared by PT Gunung Mas Raya can be classified as High Conservation Value Forest (HCVF) mainly because:
 - The forest contains globally, regionally or nationally significant concentrations of biodiversity values (e.g. endemism, endangered species, and refugia).
 - The forest provides basic services of nature in critical situations (e.g. watershed protection, erosion control).
 - The forest is critical to local communities' traditional cultural identity (areas of cultural, ecological, economic or religious significance identified in co-operation with such local communities).

Conversion of HCVF exposes both Indofood and ING to reputation risk.

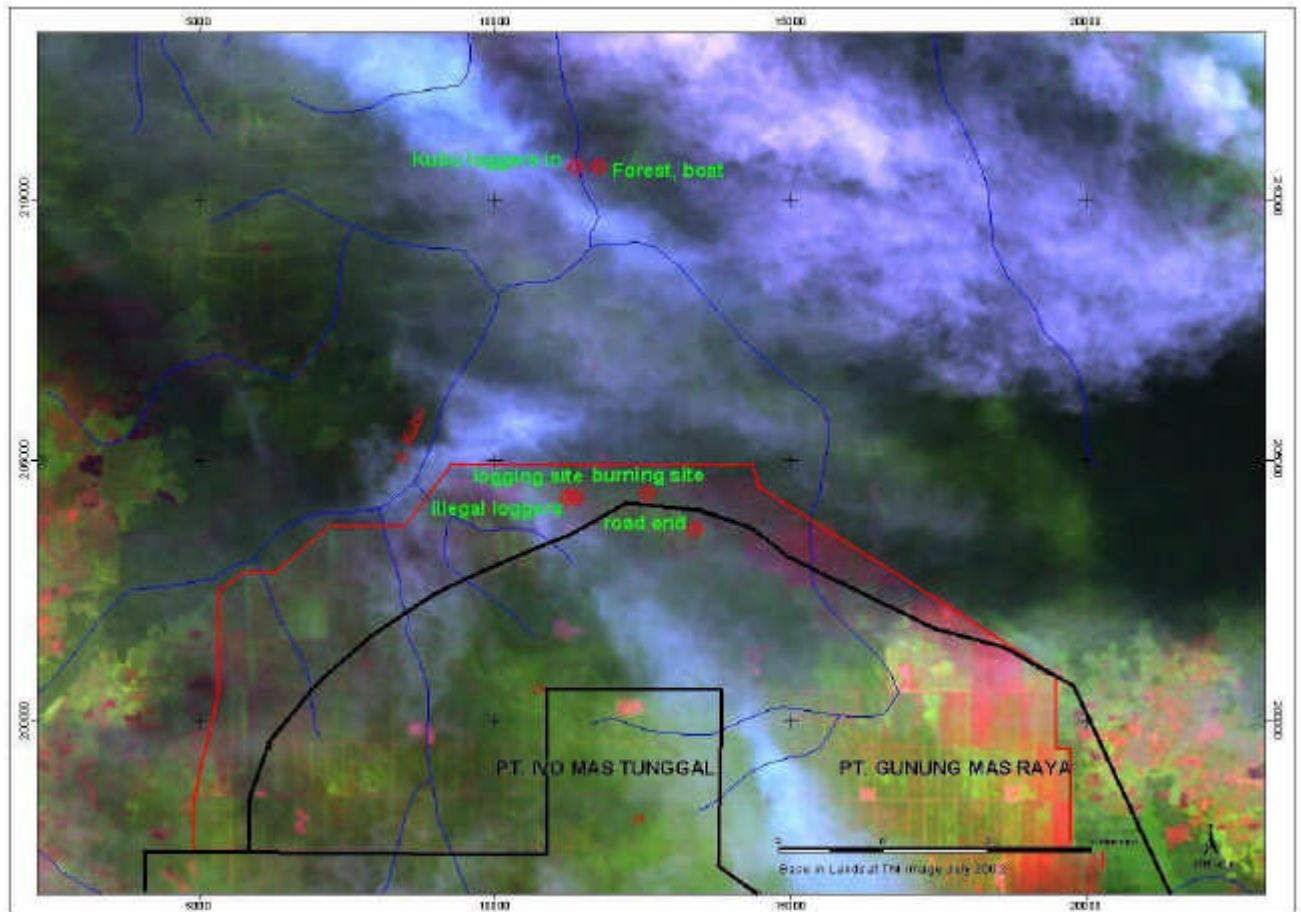


Figure 15. The PT Gunung Mas Raya concession and land use cover in July 2002.

Red line: plantation area according to PT Gunung Mas Raya
 Black line: concession area according to the Riau Department of Forestry and Agriculture.
 Pink areas represent recently disturbed soils, light green agriculture and estate crops and dark green peat swamp forest.¹¹⁷

3. PT Gunung Mas Raya converted ecologically sensitive peat swamp forest. Whereas Indofood appears to address the medium-term business risks associated with peat swamp conversion, overall doubt remains about the sustainability of developing the oil palm plantations in such habitat if ecological externalities are considered in the equation. Peat swamp conversion represents operational risks to Indofood and reputation risk and credit risk to ING.
4. Illegal loggers are active in the forest area adjacent to the PT Gunung Mas Raya concession area. These loggers make use of the company's road access. Logging activities and forest conversion for oil palm development are intimately connected to the mutual benefit of the loggers and the plantation company. Illegal logging is a sensitive issue in the international policy and market debate on forests that investors would not want to be associated with this. The fantastically complex system of licensing makes it very difficult for ING to judge the legality of its clients' operations but the bank faces reputation risk whereas the plantation company is exposed to potential legal liability.

5. The recently cleared forest area was visibly burning during the field investigation. Even when these fires were accidental (which appears unlikely) and even though the company took some measures to avoid spread of fire in the plantation estate, PT Gunung Mas Raya is legally required to put out any fires in its area. Failure to do so violates Indonesia's Environmental Management Act No. 23, thus representing legal liability risk, which may affect the company's ability to pay back its debt (credit risk). Furthermore, there is a possibility that the fires would destroy the readily planted area that poses operational risk. The fires also expose Indofood and ING to considerable reputation risk.
6. Since early 2003, a Sumatran tiger frequented the plantation estate after heavy flooding in the forest area. Human-mammal conflicts can pose significant problems to estate managers, be it in the form of lack of safe working conditions to estate personnel (tigers) or economic damage to recently planted oil palms (elephants). Human-mammal conflicts represent operational risks to the plantation company whereas the conversion of tiger habitat furthermore poses a significant reputation risk to Indofood and ING.
7. Part of the PT Gunung Mas Raya estates is subject to land tenure claims from the indigenous Orang Sungai Kubu communities. It appears that commitments have been made by some government officials to address the land ownership and usufruct rights conflicts in the area. However, if this issue is not adequately addressed, the smouldering conflict could potentially lead to violent protests and/or land reclaiming, posing operational risk to Indofood. This poses significant credit and reputation risk to the company and its investors.

6.4 The effectiveness of ING's policy

This case study found that ING's new guidelines and procedures did not prevent its client's daughter company from expanding its estates in a forested area (most likely HCVF). Furthermore, the legality of some of PT Gunung Mas Raya's activities is in question and there are no indications that the company addresses the wishes of local communities. The case study revealed a number of weaknesses in the content of ING's policy and in the way it is implemented:¹¹⁸

1. **Narrow scope:** Despite the use of popular wording (HCVF, illegal logging, rights of local communities), ING ultimately does not require its clients to perform beyond legal compliance. The bank would still finance the legal conversion of HCVF. This may be consistent with the Bank's overall Business Principles but not with the criteria proposed by the Dutch NGOs (see 5.2; legal compliance is only one criterion). Furthermore, legal compliance does not guarantee low risk in the Indonesian context.
2. **Unclear:** ING's policy is unclear with regards to its stipulations on holding companies, which are exempted unless they are involved in deforestation or burning. Holding companies are never involved in field level activities. It is also unclear how ING Bank assesses whether or not holding companies' daughter companies are involved in deforestation or burning.¹¹⁹ The policy is also unclear with regard to the reference to the World Bank Forest Policy i.e. ING does not specify what elements of this policy apply.

3. **Loan conditions insufficiently strict:** ING Bank tied only one condition to the working capital facility: It had specified that the facility and could "absolutely not be used for the purchase of plantations or land for cultivation". If Indofood would not adhere to this condition, this could be considered an 'event of default' which could then lead ING to prematurely call the loan.¹²⁰ This condition is ineffective as it ignores the fact that PT Indofood Sukses Makmur and its subsidiaries are still in the process of land clearing within existing concessions.¹²¹
The financing at the holding company level furthermore allows for internal re-budgeting by the client. PT Gunung Mas Raya has not attracted new loans since 1996 and most likely depends on group capital to implement its expansion program. The investment required for the expansion activities (including purchasing or renting of land clearing equipment) could easily have been released through internal re-budgeting.
4. **Inadequate due diligence:** ING Bank's risk assessment prior to its decision to arrange the US\$ 100 million working capital facility has not been conducted in a comprehensive way. PT Gunung Mas Raya's expansion program has been ongoing since 1998 and it is reasonable to say that ING Bank should have known about it. It may be that PT Indofood Sukses Makmur failed to provide all relevant information to the bank. This means that ING Bank's risk assessment was inadequate.
5. **Inconsistent transparency:** ING Bank stated that the April 2002 loan to PT Indofood Sukses Makmur complied with the bank's oil palm investment criteria while the findings of this case study suggest it did not. If ING Bank was aware of Indofood's expansion activities, it withheld this information from Friends of the Earth Netherlands. That decision may have been based on the principle of confidentiality between the bank and its client but then it could also be argued that ING breached this same principle by communicating that it believed its client did adhere to the policy.

6.5 Event of default?

The question whether or not Indofood is in default with ING's policy can be answered in two different ways.

- ING may argue that the case involved a transaction with a holding company (which is excluded from the policy) and that Gunung Mas Raya did not purchase new plantations or land for cultivation. Therefore, Indofood would not be in default. Although the case could possibly be interpreted in such manner, such narrow argumentation would reveal a serious lack of commitment on the Bank's end to address the NGO's concerns and to take investment risks into account.
- An alternative broader interpretation view would be to say that Indofood is in default with the overall objectives of the ING policy because the company contributes to the destruction of tropical rainforest, possibly illegally on various accounts. To be fair, this interpretation implies foremost that ING's specific loan conditions are 'in default' with the overall policy objective.

6.6 Indofood's planned expansion

Relative to the overall size and scope of Indofood's operations, the expansion activities of PT Gunung Mas Raya case are of fairly limited scale. However, the PT Gunung Mas Raya case is only one in the group's estates, which are scattered all over Riau. Although some BMP's are implemented in these estates there are indications that other Indofood subsidiaries are also entangled in land disputes with local communities and illegal burning and logging.

Moreover, the PT Gunung Mas Raya case provides lessons that are relevant in view of Indofood's future expansion. It is estimated that the company group may require an additional 160,000-210,000 ha to supply the group's total CPO demand. If the group manages to acquire new plantations or concessions (which may be illegal if the group's area under non-listed holding companies exceeds 100,000 ha in Indonesia in total), it will thereby face the challenge of addressing the various issues and related risks in a much bigger area.

6.7 The need for a comprehensive management plan

One of the key problems that ING's risk assessors and its credit committee face is the lack of reference framework. Neither Indofood nor First Pacific has publicly available plantation development and management policy that addresses relevant environmental and social impacts of their operations.¹²² The lack of an explicit policy hinders the company's investors and its buyers to fully assess and value the risks involved when providing financial services to the company. To enable such assessment, Indofood would require a comprehensive plantation management and development plan that addresses both agricultural risks and potential ecological and social externalities.

With a policy in place, Indofood would be able to significantly increase its understanding of its impact on other stakeholder interests and seek, where possible, win-win solutions. Such policy would, at least in theory, make it easier for Indofood to attract foreign capital and access certain markets and it would be better prepared to face the issues that would arise from the possible acquisition of new plantation areas. Investors and buyers would be in a better position to reliably communicate externally about their client/supplier's performance while nature conservation interests and local peoples' needs, rights and wishes could be better accommodated.

6.8 Conclusions

The following overall lessons are drawn from this case study:

1. Financial services provided to the oil palm plantation sector pose significant risks to investors, particularly because of the strong social and environmental impacts of oil palm plantation development. Even financial services to reputable oil palm plantations companies are exposed to such risks at present conditions.
2. Criteria and procedures to value and address risks related to financial services provided to the oil palm plantation sector require thorough consultation, implementation and monitoring by the financial institution.
3. Conditions for financial services should be formulated precisely, especially when financial services are provided at the group level. Policies that do not require performance beyond legal compliance do not prevent social conflicts or the conversion of High Conservation Value Forests and hence do not guarantee low risk.
4. After contracts have been sealed, monitoring of compliance is required. Plantation development and management plans and work plans, which take the financial institution's criteria into account, will make it easier to do this. Such plans would also allow for gradual improvement towards performance beyond legal compliance.

Transparent reporting is hindered by confidentiality agreements between financial institutions and their clients. Such agreements draw heavily on outsiders' trust, especially when public statements are made which can not be verified by third parties.

Chapter 7 Management of oil palm related risks

7.1 Introduction

Financial institutions cannot ignore the externalities generated by the activities of their clients in the oil palm sector. Based on the risk analysis in Chapter 3 and the case study in Chapter 6 this chapter formulates recommendations for financial institutions to strengthen their risk management strategies.

For a risk management strategy to be effective in the long-term as well as responsive to public expectations, it should encompass at least the following four elements:

- Increasing the internal risk awareness;
- Formulating and implementing a risk policy;
- Stimulating an oil palm sector development plan;
- Stimulating plantation company development and management plans.

We will elaborate on these four elements in the next paragraphs.

7.2 Risk awareness

Providing financial services to Indonesian oil palm plantation companies incurs high risks to financial institutions, *credit or price risks* as well as *reputation risks* and *compliance risks*. Financial institutions should therefore consciously review and reconsider their involvement in this sector in view of these risks. If they decide to remain or become active in the sector, it would be advisable to revise standard risk assessment procedures such that they take the range of risks identified in Chapter 3 into account in a structured manner. Knowledge of relevant issues as well risk awareness should be fostered for all employees dealing with the oil palm plantation sector through internal education and training.

7.3 Risk policy

A risk policy is needed to make sure that no financial services are provided to clients whose activities pose unacceptable risks for the financial institution. To identify and limit the risks associated with financial services provided to the Indonesian oil palm plantation sector in an effective way, financial institutions should:

- Consultation with other stakeholders in the formulation of the risk policy
- Clear definition of the policy scope, taking into account the variety of financial services provided to a variety of activities in the full palm oil chain-of-custody
- Guidelines for impact assessments before financing
- Tight conditions in loan and other agreements (legal compliance is insufficient!)
- Client reporting and periodic monitoring
- Transparent reporting of results to internal and external stakeholders.

As regards to the performance level required from clients, of course much depends on the risk that an investor is willing to take. It should be stressed, however, that requiring compliance to Indonesian national and/or regional laws does not sufficiently protect investors from many of the risks identified in this report: legal compliance does not guarantee low risk!

Moreover, for financial institutions it is difficult to oversee their clients' compliance to the Indonesian web of laws, decrees and other regulations whereas illegal practises can be

legalised through corruption. Government data may in some cases be so inconsistent and unreliable that ultimately it is impossible to determine the legality or illegality of a certain activity. Although inconsistency provides some level of protection to investors as well (charges may be reversed), there is obviously a reputation risk involved.

The vacuum in Indonesia's regulatory system as well as in international law requires investors to define specific performance standards that adequately avert unnecessary risk and avoid the creation of ecological, social and economic externalities. Similar requirements are posed by a variety of internationally agreed conventions, such as the ILO-standards, and voluntary codes of conduct, such as the OECD Guidelines for Multinational Enterprises and the UNEP-Finance Initiatives.

A practical but comprehensive approach to these issues will be suggested in the forthcoming WWF-Friends of the Earth Model Forest Policy, which draws from and builds on existing standards such as the "Forests and Plantations Policy" developed by ABN AMRO Bank (The Netherlands) and a similar policy of Rabobank (The Netherlands).

7.4 Oil palm sector development plan

Financial institutions willing to stay involved in the oil palm sector should consider working with the Indonesian government, nature conservation organizations and representatives of local communities and the labour movement to develop a plan that addresses sector-wide issues. Such a plan would aim to reduce key risks at the sector level and address at least the following issues in an integrated manner:

- legal and policy analysis to determine exactly which regulations are applicable
- mapping of areas in which further development of the oil palm sector is (not) allowed or encouraged
- classification of types of land use which can be converted into oil palm plantations
- framework to settle disputes with local communities
- conservation and restoration plan for oil palm related damage done to HCVF (High Conservation Value Forests)
- action plan to further develop oil palm related infrastructure and marketing
- organisation of independent monitoring and transparency regarding the development of the oil palm plantation sector as a whole

7.5 Company level plantation development and management plans

Financial institutions should require that their clients develop detailed plantation development and management plans that take into account the risk areas defined in the risk policies of financial institutions. Apart from standard risk assessment parameters, such a plan would minimally elaborate on the following items in an integrated manner (to be based on specified norms and indicators):

- maps and list of plantation companies and estates to which the plan applies
- names of directors and personal background
- list of permits required and secured (per estate licenses required and secured)
- description of the areas (communities, biodiversity and land use present prior to oil palm development)
- (un)suitability of the areas (soils, steepness, hydrology, rainfall, flood risk)
- fire risks (land clearing techniques, fire fighting equipment, community relations)
- efforts to preserve and restore High Conservation Value Forest (including management of human-wildlife conflicts, riverine conservation areas)
- impacts on local communities' livelihoods (settlement of outstanding disputes, grievance procedures)

- labour working conditions (labour force, salaries, health & safety, secondary facilities, freedom to unionize, grievance procedures)
- relationship with smallholders (loan conditions, training and other support provided, grievance procedures)
- pest and nutrients management (type and volumes of agro-chemical inputs per stage of development, impacts on workers and environment)
- plantation environmental impacts (water and air, in and outside the plantation)
- processing mill environmental impacts (impact of Palm Oil Mill Effluent on water, soil and air quality in and outside the plantation, energy sources)
- research and development efforts
- implementation process, independent monitoring and transparency (internal and external communication manager, mechanism for adjustment, internal and external assessors and reporting).

Chapter 8 Options for further research

This final chapter briefly lists the main options for further research:

- Even though we have found that legal compliance *per se* does not guarantee a low level of risk, a more systematic review of relevant environmental and social legislation applying to oil palm plantations (and their investors) in Indonesia would help lay a bottom line for risk assessment.¹²³
- Too little information is presently available on if and how financial institutions have insured their credits, how this translates in a reduction of the risks identified and who are involved (for example government bodies, ECAs and insurance companies).¹²⁴
- The oil palm sector's growth shares many similarities with the expansion (and retraction) booms experienced by the coffee, cacao and sugar sectors. A comparison with the developments in these sectors and their impacts on the environment, workers and investments could provide greater insight in the future development of the oil palm sector.
- The financing of oil palm companies involves a very large number of different financial institutions, mostly commercial banks. It is hard to see how hundreds of financial institutions could be motivated to adopt rather labour intensive risk policies without government regulation.
Options for government regulation in Indonesia and other production countries could be researched. In the Philippines for instance, depending on the project the proponent may be required to put up an Environmental Guarantee Fund to cover payment for environmental damages (including compensation to affected parties) resulting from project implementation. The proponent could therefore lose this money, which could affect its financial performance.¹²⁵
But options for financial regulation in the home countries of the financial institutions should also be researched. While providing of financial services to Indonesian oil palm plantation companies obviously is related to a large number of risks, government regulation in the home countries does not seem to be able to force financial institutions to deal with them in a comprehensive way.
- Risk policies tend to be defensive rather than offensive. This implies that these policies are not adequate tools to promote truly sustainable management of oil palm plantations. When a widely accepted definition of sustainable oil palm management practices is completed (e.g. in the framework of the *Roundtable on sustainable palm oil* ¹²⁶) it would be appropriate to assess how adoption of these management practices would translate into reduced risk.
- Applying risk policies to the financing of holding companies poses special challenges for financial institutions because the activities of the whole group need to be assessed. While at the one hand credit risk and price risk are obviously reduced, the financial institution at the other hand gets exposed to compliance and reputation risk related to all the subsidiaries of the holding company.
Similarly, financing trading companies raises questions about how to assess the client's suppliers. Some form of chain-of-custody assessment is required.

Annex 1 Notes

- 1 See for further details "Wakker, E. and J.W. van Gelder, 2003. Case Study PT Gunung Mas Raya. Assessment of investment risks associated with environmental and social issues related to an Indofood Sukses Makmur subsidiary in Rokan Hilir, Riau (Indonesia). Report prepared for WWF. AIDEnvironment / Profundo.
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