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**CIFOR** Occasional Paper No. 44

# Fighting forest crime and promoting prudent banking for sustainable forest management

The anti money laundering approach

Bambang Setiono and Yunus Husein

## Donors

The Center for International Forestry Research (CIFOR) receives its major funding from governments, international development organizations, private foundations and regional organizations. In 2004, CIFOR received financial support from Australia, African Wildlife Foundation (AWF), Asian Development Bank (ADB), Belgium, Brazil, Canada, Carrefour, China, CIRAD, Conservation International Foundation (CIF), European Commission, Finland, Food and Agriculture Organization of the United Nations (FAO), Ford Foundation, France, German Agency for Technical Cooperation (GTZ), German Federal Ministry for Economic Cooperation and Development (BMZ), Indonesia, International Development Research Centre (IDRC), International Fund for Agricultural Development (IFAD), Innovative Resource Management (IRM), International Tropical Timber Organization (ITTO), Italy, Japan, Korea, Netherlands, Norway, Organisation Africaine du Bois (OAB), Overseas Development Institute (ODI), Peruvian Institute for Natural Renewable Resources (INRENA), Philippines, Sweden, Swedish University of Agricultural Sciences (SLU), Switzerland, The Overbrook Foundation, The Nature Conservancy (TNC), Tropical Forest Foundation, United States, United Kingdom, United Nations Environment Programme (UNEP), Waseda University, World Bank, World Resources Institute (WRI) and World Wide Fund for Nature (WWF).

**ISSN 0854-9818**

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Cover photos by Carol Colfer, Romain Pirard, Petrus Gunarso,  
Hari Priyadi, Carmen Garcia, Rona Dennis, Gideon Suharyanto, Catur Wahyu

Published by  
Center for International Forestry Research  
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## Abbreviations and acronyms

<b>ADB</b>	Asian Development Bank
<b>AG</b>	Attorney General
<b>AML</b>	anti money laundering
<b>APG</b>	Asia Pacific Group (on money laundering)
<b>AWF</b>	African Wildlife Foundation
<b>BMZ</b>	German Federal Ministry for Economic Cooperation and Development
<b>BPKP</b>	<i>Badan Pengawasan Keuangan dan Pembangunan</i> (Indonesian Government internal auditor)
<b>CASIO</b>	<i>dikasih orang</i> ('provided by somebody else')
<b>CDD</b>	customer due diligence
<b>CGI</b>	The Consultative Group on Indonesia
<b>CIF</b>	Conservation International Foundation
<b>CIFOR</b>	Center for International Forestry Research
<b>CIRAD</b>	<i>Centre de coopération internationale en recherche agronomique pour le développement</i> (France)
<b>CTR</b>	cash transaction report(s)
<b>DFID</b>	Department for International Development (UK)
<b>DPNP</b>	<i>Direktorat Penelitian dan Pengaturan Perbankan</i> (Directorate of Banking Research and Regulation)
<b>DPR</b>	<i>Dewan Perwakilan Rakyat</i> (Indonesian Parliament)
<b>DR</b>	<i>Dana Reboisasi</i> (reforestation funds)
<b>eds.</b>	editors
<b>EIA</b>	Environmental Investigation Agency
<b>EU</b>	European Union
<b>FAO</b>	Food and Agriculture Organization of the United Nations
<b>FATF</b>	Financial Action Task Force on Money Laundering
<b>Fig.</b>	Figure
<b>FIU</b>	Financial Intelligence Unit
<b>FLEG</b>	Forest Law Enforcement and Governance
<b>FSP</b>	financial service provider
<b>GTZ</b>	German Agency for Technical Cooperation
<b>ha</b>	hectare
<b>HPH</b>	<i>Hak Pengusahaan Hutan</i> (the forest concessionary right)
<b>IBRA</b>	Indonesian Bank Restructuring Agency
<b>IDRC</b>	International Development Research Centre
<b>i.e.</b>	that is
<b>IFAD</b>	International Fund for Agricultural Development
<b>IMF</b>	International Monetary Fund
<b>INRENA</b>	Peruvian Institute for Natural Renewable Resources
<b>INTRAC</b>	Indonesian Financial Transaction Report and Analysis Center (PPATK)
<b>IRM</b>	Innovative Resource Management
<b>ISSN</b>	International Standard Serial Number
<b>ITTO</b>	International Tropical Timber Organization

KPK	<i>Komisi Pemberantasan Korupsi</i> (Indonesian Corruption Eradication Commission)
KUHAP	<i>Kitab Undang-Undang Hukum Acara Pidana</i> (Criminal Procedure Law)
KYC	Know Your Customer
m	metres
MLA	mutual legal assistance
MOU	Memorandum of Understanding
NCCT	Non Cooperative Countries and Territories (FATF)
NGO	non-governmental organisation
No.	number
OAB	Organisation Africaine du Bois
ODI	Overseas Development Institute (UK)
p.	page(s)
PBI	<i>Peraturan Bank Indonesia</i> (Bank Indonesia Regulation)
PDR	People's Democratic Republic (Lao)
PP	<i>Peraturan Pemerintah</i> (Government Regulation)
PPATK	<i>Pusat Pelaporan dan Analisis Transaksi Keuangan</i> (INTRAC, the Indonesian Financial Intelligence Unit)
PSDH	<i>Provisi Sumber Daya Hutan</i> (forestry taxes)
PTIK	<i>Perguruan Tinggi Ilmu Kepolisian</i> (Indonesian Police Science Institute)
Rp.	rupiah (Indonesian currency)
SLU	Swedish University of Agricultural Sciences
SKSHH	<i>Surat Keterangan Sahnya Hasil Hutan</i> (timber transportation documents)
STR	suspicious transaction report(s)
TNC	The Nature Conservancy
TNI	<i>Tentara Nasional Indonesia</i> (Indonesian Army)
TNKS	<i>Taman Nasional Kerinci Sebelat</i> (National Park Kerinci Sebelat)
UK	United Kingdom
UNEP	United Nations Environment Programme
US	United States (of America)
US\$	United States dollars
USA	United States of America
WRI	World Resources Institute
WWF	World Wide Fund for Nature

## Acknowledgements

The authors greatly appreciate the financial support of the DFID Multi-stakeholder Forestry Programme, as well as the comments of David Kaimowitz, Doris Capistrano, Bambang Setiawan, Garda T. Paripurna, Djoko Kurnianto, Ivan Yustiavandana, and I Gde Yadnya Kusuma. Special thanks to Nathan Schenkman for help in editing the paper.

## Abstract

*If illegal logging was a crime involving only poor forest-dependent people, truck drivers or underpaid forest rangers, it would not be difficult to stop. With involvement of financiers of illegal logging, known as cukong, legal timber industries, and government officers, illegal logging becomes a complex problem not only for Indonesia, but also for the international forestry community. The current forestry law enforcement approach fails to capture the masterminds of illegal logging. However, the money laundering law enforcement approach which 'follows the money' provides an important option to deal with the masterminds of illegal logging. This new approach requires banks and other financial service providers to be more active and prudent in dealing with financial transactions related to their customers. Bank customers could include financiers of illegal logging, timber industries, law enforcement and government officers. Overall, proper implementation of the anti money laundering regime should provide opportunities for promoting prudent banking practices and sustainable forest management, and for curtailing forestry crimes.*

## 1. Introduction

Both local and international banks have financed forest-based industries in Indonesia. Before the Indonesian financial crisis of 1997, Indonesian local banks provided more than US\$4 billion in loans to the Indonesian timber industries. The timber industries also received more than US\$7 billion in short-term loans and long-term financing from international financial institutions (Setiono in press). All of the top ten local banks in Indonesia financed the timber industries. These banks included the former state banks that are now merged into Bank Mandiri, Bank Danamon, Bank Umum National (now closed by the government) and Bank International Indonesia. International institutions, Credit Suisse First Boston, ING Bank N.V. and Credit Lyonnais of Singapore have also financed timber extraction in Indonesia (Setiono in press). Besides these, by 1999 four Dutch banks—ABN-AMRO Bank, ING Bank, Rabobank and MeesPierson—had invested in 740,000 ha of oil palm plantations in Indonesia (Wakker *et al.* 2000). Since the early 1990s, private international financial institutions have also played a critical role in facilitating the rapid expansion of the Indonesian pulp and paper industries. These institutions were responsible for channelling over US\$12 billion to the industries by 1999 (Barr 2001).

With extensive illegal logging activities throughout the Indonesian archipelago and shortages of legal wood supply in the region (including China and Japan), forest-based industries in Asia are taking advantage of Indonesia's illegal log trade. Institutions providing financial assistance to these companies are required, under the anti money laundering laws of their respective countries, to report transactions conducted by the companies or their trading partners using

resources that are not from legal businesses. Under these law, banks and other financial institutions should know their customers and deny any bank facilities to any that are not able to show their true identity and the sources of their income.

Fighting forestry crimes has become a growing international concern since about 2000.<sup>1</sup> Several wood-producing countries in Asia, Africa and Latin America have multilateral or bilateral programmes with wood-consuming countries to combat forestry crimes. On 13 September 2001, the governments of Cambodia, China, Indonesia, Lao PDR, Papua New Guinea, the Philippines and Thailand signed the Bali Ministerial Declaration on Forest Law Enforcement and Governance. This declaration calls for immediate action to intensify national efforts and to strengthen bilateral, regional and multilateral collaboration to address violations of forest law and forest crime (particularly illegal logging), associated illegal trade and corruption, and their negative effects on the rule of law. The Bali initiative was followed by other international initiatives as follows:

- US President's Initiative on Illegal Logging (February 2002)
- Norway-Indonesia Letter of Intent (August 2002)
- China-Indonesia Memorandum of Understanding (MOU) (December 2002)
- EU Action Plan for Forest Law Enforcement Governance and Trade (May 2003)
- Japan-Indonesia MOU (June 2003)
- Africa FLEG Ministerial Declaration (October 2003)
- China-UK Letter of Intent (May 2004)
- Asia Pacific Group on money laundering Typology Workshop 2004 in Brunei: Indonesia to develop the typology of illegal logging.



Each country involved in these international programmes can use other members' anti money laundering regimes to help combat forestry crimes. The use of the anti money laundering regimes to combat forestry crimes and promote sustainable forest management should be encouraged by the Financial Action Task Force on Money Laundering (FATF). In the 1989 G-7 Summit in Paris, the FATF was created to guide and promote national and international policies to combat money laundering and terrorist financing. The FATF is a multidisciplinary body, which meets several times each year and brings together legal, financial and law enforcement experts. In addition to monitoring the status and progress of member countries, the FATF investigates money laundering, terrorist financing techniques and counter measures, and promotes the creation of appropriate global measures. The FATF has issued *forty recommendations* and *eight special recommendations* on counter measures against money laundering and terrorist financing. These recommendations are intended for adoption by member countries, as well as other countries around the world.

This paper is organised as follows. The next section describes the interaction between banks and forests, followed by a discussion of the role of forest-based industries in the economy and the problems faced by these industries. The third section assesses the financial risks that banks assume by investing in forest-based industries or projects and the sources of these risks. The fourth section explains various types of money laundering related to forestry crimes, especially illegal logging, and discusses the flow of money and the role of the banks in concealing the proceeds of forestry crimes. The fifth section elaborates on the concept of, and challenges in, using the anti money laundering regime to create prudent banks and sustainable forest-based industries, and to curtail forestry crimes. The final section summarises the paper and provides recommendations.

## 2. Banks, forests and industries

### 2.1. Banks and forests

Banks and other financial institutions are major forces in facilitating the use of forest resources. They are important players in both the forestry sector and the broader economy. They help to finance trade and investment in sectors dependent on forest resources. These sectors include the timber and agricultural

(i.e. oil palm and soya bean) industries, as well as the oil, gas and mining industries. The timber industries cut the timber from natural forests and timber plantations to produce wood-based products such as plywood and pulp. The non-timber industries sometimes clear forests to gain access to the land, in order to extract oil, gas, coal and diamonds, or to grow oil palm trees or other tree crops. In this paper, all industries that extract forests for timber or land will be referred to as forest-based industries.

Without bank financing, large-scale forest exploitation projects would not be commercially feasible. Forest-based projects require capital not only to buy equipment and machinery, but also to pay the costs of harvesting the timber, processing it, and transporting the finished products to the markets. Banks also serve as important players in the trade of products produced by forest-based industries. They provide (among other things) credit for trade, letters of credit to guarantee payment of trade, facilities for discounted trade credit and other short-term financing instruments. Without bank financing, forest-based industries could not work their way into the equity and bond markets that allow them access to long-term financing.

Prudent bank policies on financing forest-based projects and industries should result in strong, sound banks, efficient forest-based industries, and sustainable forests. A prudent bank would not finance forest-based projects involved in crimes such as illegal logging or the pollution of water and air by dangerous waste. This paper will refer to projects and industries of this nature as high-risk forest-based projects and industries.

The financial risks faced by banks are default or credit risk, legal risk and reputation risk; all three of these can cause banks loss of money. Forest-based industries involved in breaking forestry and environment regulations are more likely to break or avoid banking laws than those that abide by the regulations. They will not be dependable bank customers when it comes to repaying their financial obligations.

Banks involved in financing high-risk forest-based industries face legal risks resulting from banking regulations and the anti money laundering law. Banking regulations require that banks know their customers, manage risk, and avoid financing projects harmful to the environment. Failure to adhere to these regulations can result in banks losing their licences and facing administrative sanctions and even criminal charges. The Indonesian anti money laundering law is a landmark legislation

that forms the basis for holding banks and other financial institutions responsible for transactions involving forestry and environmental crimes. In October 2003, the Indonesian Government enacted Law No. 25/2003 to amend Law No. 15/2002. Among the changes under this new law was the categorisation of forestry and environmental crimes as new predicate offences. Consequently, banks involved in financing high-risk forest-based projects could lose not just their reputations as responsible banks but also their businesses.

Having banks curtail financing for high-risk forest-based projects is important to anti money laundering policy. However, it is the prosecution of the financial backers of illegal logging, the 'intellectual actors' behind it, which forms the keystone of the regime. These intellectual actors could undermine all the government programmes for creating prudent banks and sustainable industries by repaying the loans they received from banks using proceeds from illegal logging. Indonesia's economic recovery lies not just in revitalising its ailing banks and bankrupt industries, but also in holding them accountable for obtaining sources of sustainable timber. In the case of forest-based industries, healthy banks and efficient industries cannot be achieved without sustainable forests. Forests and natural-resource-based industries are still key components of the Indonesian economy. Poor governance in managing natural resources allows intellectual actors to exploit natural resources in an unsustainable and illegal manner. These criminal acts in turn lead banks and forest-based industries to engage in money laundering, by reporting and financing illegal forest-based transactions as if they were legitimate.

## 2.2. Unsustainable forest-based industry

Forest-based industries are a source of important economic activities for Indonesia; however, they are being operated in a manner that is unsustainable. The timber industry provides between US\$6.1 billion and US\$9 billion in exports and ranks third among the non-oil, non-gas exports. When the Indonesian Bank Restructuring Agency (IBRA) received non-performing loans from Indonesian banks under the government bank recapitalising programme, more than 25% of those loans were linked to timber industries, including the pulp and paper industry. These loans included loans provided to non-forestry sectors of the forestry conglomerates. Forest conglomerates represented the largest sector

receiving loans from Indonesian banks (IBRA 1998). Unfortunately, few of the economic profits received by the industries were invested back into the forests or the livelihoods of the local communities, or used for updating out-of-date machinery and plants. Sustainable forests, efficient machinery, equipment, technology and capable human resources are the keys elements for forest-based industries to compete consistently and effectively in the global markets.

Under current forest management, forest industries pose serious threats to natural forests, local livelihoods, banks and government budget. The central government's introduction of large forest concessionaires (HPH companies) has resulted in extensive exploitation of forest resources and the marginalisation of local communities (Nuridin 2002). The introduction of HPH was designed to promote exploitation of the forest resources to significantly increase government non-oil revenues. Forestry industries have added to the problems through their numerous unsustainable policies. First, they have failed to develop timber plantations, while at the same time rapidly expanding their mill capacities. Conservatively, these forestry mills (pulp, plywood and sawn-wood) require more than 60 million m<sup>3</sup> of wood, while natural forests, timber plantations and local community forests can legally and sustainably only produce around 20 million m<sup>3</sup> of wood (Barr 2001). This overcapacity problem exacerbates illegal logging problems. Coupled with weak law enforcement, a huge demand by forestry industries increases the incentive for illegal loggers to log in protected areas and national parks, as well as in HPH forest areas. Besides this, the forestry industry (other than the pulp industry) uses old machines that generate a lot of waste in processing logs into various wood products (ITTO 2001). Second, when forest industries have expanded their HPH areas and forestry mills, they have often taken over forestland that communities use to derive earnings—creating social conflicts between timber companies and local communities. Third, forestry conglomerates have huge debts with both domestic and international financial institutions that they have failed to repay. Some of the forestry conglomerates have their own banks, which have violated banking regulations and caused the Indonesian Government to spend more than US\$3 billion to bail them out of bankruptcy (Setiono in press). They have also failed to properly pay reforestation funds (DR) and forestry taxes (PSDH) to the government. When they have

borrowed DR for timber plantations, they failed to establish the timber plantation or repay the debts.

Where then have they put all their money from the forests? The forest industries used the timber money to expand their business in non-timber industries, both in Indonesia and abroad—especially in China, where they could tap into growing opportunities. Forestry companies took forest rent and invested it in property, finance, insurance, trade, agriculture, chemicals, transportation and other businesses (PDBI 1997). They also spent significant amounts of the cash flows from primary timber industries (sawmill and plywood) to build the largest state-of-the-art pulp and paper mills in the world (Setiono in press).

The oil palm and mining industries are two other industries that are extremely important to Indonesia's economy, but at the same time a threat to its natural forests. The major problem with these industries involves large-scale development in natural forest areas. Instead of developing oil palm plantations in unforested areas and on abandoned lands, as forestry regulations suggest, all of the major oil palm plantations have been developed in forested areas and on disputed lands. Many mining industries (also operating in protected areas) were in violation of the forestry law before the recent amendment.<sup>2</sup> For the purpose of this study, however, the discussion will focus on the timber industry.

### 3. Financial risk related to the forestry sector

When they invest in the forestry sector, banks and other financial service providers (FSPs) face financial risks from the following sources, broadly defined as default, legal and reputation risks.

#### 3.1. Illegal logging, illegal trade and log smuggling

One element of financial risk related to the forestry sector deals with bank customers that are involved in forestry crimes, especially illegal logging. Banks face legal and reputation risks when their customers are known or suspected to be involved in illegal logging activities. Banks could also face default risk when their forestry customers cannot continue their business using legal business operations. The forestry customers of banks range from forest-based industries to timber traders and government officers in charge of managing and protecting forests. The forestry customers

might live either in Indonesia and abroad (especially in Malaysia, Singapore and China).

Banks and other FSPs should know that illegal logging is the main cause of deforestation in Indonesia—deforestation that is currently running at the rate of 1.6–2.0 million hectares per year. The Indonesian Minister of Forestry placed fighting illegal logging activities, including the trade in illegal logs, at the top agenda of the five-priority forest sector policy of the Megawati administration. The administration of Susilo Bambang Yudhono, the new Indonesian President, has pledged to continue this policy with a more proactive approach. The Forestry Minister estimated that illegal logging activities cost the government Rp.30 trillion or US\$3.3 billion annually. This amount represented 11% of the Indonesian Government's budget for fuel subsidy in 2004.

Banks and other FSPs (both domestic and foreign) should realise that their customers might be involved in illegal logging activities in Indonesia. Illegal logging is defined as the act of cutting timber against forestry regulations. It is a criminal offence that covers cutting timber in protected areas, conservation areas and national parks, as well as cutting without appropriate permits in designated production forests. Transporting and trading illegal logs, as well as processed wood from illegal logs, are also considered forestry crimes. As mentioned earlier, the huge demand for timber from local and foreign timber industries, especially those in Malaysia and Singapore, has encouraged this criminal activity (Rukmana 2004). The Minister of Forestry openly criticised both of these neighbouring countries for doing nothing to stop their industries from stealing from Indonesian forests. The minister also took action against these activities by once again banning the export of logs from Indonesia in October 2001.

Given that illegal logging is so widespread and is difficult to stop, the risks for banks becoming involved in financing illegal logging are clear and can be predicted. The criminal activity is not limited to illegal cutting of timber, but it also includes corruption. Although the central government has introduced several initiatives, including joint operations involving military and police officers, the problem persists. Illegal logging activities are widespread and carried out openly in the current era of local government autonomy.

There are several reasons why illegal logging activities have proven too difficult to stop or reduce by the Indonesian Government or the Ministry of Forestry. First, illegal logging is supported by financial backers, or *cukong*,

who operate like an institution of organised crime. The backers are known only by their first names, even to the police and forestry regulators. Information as to where they live, their families, their actual businesses, and their banks is kept hidden. They are able to move freely from one place to another within Indonesia and neighbouring countries (for an example see Box 1). The forestry regulation enforcers have limitations on their resources for dealing with the *cukong*. The enforcers focus on finding physical evidence of illegal log possession, i.e. owning, holding and transporting logs and other forest products without proper documentation. Since the focus is on physical evidence, the easiest targets for law enforcement are truck-drivers carrying illegal logs. However, for an enforcer to prove the connection of this physical evidence to a financial backer is difficult (Police Chief of North Sumatra 2004).

Banks with customers in Malaysia involved in forestry business should be aware of the risk of providing banking facilities to traders of illegal logs from Indonesia. There are three gateways for illegal Indonesian logs to enter Serawak Malaysia—Entikong, Badau and Sematan Harbour. In 2002, illegal logs transported via Entikong totalled 354 816 m<sup>3</sup>, those transported via Badau 360 866 m<sup>3</sup>, and those passed through Sematan Harbour tallied 372 168 m<sup>3</sup> (Budiarto 2003). Assuming an average log price of US\$100 per m<sup>3</sup>, the total value of illegal logs processed and transported to Serawak Malaysia from West Kalimantan was equal to US\$108.79 million or almost Rp.1 trillion. To earn this fortune, financial backers from Malaysia financed

local community members, including Adat (local community) leaders, in purchasing the equipment to cut the timber (this expense totalled about Rp.10 million per group), and obtaining local government permits (a cost of about Rp.30 million per 100 ha permit) (Alqadrie *et al.* 2002). Taking into account that one hectare produces around 50 m<sup>3</sup> of logs, the backers needed permits to clear more than 21 000 ha of natural forests in 2002. This means that they spent about Rp.6.3 billion or the equivalent of US\$741 000 that year. In several cases, the backers also worked with local communities, without permits, to exploit natural forests—especially those in forest areas designated as national parks and conservation forests.

Second, illegal logging and related practices have intensified due to the presence of corruption. The financial backers who operate the illegal logging and trade activities know who they need to pay to protect their timber businesses. For their operations, they pay the key officers in district forestry services to obtain timber transportation documents (SKSHH), and pay officers at all checkpoints when transporting the illegal timber. They also maintain good relations with decision-makers in the legislative body and local governments, as well as with army and police units in the areas where they operate their timber business. When they fail to maintain this relationship and get into trouble with the police, they can bribe the government prosecutors and the judges in order to get favourable decisions.<sup>3</sup>

Third, there is a feeling of insecurity among responsible individuals who are concerned

### Box 1. Financial backer operation

The National Park Kerinci Sebelat (TNKS) is located on Sumatra, spanning the provinces of Bengkulu, West Sumatra, Jambi and South Sumatra, and covering an area of 1.4 million ha. It is one of three national parks suggested by the Indonesian Government to receive World Heritage Site status. For one *cukong*, the Kerinci Sebelat is the source of his fortune. The backer has financed about 100 groups of logging teams, each comprised of 10-20 people from District Pesisir Selatan in West Sumatra, to go to the Bengkulu part of the National Park. Upon completing the four-day journey to reach Bengkulu, each group received about Rp.10-20 million or about US\$1000-2000 to cut wood known as *kayu rasak* or *damar laut* in the National Park. The logging groups transported the logs by river to the nearest log pond. The backer had trucks ready to take the logs into Medan, the capital of North Sumatra province. He used legal forest transportation documents (SKSHH) issued by the forestry service offices in Bengkulu. From Medan, he sent the logs or processed wood to Malaysia and Singapore. To assure smooth transportation of the logs, he maintained a good relationship with all of the checkpoints in Bengkulu, West Sumatra and North Sumatra provinces. These checkpoints included the police, forestry service and customs checkpoints (Police Criminal Unit, West Sumatra personal communication).



with the illegal logging and related problems. Although corruption already influences most government functions, there are still some responsible individuals in the police, army, forestry services and custom offices willing to fight these forestry crimes as required by their oaths and functions as public servants. These people, however, work individually and the government does not protect their interests. They risk transfer or job loss because of their efforts to stop illegal logging.<sup>4</sup> They also fear clashes with angry members of local communities that benefit from illegal logging. Under the Reformasi era, the Indonesian army (TNI) was relieved of internal security duties and the job was given to the Indonesian police. Following this era, illegal loggers have become brasher in their actions. They openly conduct their illegal logging activities day and night, without fear of the police or army (Alqadrie *et al.* 2002).

### 3.2. Competing government policy

Another element of financial risk in the forestry sector involves competing government policies. Banks face default risk when the forest-based industries cannot achieve their production targets due to different policies related to exploitation of forest resources among different government institutions. There are at least two levels of competing policies in the forestry sector.

First, the Ministry of Forestry wants to control the management of both the supply of wood (access to timber resources) and the demand for wood (control of timber industries). The Ministry of Forestry is not currently controlling the pulp and paper industry, which is still under supervision of the Ministry of Industry. Under the current system of local government autonomy that was started in early 2000, district governments are granted more say about the supply and demand of wood, with general guidelines provided for them by the Ministry of Forestry. Unfortunately, the decentralisation of forest management was too narrow: it focused only on the rights of providing access to timber resources, not on accountability of holding both the rights to give timber access and the rights to establish timber industries. The Ministry of Forestry policies are in conflict with the policies introduced by local governments related to the use of forest resources. As a result, timber industries have more problems to deal with in terms of uncertainty of the business climate (Setiono 2004).

Second, the Ministry of Forestry wants to reduce pressures on Indonesia's dwindling

natural forests by introducing two policies. The Soft Landing Policy is aimed at reducing annual timber production gradually, while the Industry Restructuring Policy is designed to downsize the capacity of the timber industry. The Minister of Trade and the Minister of Industry, however, would like to see more exports and trade from the timber industry. These ministers consider the timber industry as one of key industries to help Indonesia get out of its financial crisis. The Trade Minister would like to at least maintain the current capacity of the timber industry if not increase the timber output. This conflict in government policy contributes to an even more unsustainable operation of the timber industry.

### 3.3. Politically exposed timber industries

Another element of financial risk in the forestry sector involves the politically exposed timber industries. This term is used to refer to timber industries that have strong political connections with top officials of the government. Under centralised management of natural resources, a few forestry conglomerates controlled most of the forest resources and industries. The HPH system, managed by the Ministry of Forestry, allocated a significant portion of natural forest areas, designated as production forests, to a few timber conglomerates. These conglomerates included Prajogo Pangestu (Barito group), Bob Hasan (Kalimanis and Nusamba groups), Sukanto Tanoto (Raja Garuda Mas group), Eka Tjipta Widjaja (Sinar Mas group) and Burhan Uray (Djajanti group). Of these, only the last one, the Djajanti group, did not possess its own bank.

Despite earning profits between US\$6 billion and US\$9 billion annually from their timber operations, they failed to pay debts of more than US\$3 billion to several Indonesian banks, including those controlled by the timber conglomerates themselves. They also failed to pay debts totalling more than US\$10 billion to their international creditors. The total amounts of non-performing loans related to these timber conglomerates was much larger since they also had businesses in non-timber sectors, such as chemical, agriculture, trading, fisheries and property (they also failed to service their debts related to these non-timber industries). Besides not paying their financial obligations, they also failed to meet forestry regulations, such as paying reforestation funds (DR) and forestry taxes (PSDH), as well as establishing timber plantations on time, and repaying government loans related to the DR fund. The conglomerates also did not use their

foreign earnings to modernise their timber plants (Setiono in press).

Instead of paying their debts to the governments and creditors, they used their political power to negotiate debt settlements that were favourable for them. These settlements came at the expense of the Indonesian people and international creditors. In the era of the New Order government, banks, including the Central Bank (Bank Indonesia), were stuck in a weak position when dealing with the politically well-connected timber industries. Even IBRA was forced into debt settlement with politically exposed people (Setiono in press). Consequently, the politically well-connected timber industries gained significant benefits from IBRA's debt settlements. They now have new fresh accounts with domestic banks, especially Bank Mandiri (Setiono in press), after IBRA wrote off more than 80% of their loans. It still remains to be seen whether or not Bank Mandiri, and other banks holding the accounts of the politically well-connected timber industries, can force the companies and their owners to service their debts.

### 3.4. Expansion of timber industries

A fourth element of financial risk in the forestry sector involves the expansion of timber industries, including new large-scale investment proposals for forest-based industries. With the Indonesian economic sector's continued search for sources of growth, unsustainable timber industries will always be tempted to expand and build new mills. Banks should consider expansion of timber industries and development of large-scale forest-based investment projects as high-risk proposals under the current forest governance framework. The mill capacity could mean more wood coming from illegal logging. Banks then face legal and reputation risks of facilitating illegal logging.

Large projects designed to build or expand timber industries, including the pulp and paper industries, would apply more pressure on Indonesia's dwindling natural forests and result in more conflict with local communities. These projects would be unsustainable if their sources of timber were from illegal felling of natural forests. In 1997, the aggregate consumption of the moulding, plywood and pulp industries was 61 million m<sup>3</sup>, while the sustainable harvest of natural forests according to the Ministry of Forestry was only 25 million m<sup>3</sup> (Barr 2001). Since the introduction of the Soft Landing Policy in 2001, the level of sustainable harvest

of natural forests has been much lower, with the level for 2004 set at only 5.7 million m<sup>3</sup>. This policy was aimed at reducing consumption of natural forests by forest-based industries. Expansion of any forest-based industry would contradict all the policies, including the Soft Landing Policy, that aim to reduce the pressure on Indonesia's diminishing natural forests.

### 3.5. Transfer pricing

The fifth element of financial risk in the forestry sector involves the ability of timber industries to transfer their timber revenues to affiliated 'high-risk' companies located in 'high-risk' jurisdictions, such as the Cayman Islands and the British Virgin Islands (Setiono in press). The timber industries could easily report that they failed to collect trade credits or loans from these high-risk companies. They could also mark up the costs of production, including the price of timber provided by the affiliated companies. Another modus operandi to transfer timber revenues involves buying shares of affiliated companies at unreasonable prices that are supported by a share valuation by 'independent' appraisal. It is very difficult to get an independent opinion if the independent appraisal was financed by the timber industry.

### 3.6. Creative accounting losses versus cash flows

The sixth element of financial risk in the forestry sector is the ability of timber industries to choose accounting policies that will give the image of poor financial performance in a time of crisis (Setiono in press). With poor financial performance, in turn, they can negotiate favourable debt-restructuring deals and avoid payment of corporate tax. Timber industries can earn profits on their operations and on foreign exchange income from exports (while they pay off production costs in rupiah). They can maintain positive cash flows but at the same time report net losses in their books. To wipe out timber profits from their accounting books, the timber companies usually use the following accounting policies:

- Bad debt allowances
- Asset write-offs
- Financial charges for unnecessary exchange losses and unpaid interest.

The first two of these practices involve transfer pricing related to affiliated companies and their affiliated high-risk companies. The companies usually report that trade credit and loans to these companies were not collected. The third practice involves showing a huge loss

for unnecessary currency and interest swaps between rupiah and US dollars. A timber company could enter into a swap contract to pay in US dollars and to receive rupiah. There is no exchange loss risk to timber industries from the fall in rupiah. Instead, when the rupiah falls, the companies gain revenue. This last accounting policy is also used to charge a huge interest expense in rupiah from loans denominated in US dollars. When the value of the rupiah falls, the company then needs more rupiah to buy US dollars to service the debts.

The timber industries have had no incentive to reach debt restructuring agreement with their creditors, including IBRA, since they could continue reporting huge losses from exchange losses and interest expenses. If they reached debt restructuring agreement, they had to record gain from the debt write-offs and start paying interest on the new restructured loans (Indonesian Accounting Association 1998). If the industries had chosen to reach a debt restructuring agreement, they would have reported much lower expenses and reported net income instead of net loss. This in turn would have made the value of the debt and the company increase.

### 3.7. Implications for banks

The above sources of financial risks to banks are real and are threatening the health of the banking sector. Several wood-based industries have reportedly closed, due to the lack of timber supply (Tahar 2003; Widuri 2003). Others are said to use logs from district government permits, an activity which is considered illegal under the national forestry law. Many forestry companies are still using transfer pricing tactics to claim losses from increased production costs and low wood product prices. The aforementioned sources of risk stand in the way of companies paying back their bank loans and interest. Banks, usually state-owned banks, are now looking for opportunities to write-off the non-performing loans of these companies. Bank Mandiri has written off debt of the Raja Garuda Mas group of US\$471.27 million (Suhartono 2003).

Writing off non-performing loans is not a new practice to the Indonesian banking community. It was practised by banks before the financial crisis, promoted by IBRA in its practices, and continued by the banks right after being recapitalised ('bailed out') at a cost to the Indonesian Government of more than Rp.600 trillion (about US\$60 billion). If this practice is to continue, Indonesia's financial system will remain unstable and have a difficult time emerging from its constant crises.

Establishing the anti money laundering regime will help banks stop this imprudent practice by reducing financial facilities to forestry customers that are involved in some of the sources of risk described above. Banks can make a good start by putting in place the 'Know Your Customer' (KYC) principles (explained in section 5.2.1). They can do even better by reporting suspicious transactions involving forest-based industries to law enforcement officers. However, banks might face difficulties in adopting the whole concept of KYC when their incomes come mostly from forest-based industries (banks might decide not to follow the KYC principles when the cost of implementing the principle, such as a loss of customers, would be higher than the benefits from it).

## 4. Typologies of money laundering in the forestry sector

Before discussing how anti money laundering regimes can be used to curtail forestry crimes, we should first discuss the typology of money laundering, as it pertains to forestry crimes. These typologies will help us to see the roles that banks, forestry supervisors and law enforcement officers can play in curtailing forestry crimes.

### 4.1. Money laundering crime

Money laundering is a new crime in Indonesia. It officially became an offence in April 2002. Money laundering is a crime that involves concealing or disguising the proceeds of predicate or original crimes. The criminals conceal or disguise the proceeds of original crimes, in the form of cash or other assets, by putting them into the financial system or changing them into different assets through placement, layering or integration.

'Placement' is an act in which the proceeds of crime in the form of cash (hard money) or soft money (e.g. cheques, promissory notes, certificates of deposit) are placed in financial systems, most notably the banking system. In the placement process, there is a physical movement of money.

Examples of placements related to forestry crimes are:

- Cash or cheques from illegal logging or corruption are deposited into local bank accounts;
- Cash or cheques from illegal logging or corruption are used to buy life insurance.

‘Layering’ involves moving the proceeds of crimes (i.e. cash or other assets) around within the financial system or changing them into different assets to disguise their origins. It is a process to separate the proceeds of criminal activities from their origin through the use of layers of complex financial transactions. When financial institutions are involved in layering, they usually use international business transactions involving both legal companies and shell companies that have no business operations.

Examples of layering related to forestry crimes are:

- Transfer of payments for illegal logs or bribes to several accounts abroad;
- Proceeds from marked up or ‘illegal’ transfer pricing related to legal forestry businesses are transferred to several accounts abroad;
- Cash from illegal logging or corruption are used to buy trucks, which are later sold to receive ‘legal’ cash;
- Cash from illegal logging or corruption are invested in share portfolios or converted to foreign money;
- Selling illegal logs using legal timber transportation documents (SKSHH).

‘Integration’ is a money laundering method that integrates the proceeds from criminal activities with the proceeds from legal activities. It usually involves using the proceeds of crimes that have been placed and layered, i.e. proceeds of crimes that have been successfully laundered.

Examples of integration related to forestry crimes are:

- A legal forestry company processes illegal logs to produce wood-based products such as pulp and plywood;
- Cash from illegal logging or corruption are invested in a resort businesses;
- Cash from illegal logging or corruption that is already placed in financial institutions is invested in a transportation business or oil palm plantation.

People that support money laundering crimes, for example bankers, can now face the same punishment as those guilty of committing the crimes. Any person may be prosecuted who helps the *cukong* place assets known, or *reasonably suspected*, to constitute the proceeds of illegal logging with a bank or other FSP; transfers those assets from one FSP to another FSP; disburses or spends, contributes or donates, entrusts, or removes from the country those assets. Such transactions,

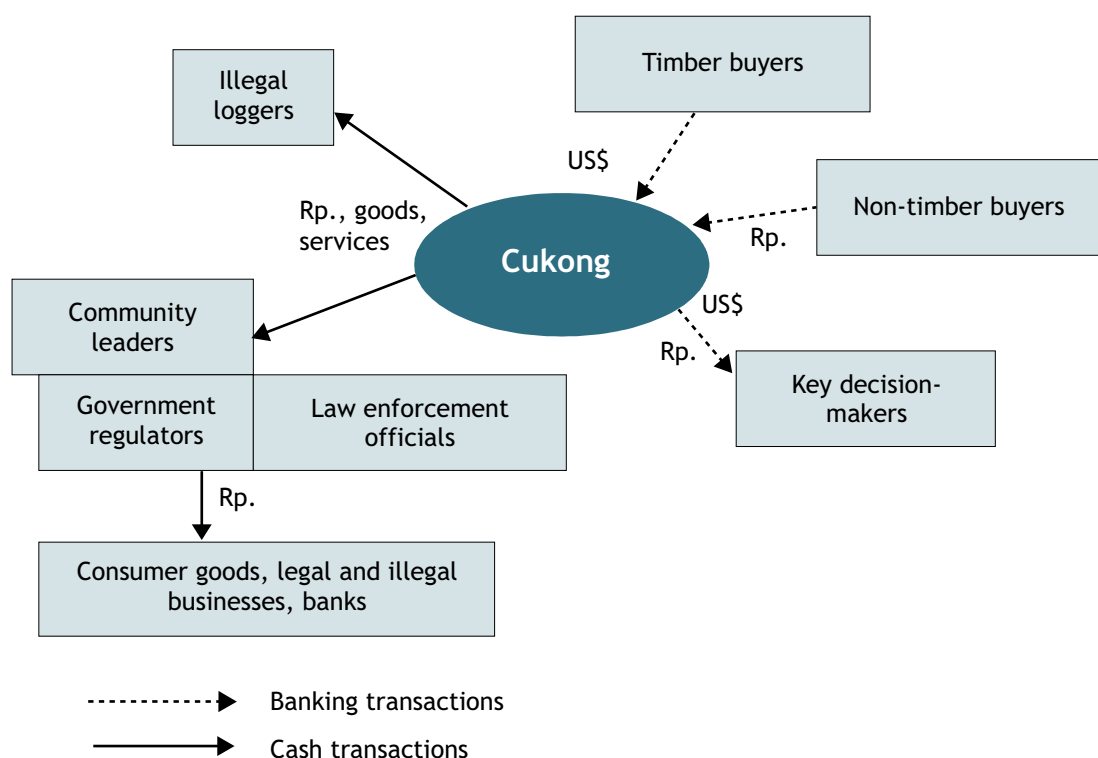
conducted either on their own behalf or on behalf of another party, with the purpose of concealing the origins of the assets, are categorised as money laundering crimes and are punishable by 5-15 years imprisonment and fines ranging from Rp.100 million (US\$10 000) to Rp.15 billion (US\$1.5 million). Any person that attempts to help or conspires to commit a money laundering crime can face the same punishment. With the exception of FSPs that perform their reporting obligations, any person receiving or controlling those assets can also be subject to this punishment. Any Indonesian citizen or Indonesian corporation outside the territory of the Republic of Indonesia that provides assistance, opportunities, instrumentalities or information for carrying out money laundering is also subject to the same penalty. The person who conceals or disguises the proceeds from crime is called the ‘active money launderer’ and the others are categorised as ‘passive money launderers’.<sup>5</sup>

In the event that managers or managers’ agents (for example, a director of a forestry company or a director of a bank) commit a crime on behalf of a corporation, both the managers and the agents, as well as the corporation, are subject to punishment. The principal penalty that can be imposed on corporations is the maximum fine plus one-third. In addition to the fine, additional penalties can be imposed on corporations—they can have their business licences revoked or even face dissolution and liquidation as punishment for money laundering crimes.<sup>6</sup>

## 4.2. Typology of illegal logging

The *cukong* is the criminal mastermind behind the illegal logging (Fig. 1). He plans out all the steps necessary to extract timber illegally, and pass it off and sell it as legal. To conceal the proceeds from illegal logs and successfully launder the profits, backers first pay fees to the loggers and the community leaders. These fees can take the form of cash, infrastructure (such as roads and other public facilities) or services (such as visits to bars and brothels). In exchange, the backers obtain the access they need to the timber. They also pay bribes to forestry regulators, in order to get legal documents. This process basically launders illegal logs into legal logs. After doing all this, backers must then pay cash bribes to the police, customs and forestry officers at multiple checkpoints to ensure the smooth transportation of the logs to targeted mills or timber buyers. These buyers could be domestic timber industries or foreign timber traders. The cash received by community leaders,





**Figure 1.** The first typology: Illegal logging and corruption

regulators and law enforcement officers will later be used for buying consumer goods such as televisions, motorcycles and cars. They can sell these goods later to completely launder the proceeds of forest crimes. Some of the corrupt money will go into legal businesses investments, such as transportation, property and trade, while other parts of it will be invested back into illegal logging business, such as building illegal mills. Some of the proceeds from the corruption will be placed into banks locally or abroad.

Upon receiving laundered logs, timber buyers instruct their banks to credit the *cukong's* accounts in the same banks or transfer the money to the *cukong's* accounts in other banks. These accounts may be located in Indonesia or abroad; so foreign banks can be involved in the payment transactions. To completely conceal traces of the illegal timber business, the *cukong* can integrate funds from legal non-timber businesses into the timber accounts. These legal businesses might include trade, hotel and entertainment businesses. In some circumstances, the *cukong* uses the proceeds from other illegal acts, such as fraud and drugs, to invest in illegal or legal forestry businesses. With the proceeds, the *cukong* can fund the trade and transportation of illegal logs as well as the development of sawmills.

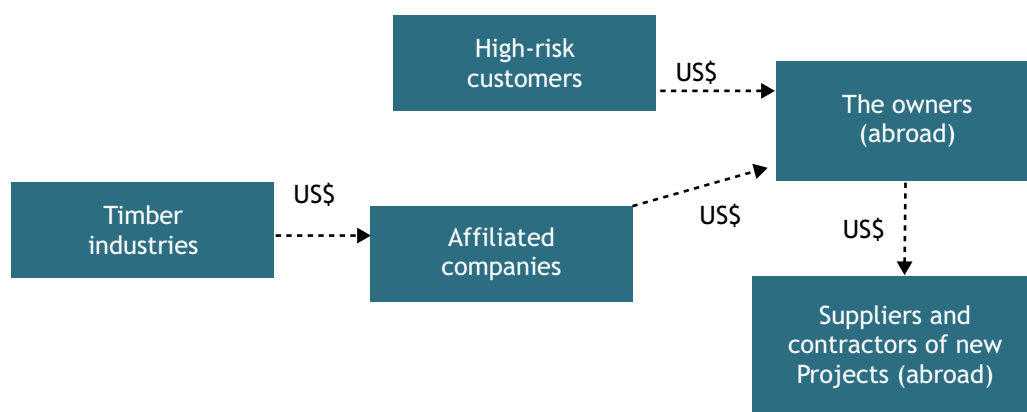
The *cukong* also maintains good relationships with key decision-makers in the government

and legislature. They usually transfer goodwill payments to bank accounts owned by key decision-makers or representatives in Indonesia and abroad. Sometimes, local banks receive deposits from local community leaders and government officers who received bribes from financial backers.

The description of illegal logging above suggests that legal timber companies are also involved in illegal logging. They have proper legal documentation from local governments to extract timber. With these licences, the timber companies often cut timber outside of their concession areas and produce more than their annual quotas of timber (Obidzinski and Andrianto 2004). With support from certain multistakeholder arrangements, a legal timber company can develop its own map to justify getting timber from protected areas (WWF Indonesia 2004). These legal timber companies then sell or process the illegal logs as if they are legal, since they are able to produce legal documentation to support the illegal logs. Banks and other financial service providers are involved in financial transactions that combine the proceeds of illegal and legal logging.

#### 4.3. Typology of transfer pricing

As mentioned previously, transfer pricing (Fig. 2) is used by timber industries to illegally channel their profits towards the development of new timber and non-timber projects in



**Figure 2.** The second typology: Transfer pricing

Indonesia and abroad, especially pulp and paper projects. The list below shows the types of laundering that can be used in concealing the proceeds from the illegal transfer of forestry revenues.

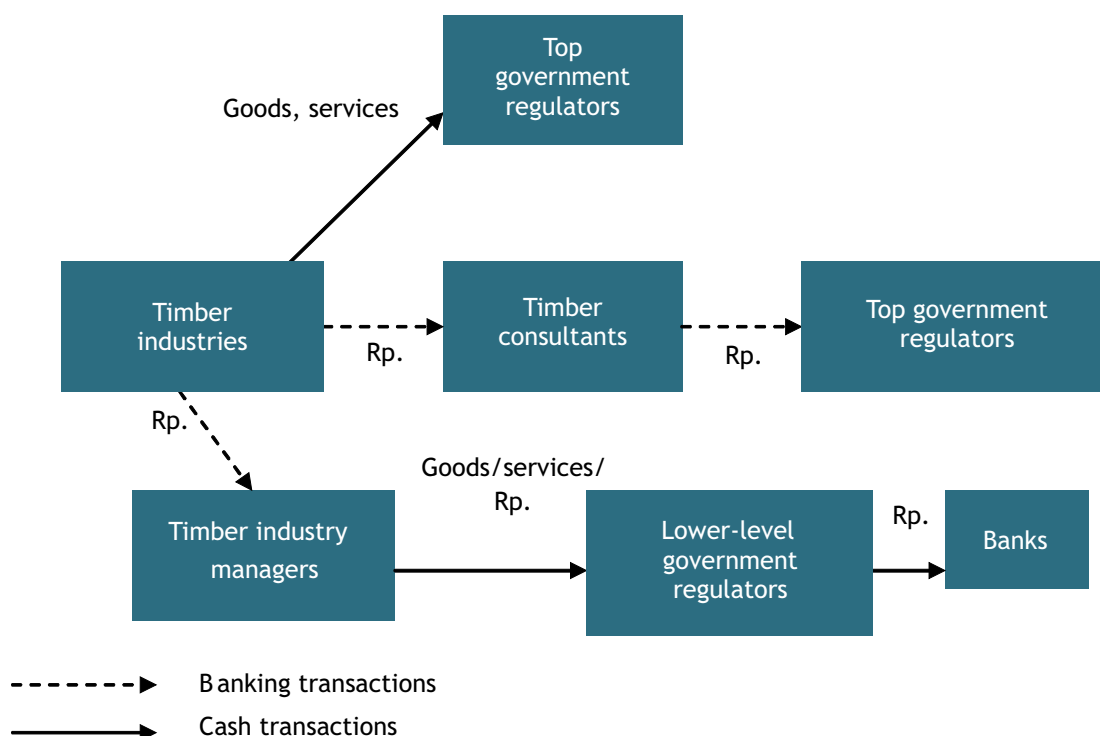
- *Concealing transferred profits in the guise of loans to affiliated companies.* With this method, a timber industry ‘lends’ money to its affiliated companies. These companies, in turn, send the transferred profits to the accounts of the timber owners or their representatives. Timber owners can then have their banks pay suppliers and contractors for new projects. To complete the cycle of transfer pricing, the affiliated companies can report the ‘loan’ from the timber industry as payment for general expenditures. Afterwards, they avoid repaying the loan by claiming to have financial problems. The timber owners then agree to write-off the uncollected loans. The same method is used by a timber company in providing a trade credit to affiliated companies and high-risk customers.
- *Concealing the transferred profits through buying shares in affiliated companies.* In this method, the timber company buys shares of affiliated companies (companies that are also mostly owned by the timber company’s main owner) at exorbitant prices. The timber industry then instructs its banks to transfer amounts equal to the total share price to the banks of these affiliated companies. To conceal the crime, the share price transaction is backed up by an ‘independent’ appraisal—an appraisal that is paid for by the timber company.
- *Concealing the transferred profit through buying timber supplied by affiliated companies at marked-up prices.* In this method, the timber company buys timber

from affiliated companies on a long-term contract at a marked-up price. The timber company instructs its bank to transfer the cost of the timber to the affiliated companies’ banks. The affiliated companies then distribute the transferred profit or abnormal profit to the owners of the timber company through dividend payments or non-interest loans.

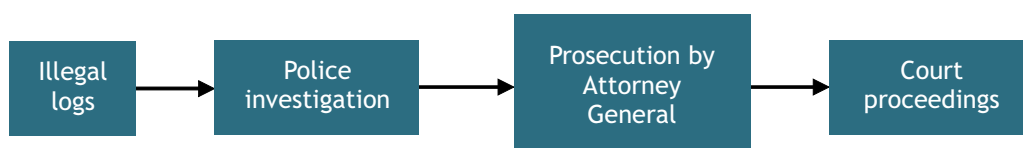
#### 4.4. Typology of corruption

The government’s internal auditor (BPKP) suggests that corruption and collusion were major forestry crimes that ruined the economic, social and environmental value of Indonesia’s natural forests (BPKP 2001). HPH companies, with the help of forestry consultants, have bribed government officers to get timber utilisation and extraction licenses (Fig. 3). The flow of money to the lower-level officers was usually conducted in cash transactions and deposited in their banks. For the top government officers, the timber companies either used the timber consultants to transfer the money to the regulators’ bank accounts or they got help from individual timber company managers to do so.

Corruption among government officers is not limited to cash transactions. The term ‘CASIO’ refers to the practice of government officials receiving bribery from companies under their supervision. CASIO stands for ‘*dikasih orang*’, which means ‘provided by somebody else’. Companies give these officials goods such as jewellery, watches, furniture and cars. They also provide services to government officers, such as luxurious accommodation and other facilities, during visits to the companies, and memberships to golf clubs. If the corrupt officers need funds, or do not like the goods they receive, they can sell them.



**Figure 3.** The third typology: Corruption



**Figure 4.** The chain of forestry law enforcement

## 5. The new approach for fighting forestry crimes

Logs, unlike drugs, are visible and to bring logs from remote forest areas to big cities where the logs are consumed they have to pass multiple government checkpoints. Government and law enforcement officers responsible for the checkpoints should stop illegal logs and bring to justice the one who carries the logs. According to the definition of the forestry regulation, illegal loggers are those who cut, move, carry and keep logs without permits, with improper permits, or by abusing the permits. Therefore, it is impossible for someone without a permit to get access to timber. However, the reality is different and illegal logging has become one of major issues not only in Indonesia, but also in international forestry and environment communities. Every year, 9 million m<sup>3</sup> of logs is smuggled out of Indonesia to neighbouring countries in Asia and later processed into

wood products and consumed by developed countries (Widakdo 2004).

### 5.1. Forestry law enforcement challenges

There are several difficulties faced by the government in its attempts to put masterminds of illegal logging into jail. Figure 4 shows the points where the forestry law enforcement can break down.

#### 5.1.1. Illegal logs

With greater autonomy of local governments, many logs have been cut using licences issued by local governments. Since early 2002, under the national forestry regulation, local governments can no longer issue forest utilisation permits and must report the annual production plans of timber companies in their respective areas to the Ministry of Forestry. However, many local governments still issue

logging permits to local timber companies. District Forestry Officers under pressure from heads of local governments issue timber transportation documents (SKSHH) that are needed to move timber from the forest to the markets. With this dualism, law enforcement officers cannot stop timber companies that cut logs using local government permits and can show the proper SKSHH.

Local timber extraction licences are issued only for production forests (primary forests, logged over forests, and industrial plantation forests); however, several case studies and NGO reports suggest that local timber companies sponsored by a *cukong* use the opportunity of proximity to gain access to timber in national parks and protected forests adjacent to their concession areas—a practice that is strictly forbidden under both local and national forestry legislations. Sometimes, the local government issues timber extraction permits in the areas already given to HPH companies (the timber company with a national permit to extract timber). The timber companies then use proper SKSHH issued (based on the licence for the degraded forest) to transport the illegal logs out of national parks or protected areas. To get this facility, the *cukong* must pay bribes to top local government and law enforcement officers, as well as to forestry and law enforcement officers to smooth his illegal logging operation. There is nothing that forestry law enforcement officers can do about this type of illegal logging.

When a group of people (some from Malaysia), financed by a *cukong* (Malaysian or other), did actually log without permits and transported the illegal logs out of the forests, the *cukong* safely smuggled the illegal logs out of Indonesia by paying bribes to customs, forestry officers and police officers at the Indonesian borders. Again, the forestry law enforcement officers cannot do anything about this type of illegal logging. The crimes were committed by foreigners (Malaysians) with no physical contact with the illegal logs and related corruption.

### 5.1.2. Investigation by the police

Civil society organizations continuously provide information on illegal logging to the law enforcement officers and the media. The last example was when Telapak and the Environmental Investigation Agency (EIA) made public their findings about illegal logging in Papua (EIA and Telapak 2005). This report drew attention from all top government officers in the country including the president and the parliament (DPR). As a result of this

report, the police were given a new project called Hutan Lestari II operation that cost the Indonesian Government about Rp.12 billion, equivalent to US\$1.3 million.

The police made several arrests, confiscated illegal logs and publicised these achievements extensively. However, no major illegal logging cases have yet been brought to the prosecutors, let alone to the courts. The police declared that 136 people were suspected of illegal logging in Papua and 31 of them were arrested. The Hutan Lestari II operation confiscated 370,244 m<sup>3</sup> of illegal logs and 19,728 m<sup>3</sup> of illegal processed wood, as well as several transportation tools such as tugboat and vehicles (Widakdo and Santoso 2005). The same poor law enforcement performance was shown in 2001 and 2002 under operations called Wanalaga and Wanabahari. There were 1031 illegal logging cases investigated in 2001 and 971 cases in 2002.

There are indications that the police are involved in illegal logging as reported by a study commissioned by the Indonesian Police Science Institute (PTIK 2005). Police involvement in illegal logging includes providing protection and running timber trade for their own personal gain. This study is supported by the results of the Hutan Lestari II operation in Papua and the court proceedings in Sorong, Papua (Ama and Santosa 2005).

When the police have the courage to investigate an illegal logging case, they can only bring the case involving truck drivers, local loggers, or the captains of boats that were actually caught carrying illegal logs by the forestry law enforcement officers. They are mostly sentenced to less than one year imprisonment, or other minimum penalties, due to their small role in illegal logging. When *cukong* cases were investigated and finally prosecuted by the forestry law enforcement, the *cukong* were sentenced to less than 6 months or acquitted due to lack of evidence that they were involved in illegal logging as defined by the Forestry Legislation.

Another problem in the police investigation on the involvement of *cukong* in illegal logging is the local community protest. The local communities that only earn US\$1 per cubic metre from illegal logging are used by the *cukong* to protect him from arrest. In West Kalimantan, the police had to surrender to the demand of the local community demanding assets (vehicles) confiscated from the scene of illegal logging. Protests from the local community contribute to the failure of the forestry law enforcement.

### 5.1.3. State prosecutors

No major illegal logging cases have been put forward by the police to the State Prosecutor. As a result, the Ministry of Forestry submitted cases involving *cukong* of illegal logging directly to the State Prosecutor and treated the case as a corruption case. The State Prosecutor is allowed to investigate a corruption case, but not an illegal logging case. However, there have still been no major cases of corruption related to illegal logging put to the court by the State Prosecutor.

### 5.1.4. Court proceedings

Since the police and the state prosecutors have failed to prosecute major illegal logging criminals, there has been no big illegal logging case or any corruption cases related to illegal logging examined in court. Even if there were such as case, the judge might be influenced by the financier of illegal logging and his representative. The judge, as any government officer, may receive bribes to make a favourable decision for the *cukong* (see the discussion on this issue below).

## 5.2. The anti money laundering approach

Stopping illegal logging using the forestry law enforcement approach will face total failure if there is no change in the forestry and local government autonomy legislation, human resource management of the law enforcement officers, and local community development programme. Even if the reforms are conducted properly, it will take years before they can actually be implemented. In the meantime, the natural forests might disappear. Therefore, using the anti money laundering approach, which 'follows the money', to combat illegal logging becomes an important option.

With the enactment of Law No. 25/2003 regarding money laundering crimes, Indonesia might have an opportunity to promote prudent banks and sustainable forest-based industries while curtailing forestry crimes. Indonesia was the first country to categorise forestry and environmental crimes as predicate offences to be prosecuted under the anti money

laundering law. Predicate offences also include crimes such as corruption, bribery, smuggling of goods, banking crimes, fraud and tax crimes, which are often linked to forest crimes. It is in the interests of the banks and the financial systems to actively carry out the Indonesian anti money laundering law. If used properly, it will significantly reduce risk related to financing facilities provided to the forestry sector. At the same time, it will help the government develop sustainable forest-based industries and prosecute the intellectual actors responsible for illegal deforestation in Indonesia.

The law enforcement approach to money laundering crimes is longer than the forestry regulation approach (Fig. 5). However, it overcomes some fundamental problems in prosecuting forestry criminals. The first half of the approach depends on the performance of the financial communities, while the second half depends on the law enforcement and judicial communities. The financial communities should give a better chance of identifying *cukong* and other masterminds of illegal logging by analysis of their financial profiles. The second phase of the anti money laundering approach faces the same problem as using the forestry law enforcement approach. However, the financial communities are less corrupt, on average, than the law enforcement communities and they can be used strategically to promote changes in the law enforcement and judicial processes.

### 5.2.1. FSP and KYC principles

The anti money laundering approach starts by requesting banks and other financial service providers to know their customers. With the 'Know Your Customer' (KYC) principles guided by the Basel Core Principle issued by the Basel Committee on Banking Supervision (1997), domestic financial institutions should put in place a system for knowing their customers. Banks should make sure that no criminals or suspected criminals put money from illegal business into the banking system. A prudent bank is required to have adequate policies, practices and procedures in place, including



Key: AG = Attorney General; CTR = cash transaction report(s); FSP= Financial Service Providers; KYC = know your customer; PPAK (FIU) = Indonesian Financial Intelligence Unit; STR = suspicious transaction report(s).

**Figure 5.** The chain of the anti money laundering approach



strict KYC rules, which promote high ethical and professional standards in the financial sector. These policies are designed to prevent the banks from being used, either intentionally or unintentionally, by criminal elements.<sup>7</sup>

Banks are required to understand the profile of their customers (including their timber customers) and pattern of their customers' transactions. This requirement became applicable to both existing customers as well as new customers under the KYC regulation introduced in December 2001. Banks are required to conduct 'customer due diligence' (CDD) to maintain profiles of their customers, at least with information covering their identity, their employment or business, their normal incomes, other accounts they have, normal financial transactions, and the purpose for opening an account with the bank.<sup>8</sup> Moreover, the bank's board of directors is also required to establish criteria for determining high-risk countries, business and customers.<sup>9</sup> A high-risk country is a country that has not adopted provisions for KYC principles; a high-risk business is a line of business that may potentially be exploited for money laundering; and a high-risk customer is an individual that may potentially be involved in money laundering. Suspicious financial transactions usually come from transactions dealing with these high-risk entities.

Since illegal logging is one of the top criminal activities in Indonesia, the financial institutions (both domestic and foreign) dealing with forestry businesses and customers conducting timber trade from Indonesia should consider these businesses and customers as high risk. This type of customer should get enhanced CDD to ensure that the funding for their financial transaction does not come from illegal logging or other criminal activities. Banks should not wait until they know that their customers are involved in illegal logging or supporting crimes before conducting proper CDD of their timber customers.

The KYC regulation requires banks to conduct identification and verification, for both individual and corporate customers, using the supporting documents provided by the prospective customer. This process includes conducting *extensive* due diligence of any prospective customer operating in a high-risk country, in a high-risk business, and deemed a high-risk customer, including state officials. For a corporate customer, banks are also required to assess the plausibility of information pertaining to the line of business of the company, financial statement, description of business operation, transaction profile,

business turnover, company location, and so on. The KYC regulation also requires banks to monitor accounts and transactions of their customers. This process includes identifying any possible entries or transactions (cash or non-cash) not compatible with the customer's profile. Banks are required to conduct intensive monitoring of high-risk customers.<sup>10</sup>

The anti money laundering approach to illegal logging breaks down if banks and other financial service providers (FSPs) fail to conduct proper CDD on their timber customers. Still many banks have not conducted proper CDD, especially on timber customers and government officers. The Indonesian Financial Intelligence Unit (PPATK) has requested all FSPs to file suspicious transaction reports (STR) regarding customers suspected of involvement in illegal logging and corruption.<sup>11</sup> Bank Indonesia has also issued Bank Indonesia Regulations (PBI) to implement the KYC principles and a Circulation Letter to impose sanctions on Indonesian banks which failure to implement it.<sup>12</sup>

### 5.2.2. Suspicious transaction and cash transaction reports

The anti money laundering legislation overrides the bank secrecy rule. Banks and other FSPs are required to report customers engaged in *suspicious financial transactions* (STR) and customers making *cash transactions* (CTR) of more than Rp.500 million or about US\$50 000 to PPATK. The anti money laundering policies also allow banks to answer questions by the police, public prosecutors and judges regarding the financial conditions of clients that are suspected of involvement in money laundering. The information provided by the bank is classified as intelligence information and the bank's name does not appear in the Police Investigation Report or in the court proceedings. The bank is placed under a special protection programme for reporting parties and witnesses. The protection programme includes protection of personal security, family and assets, and allows for a change of identity and the option not to appear in the court.<sup>13</sup> The banks are protected to the point where even the STR, from which the police drew their evidence, is mentioned in the Police Investigation Report as if it were derived from the investigator's own work. During court sessions, the witnesses, public prosecutors and judges are prohibited from mentioning the names or addresses of the reporting parties, or other matters that may lead to the disclosure of the reporting party's identity.<sup>14</sup>

Theoretically, banks should not lose their customers or business, or suffer any other

negative consequences by reporting STR and CTR to PPATK. Suspected customers must not be aware that they are under investigation by PPATK and the police. The anti money laundering policy has a provision specifically addressing this issue. Directors, officials, banks employees, PPATK employees and police investigators are not allowed to disclose to bank customers or others if a bank is contemplating reporting or has already reported an STR to PPATK. A violation of this provision can result in imprisonment for three to five years and a fine ranging from Rp.100 million (US\$10 000) to Rp.1 billion (US\$100 000).<sup>15</sup>

With respect to illegal logging, banks and other FSPs should submit an STR to PPATK if a timber customer conducts or cancels a financial transaction using assets reasonably suspected to have arisen from criminal proceeds or if the financial transaction deviates from the usual patterns.<sup>16</sup> Banks should understand the profile of legal timber customers to be able to *suspect* whether a timber customer is involved in illegal logging or not. Banks only need to suspect, not to prove, that a timber customer is involved in illegal logging. When they have reasonable suspicion that proceeds of illegal logging enter into their banks they should file an STR.

There are several points of interaction between banks and timber customers that should trigger proper CDD before finally reporting STR to PPATK. First, banks provide financial and banking facilities to legal timber companies that might use illegal logs for producing wood-based products such as pulp, plywood and sawn-wood. Banks also provide banking facilities to furniture companies that might use illegal logs. Second, timber customers make large cash transactions, especially cash withdrawals. *Cukong* of illegal logging will need large sums of cash to provide advance payment for several groups of loggers who will go into the forest field for weeks. *Cukong* need to pay the suppliers who will then provide logistics such as food, chainsaws and heavy equipment to the loggers. They also need to pay a tugboat or ship to carry the wood to the market. If the *cukong* wants to get a licence or protection from the powerful individuals in the local government and law enforcement offices, they must pay bribes. In most cases, *cukong* will pay these expenses in cash. Third, timber customers may receive transfer payments from abroad. The *cukong* may receive transfer payments from the buyers when illegal logs are exported (or appropriately smuggled). Fourth, timber customers may make transfers to pay for the logistics of logging operations that can only be

provided by suppliers in Java or they have to make transfer to their key contacts' accounts for paying bribes to powerful individuals in Jakarta. In all these points, banks and other FSPs should conduct proper CDD.

In addition to illegal logging, banks must already be aware of the degree of corruption in Indonesia. Several reports have suggested that Indonesia is the most corrupt country in the world.<sup>17</sup> Banks must interact with government and law enforcement officers at both local and national levels. The Financial Action Task Force (FATF) on money laundering has defined a government officer as a Politically Exposed Person (PEP). The Indonesian money laundering regulators have not yet issued a KYC regulation for a PEP, but the FATF has recommended financial institutions to conduct *enhanced* CDD on PEPs to ensure the funds managed by financial institutions on behalf on the PEPs are not derived from a corrupt source.<sup>18</sup> As described above, it is impossible for illegal logging to take place without support from corrupt government and law enforcement officers. Therefore, banks and other FSPs should conduct proper CDD when they provide banking and financial activities to government and law enforcement officers, especially those that work in forested regions. They are high-risk customers with respect to illegal logging.

The Ministry of Forestry can help banks and other FSPs to identify suspicious transactions (especially since it signed an Memorandum of Understanding with PPATK at the end of March 2005). The Ministry can help banks to develop normal transaction patterns of forestry-related customers, especially those that operate in Kalimantan, Sumatra and Papua. The Ministry of Forestry can also help banks to develop *reasonable suspicion* regarding bank customers, by providing information regarding the suspects of illegal logging and corruption in the forestry sector. A bank should have *reasonable suspicion* due to information from many sources, including but not limited to law enforcement agencies (for example, the police investigators and state prosecutors), government institutions (for example, Ministry of Forestry), civil society (forestry NGO), news media, Bank Indonesia, PPATK, and its own records. Since many illegal logging and corruption cases in the forestry sector have become public information, banks should report to PPATK any customers that have relations with illegal logging crimes.

Banks should not only be concerned with illegal logging and corruption, but also with banking fraud. As discussed in Section 3, banks also face default risk from politically

exposed timber industries. The forestry conglomerates might apply transfer pricing to move their foreign earnings to their interests abroad, ignoring debt agreements or debt covenants with banks and other creditors. With artificially poor earnings, they will then look for debt restructuring opportunities to write-off their debts. Under pressure from the government policy to support the timber industries, banks will write-off some of the debts. Banks will suffer significant losses, and will have lower capital adequacy ratio. This practice is regularly applied by timber industries and other industries in Indonesia, and supported by banks (especially state-owned banks) whenever there is banking, financial or economic crisis.

Banks should conduct proper due diligence to transactions by politically exposed timber industries involving exports or loans to affiliated companies or buyers located in high-risk financial jurisdictions such as the Cayman Islands. When there is suspicion that the customer wants to move their foreign earnings abroad, banks should file an STR to PPATK.

Sometimes banks and FSPs receive information from PPATK regarding their customers. The police that have already investigated many illegal logging cases and suspect the *cukong* of illegal logging can request PPATK to provide financial intelligence analysis on the suspected *cukong*. PPATK then creates an *artificial* STR by requesting banks or other FSPs to file STR reports on the suspected *cukong* of illegal logging. An artificial STR is an STR created by banks from information supplied by PPATK. A normal STR is one created by banks from information supplied by their internal KYC system.

### 5.2.3. The Financial Intelligence Unit and financial intelligence services

An STR must be reported no later than three business days after a bank knows a suspicious financial transaction took place, and a CTR must be reported no later than 14 business days after a transaction. Based on these reports, PPATK will conduct financial intelligence investigations and analysis to indicate the existence of money laundering crimes. The results of its financial analysis then will be submitted to the money laundering investigator. Under current government regulations, the Indonesian police are the only investigators allowed to investigate a money laundering crime.

PPATK is neither an investigator nor a prosecutor of money laundering crime. PPATK is a government body directly responsible to

the President of the Republic of Indonesia. Its responsibilities include providing advice and assistance to relevant authorities concerning information obtained by PPATK, issuing guidelines for FSPs, reporting the results of analysis to the police and the Public Prosecutor's Office, and providing information to the public concerning its institutional performance. To fulfil these duties, it has authority to request and receive reports from FSPs, to request information concerning the progress of investigations or prosecutions of money laundering, and to audit FSPs for compliance with the anti money laundering law.<sup>19</sup>

In the context of prosecuting the *cukong* of illegal logging, PPATK plays a significant role in identifying the flow of money for investment in cutting logs, for bringing the logs to the markets, and for receiving payment from buyers as suggested by the typology of illegal logging. This information is vital for the investigator to identify and confiscate the proceeds of crimes and collect evidence of money laundering offences.

### 5.2.4. New powers of the law enforcement officers

If the law enforcement officers do not have integrity in prosecuting money laundering crimes, *cukong* of illegal logging will go free and the money laundering approach to illegal logging will break down. The law on money laundering crimes has overcome many limitations to prosecuting *cukong* of illegal logging using the forestry law enforcement approach described above.

The anti money laundering legislation provides law enforcement officers with new powers needed to stop illegal logging. First, they have access to financial information, flows and analyses of suspected transactions. With the assistance of PPATK, an investigator can locate proceeds of crimes, identify all the parties involved in the crime and start collecting evidence. PPATK provides the police with results of analyses of financial transactions that indicate money laundering crimes. The police investigator then only needs a letter signed by the Chief of the Indonesian National Police or a Regional Chief of Police to collect evidence from a bank.<sup>20</sup> There are no other requirements to get approval from the Governor of the Central Bank or the Minister of Finance to open the accounts of suspects of money laundering crimes. Second, the law enforcement officers have the power to request that a bank freeze bank accounts of suspects. They do not need to wait for a court



decision to freeze assets suspected of having a criminal origin. Through this, law enforcement officers can reduce the incentive to commit crimes—although at this stage, the criminal is not yet jailed. To prosecute a money laundering crime, the court does not need to first prove a predicate crime such as corruption, banking fraud, or illegal logging. Article 1 paragraph 1 of Act No. 25/2003 states that ‘in beginning an examination of the crime of money laundering in the court, in order to proceed on money laundering charges that relate to assets that are suspected to be proceeds of crime, there is no need to first prove a predicate crime’.<sup>21</sup> The anti money laundering regime aims to seize proceeds of crimes concealed throughout the world, to prevent criminals from accessing them. Prosecution of the original crimes, an event that might have taken place in a different country, is not the approach of the anti money laundering regime. Third, they have more types of legal evidence that can be used to prove a money laundering crime. In addition to the legal evidence under the Criminal Procedure Law (KUHAP), the money laundering legislation considers information uttered, sent, received or saved in electronic form—i.e. maps, designs, photographs, letters, signs, numbers, symbols or ‘perforations which have meaning’—as legal evidence.<sup>22</sup>

If police investigators use this new power properly and professionally, banks and other financial institutions as well as forests should receive benefits. FSPs would be cleared from any connection to illegal money and the criminals, and degradation of forests can be significantly reduced. By May 2004, there were 121 cases of illegal logging under investigation by the Indonesian National Police.<sup>23</sup> The police can use the anti money laundering law to prosecute the financial backers of these illegal logging cases. The first thing the police need to follow up is to find out which banks are helping the financial backers and timber industries to launder the proceeds of crimes. After that, they can request PPTAK to create artificial STR.

Another issue of law enforcement is the choice of prosecution process. Since the Law on money laundering crimes was introduced in early 2002, the police and the public prosecutor still consider money laundering crimes as a ‘subsider’ (second degree of, or alternative) prosecution, after illegal logging or corruption prosecutions. As a result, the money laundering approach has not yet become effective in tackling predicate crimes or original crimes.

Although the anti money laundering legislation allows for the seizure of proceeds of crimes and the jailing of money launderers, the aim of the anti money laundering regime is to stop or reduce original, predicate crimes such as illegal logging and corruption. In this spirit, money laundering prosecution may be tacked onto the prosecution of original crimes. If a *cukong* is proven guilty of committing illegal logging and money laundering, he can face the full penalty for the forestry crime, plus an additional one-third of the penalty through the money laundering legislation. However, because under the Indonesian legislations the punishment for money laundering crimes is actually stricter than that for illegal logging crimes, the order can be reversed so that the penalty applied may be reversed.

Unlike the subsider approach, the accumulative approach to the prosecution process can make pre-investigation and investigation of original crimes effective. If the anti money laundering law allows the financial analysis reports of the Indonesian Financial Intelligence Unit (PPATK) to be used not only for investigating money laundering crimes, but also for supporting pre-investigation and investigation of illegal logging, investigators can gain information on the flow of the proceeds of illegal logging. With this information, investigators could quickly obtain solid evidence of illegal logging crimes.

#### 5.2.5. New approach for court proceedings

Not only is law enforcement provided with new tools to catch the masterminds of criminal activity, the Court Proceeding is also made easier to convict them. The anti money laundering legislation provides a special protection programme for reporting parties and witnesses, especially in the court. Special protection can involve personal security protection, it can also extend to the protection of the families of the reporting parties and witnesses, as well as their assets. It can be used to conceal the identity of reporting parties and witnesses as well as allow witnesses to provide information without having to meet face to face with the defendants at each level of court proceedings. The government provides special protection to protect reporting parties or witnesses from threats to their lives, assets or families. Reporting parties can be any person that submits a report to PPATK regarding STR and CTR, or any person that voluntarily provides investigators with reports on money laundering cases. A witness is a person that

can provide information for the purpose of investigation, prosecution or court proceedings regarding a money laundering case that he or she experiences for him- or herself.<sup>24</sup>

The next innovation in fighting criminals is the reversal of the burden of proof. In court proceedings, defendants will have the burden of proving that their assets were not derived from crimes.<sup>25</sup> The anti money laundering legislation broke standard court norms by reducing the burden of the prosecutors and the investigators (the police) to prove the criminal origins of the money under investigation. Unlike court cases involving original crimes such as illegal logging and smuggling, in money laundering cases the prosecutors can force the defendants to explain the sources of their assets.

It should be noted that the reversal of burden of proof only applies in the courtroom. Investigators and prosecutors may not use this measure during the investigation and collection of evidence. This should prevent them from abusing their power or using it to encourage bribes.

As described previously, there are more types of legal evidence that can be used to prove a money laundering crime. In addition to the legal evidence under the Criminal Procedure Law (KUHAP), the anti money laundering legislation considers information uttered, sent, received or saved in electronic form—i.e. maps, designs, photographs, letters, signs, numbers, symbols or ‘perforations which have meaning’—as legal evidence.

### 5.3. Another challenge for Indonesia

The above innovations in the law enforcement process and court proceedings should help law enforcement and judicial officers to bring the masterminds of illegal logging to justice. The only remaining (but not insignificant) problem in this effort is the integrity of law enforcement officers as well as judges responsible for making final court decisions. Many people believe there is a ‘court proceedings mafia’ in Indonesia, where defendants can make choices of sentences, jail or acquittal depending on the size and levels of bribes they give to law enforcement officers and judges. In a breakthrough in combating corruption, the Indonesian Corruption Eradication Commission (KPK) has successfully caught a court clerk and a lawyer red handed in a bribe of Rp.250 million (about US\$25 000) for helping the convicted Aceh Governor Abdulah Puteh to receive a preferential jail sentence (Anonymous 2005).

The Susilo Bambang Yudhono administration has taken some steps to address the integrity issue, including creating independent bodies such as the National Police Commission, the Prosecutor Oversight Commission, and the Judicial Commission. Members of these independent bodies are former law enforcement officers and judges, as well as from the public. Except for the National Police Commission, members are recruited by the Indonesian Government and the Indonesian Parliament (DPR), and public participation is invited in the recruitment process. The main mandate of these commissions is to increase the effectiveness of law enforcement in Indonesia.

The Indonesian Government has put priorities on combating corruption, illegal logging and terrorism. Currently, the Center for International Forestry Research (CIFOR) and its partners are helping the Indonesian Government to increase the capacity of the law enforcement officers and judges to use anti money laundering and corruption legislation to uncover the masterminds of illegal logging. With strong government commitment and support from donor countries, we may soon see some *cukong* of illegal logging put behind bars and their assets confiscated for the country.

### 5.4. Clamping down on the international syndicate

However, stopping illegal logging cannot be done by the Indonesian Government alone. According to ‘The Last Frontier’ (EIA and Telapak 2005)—which describes a recent investigation by a UK-based NGO, the Environmental Investigation Agency (EIA) and an Indonesian NGO, Telapak—an international syndicate is currently responsible for the felling of 300 000 m<sup>3</sup> of *merbau* logs per month. Smuggled to China and India, a month’s supply has a street value of US\$72 million. Just like the drugs trade, meagre takings for local forest dwellers translate into ‘big bucks’ for a few timber barons far from the scene of the crime. The Papuans who cut the trees get US\$1 for each cubic metre. The financiers in Singapore, Malaysia and Hong Kong translate that into US\$240 per cubic metre.

According to the Ministry of Forestry, the amount of logs smuggled out of Indonesia in 2001–2003 was about 9 million m<sup>3</sup> (*Kompas*, 3 August 2004). An estimated value of this illegal log trade was US\$2.16 billion, an amount close to the financial assistance pledged by the Indonesian Consultative Group (CGI) to the Indonesian Government in 2003 as well as in 2004.

Around 90% of the proceeds from illegal logging in Indonesia end up in bank accounts elsewhere, particularly in Singapore, Malaysia and Hong Kong. Without the financial support of individuals in those countries, there would be no illegal logging in Papua. The profits may be huge, but the costs are considerable. The syndicates must purchase heavy equipment, pay local communities, bribe officials, hire ships, buy letters of credit, and falsify import-export documents.

Efforts to stop international syndicates of illegal log trade are not only necessary, but they can support efforts to curb corruptors and local *cukong* in Indonesia. However, if the international community applies pressure for change only on Indonesia, the results are likely to be counterproductive—illegal logging in Indonesia is quite clearly not solely an Indonesian matter. These criminals can use their political and economic power to soften any Indonesian Government efforts to stop illegal logging on the basis of nationalism and economic revivalism. They will see international timber companies as enjoying illegal logs from Indonesia and consider themselves as victims of an international agenda.

#### 5.4.1. A framework for international cooperation

The only way in which the trade in illegal logs will be curbed is by targeting and prosecuting the syndicates that finance these operations. This means finding out which banks they use and freezing their assets. A framework for action, in the form of anti money laundering laws, already exists. Under most jurisdictions—including those of Singapore, Malaysia and Hong Kong—illegal logging activities, such as those in Papua, are classified as ‘serious foreign crimes’ and smuggling illegal logs as well as falsifying documentation are considered as ‘serious crimes’.

The financiers of illegal logging can be traced through their financial transaction profiles and business behaviour. What is needed now is greater cooperation between the law enforcement agencies and financial experts of different countries in the region, and the wholehearted participation of global organisations such as the Financial Action Task Force on money laundering (FATF). Then there will be a real chance that the forests will be saved.<sup>26</sup>

The FATF and the Basel Committee on Banking Supervision can help governments and central banks around the world to freeze accounts of the financial backers of illegal logging. Both institutions can use

their policies and networks to help countries such as Indonesia—which are trying to stop illegal logging and other forestry crimes—to criminalise financial backers of illegal logging and freeze the proceeds of illegal logging crimes.

#### 5.4.2. Financial Action Task Force on Money Laundering

The FATF can issue a special recommendation or policy on illegal logging crimes. The recommendation should encourage member countries to criminalise financial backers of illegal logging and illegal log trade. Once the recommendation or the policy has been issued, FATF can invite member countries to identify countries and territories both inside and outside of the FATF that have not implemented FATF recommendations including the one on illegal logging.

Once countries in the world criminalise financial backers of illegal logging, there will be at least two channels by which countries can freeze accounts of the financial backers. The first channel, which is an informal but effective one, is through the exchange of financial intelligence among Financial Intelligence Units (FIUs). The FATF recommends that all countries create FIUs to serve as national centres for receiving (and, as permitted, requesting) analyses and disseminations of STR and other information regarding potential money laundering or terrorist financing.<sup>27</sup> Since 1995, a number of FIUs in the world have begun working together in an informal organisation known as the Egmont Group (named for the location of the first meeting in the Egmont-Arenberg Palace in Brussels). The goal of the group is to provide a forum for FIUs to improve support for their national anti money laundering programmes. This support includes expanding and systematising the exchange of financial intelligence, improving expertise and capabilities of the personnel of such organisations, and fostering better communication among FIUs through the application of new technologies.

PPATK joined the Egmont group in June 2004. PPATK can pass along information to Malaysia's or Singapore's FIUs regarding illegal logging financiers from Malaysia or Singapore. PPATK can copy the information to the FATF and the APG to ensure follow up from the FIUs. However, banks, Ministry of Forestry or the police investigators must first supply information regarding the Malaysian or Singaporean financial backers to PPATK.

The second channel for pursuing proceeds of crimes abroad involves setting up mutual legal

assistance (MLA) with the countries where the proceeds of crimes are transferred, deposited or invested. The MLA could include collecting evidence and statements from people; providing evidence in the form of documents and other notes; identifying and locating people; executing search and seizure warrants; searching for, freezing and sequestering the proceeds of crimes; or obtaining agreements of persons to testify or provide assistance to investigations. PPATK can also implement new initiatives from international conventions or recommendations for preventing and eradicating the crime of money laundering in a manner consistent with law and regulation.<sup>28</sup> The Indonesian Government has set up MLA with the Australian Government and signed MLA with the governments of South Korea and China. In addition, on 29 November 2004, the Government of Indonesia signed a Treaty on Mutual Legal Assistance in Criminal Matters with the Governments of Brunei Darussalam, Cambodia, Laos, Malaysia, the Philippines, Singapore and Vietnam. This multilateral treaty represents a significant development in regional thinking about MLA, and has the capacity to be extremely useful throughout Southeast Asia. However, the Indonesian Government can only implement MLA agreements that have been made into laws.

#### 5.4.3. Basel Committee on Banking Supervision

In support of the FATF, the Basel Committee on Banking Supervision should issue a special recommendation on prudent requirements related to high-risk sectors such as the forestry sector and the public sector in developing countries where corrupt practices are widespread. One key policy on the prudent requirements is the implementation of the KYC principles. The Basel Committee should request bank supervisors to monitor the implementation of the KYC by banks for forestry-related transactions. Many major international and local banks are financing pulp and paper industries as well as timber industries.

The Basel Committee, through the Core Principles Liaison Group including the International Monetary Fund (IMF) and the World Bank, can enforce its recommendations through assessment of the implementation of the Core Principles of Banking Supervision by bank supervisors in the world. The Core Principles were developed to provide the international financial community with a benchmark against which the effectiveness of bank supervisory regimes can be assessed. The

need for strengthening supervision of banks has been stressed as a major priority since it is now widely recognised that weaknesses in banking systems have been at the core of financial crises in many countries over the 1990s (Basel Committee on Banking Supervision 1999).

The IMF and the World Bank can play an active role on the implementation of the Core Principles. The IMF can influence its member countries to comply with a special recommendation on high-risk sectors in the context of its surveillance mandate. The World Bank can also encourage its clients to adopt a special recommendation on high-risk sectors in the course of its regular operation.

## 6. Conclusions and policy recommendations

This paper discusses the opportunities and challenges in using the new Indonesian anti money laundering law to simultaneously build prudent banks and sustainable forest-based industries. Despite providing a significant contribution to the Indonesian balance of payment, forest industries pose serious threats to Indonesian natural forests and local livelihoods. Recently, they have also come to pose a threat to the government budget—as was the case when the Indonesian Government spent more than US\$3 billion to bail the forestry conglomerates out of bankruptcy.

### 6.1. Conclusions

The threat of the timber industry to the banking sector is persistent and growing. Banks are incurring financial risk from the following sources: *illegal logging, illegal trade, log smuggling; competing government policy; politically exposed timber industries; expansion of timber industries, transfer pricing and creative accounting loss*. Banks that are not ready to deal with these sources of threat will face higher financial risks than those that are ready to deal with them.

Banks can use the anti money laundering regime to combat these threats. With the enactment of Law No. 25/2003 that amended Law No. 15/2002 regarding money laundering crimes, Indonesia, as well as the international financial community, has a rare opportunity to build prudent banks and sustainable forest-based industries at the same time. Indonesia was the first country to put forestry crimes and environmental crimes on the list of predicate offences. This demonstrates the government's commitment to making them a priority. This action put forestry crimes in the same class as



crimes such as corruption, bribery, smuggling of goods, fraud, and banking and tax crimes.

Bankers risk being involved in money laundering crimes by helping criminals launder the proceeds of crimes. They can face the same punishment as the criminal they are helping. As a company, a bank involved in this crime can also lose its banking licence and be liquidated. To encourage banks to change their behaviour, the anti money laundering policies provide some incentives for banks to become prudent banks. Banks are only required to report customers engaged in a *suspicious financial transaction* to PPATK; they do not need to breach the bank secrecy law when reporting their clients to PPATK. Also, information provided by the bank is classified as intelligence information and the name of the bank does not appear in the police investigation report or in the court proceedings.

Although it would appear that there are sufficient grounds for banks to report forestry sector STRs, by November 2004 there had been none reported by the banks to PPATK.<sup>29</sup> One possible reason for this lack of progress is that most forestry customers could be regarded as prime customers by most banks. They bring significant business and profit to the banks. Another possible reason is that banks have not been convinced that they face negative consequences from not reporting STR for forest-related crimes. Another challenge of having banks comply with the anti money laundering policy involves accountability throughout the police investigation. Without much progress on the police investigations, especially in combating forestry crimes, the flow of STR from banks to PPATK would be slow.

Finally, without support of the international anti money laundering regime, illegal logging in Indonesia cannot be stopped. Both the Indonesian forestry legislation and money laundering legislation are useless to prosecute international illegal timber trade syndicates. It is well documented that foreigners (especially Malaysians, Singaporeans and Chinese) are masterminding illegal logging in Indonesia. FATF, APG and the Basel Committee on Banking Supervision should encourage their respective members to use their money laundering legislations to prosecute these international illegal log trade syndicates.

## 6.2. Policy recommendations

1. The Indonesian financial regulators should start auditing the implementation of the KYC principles and anti money laundering (AML) law of the top five financial service providers involved in the forestry sector.
2. The Basel Committee on Banking Supervision should encourage banking supervisors in Singapore, Malaysia, the USA and Europe to audit the implementation of the KYC principles and the AML law of financial institutions that are significantly involved in plywood, sawn timber, pulp and paper, oil palm and mining industries.
3. The Indonesian and international financial regulators should develop a special policy on high-risk sectors such as the forestry sector.
4. The Ministry of Forestry should help banks and other FSPs to identify any suspicious financial transactions related to forestry crimes. The minister should also encourage police investigators to use the anti money laundering legislation to chase the financial backers of illegal logging. They can work with PPATK to achieve these objectives.
5. Banks should file STR to PPATK for customers that have been reported by the Ministry of Forestry, Ministry of Environment, NGOs or the media as being implicated in forestry crimes—especially for those customers already under police investigation.
6. The police investigators should start using the anti money laundering law to find the financial backers of the illegal logging cases under its investigation. The police and state prosecutors should develop a common approach to prosecute money laundering crimes as well as the predicate crimes.
7. The money laundering tool should be used to reduce predicate crimes. The Indonesian parliament (DPR) should also provide the legislation support for PPATK to provide its results of analysis to appropriate authorities for the purposes of fighting predicate crimes such as banking fraud, corruption and illegal logging.
8. At this stage, international cooperation to use anti money laundering legislation to fight forestry crimes has just begun. It is encouraging that the Asia Pacific Group (APG) on money laundering considers illegal logging crimes as serious as drug trafficking and terrorism. The FATF should support the APG to create working groups to study illegal logging and create measures to combat the crimes. The FATF should also issue a special recommendation or policy regarding forestry and environment crimes.

## Endnotes

<sup>1</sup> For details about the history of the growing international concern about forestry crimes see *International Forestry Review* Volume 5 Number 3, September 2003, Special Issue: Illegal Logging.

<sup>2</sup> The *Kompas* newspaper suggested that members of the Indonesian Parliament (DPR) received bribes to pass the Government Regulation in lieu of Law (Perpu) No. 1/2004 amending the Forestry Law No. 41/1999.

<sup>3</sup> Many news stories have reported these practices, as well as CIFOR and its partners' case study reports on decentralisation of forest management.

<sup>4</sup> Dialogue with members of the Indonesian Police, the Attorney General's Office, and the Indonesian Courts at a Workshop on Money Laundering organised by the Indonesian Financial Intelligence Unit (PPATK), Batam, 11 August 2004.

<sup>5</sup> Articles 3, 6 and 7, Act No. 25/2003.

<sup>6</sup> Articles 4 and 5, Act No. 25/2003.

<sup>7</sup> Prudent banks are also required to have prudent policies, practices and procedures with respect to granting of loans and making of investments, and the ongoing management of the loan and investment portfolios. Banks are required to be prudent when they evaluate the quality of assets and the adequacy of loan loss provisions and loan loss reserves. Banks should set prudent limits to restrict bank exposure to single borrowers or groups of related borrowers. When banks lend to related companies and individuals, they should be on an 'arm's-length' basis—monitoring the situation and taking appropriate steps to control or mitigate the risk. They should have control over market risk, country risk and transfer risk in their international lending and investment activities, and maintain appropriate reserves against such risk. They should also have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks. Finally, a prudent bank is required to have an adequate internal control for the nature and scale of its business. It should have appropriate independent audit and compliance functions to test adherence to the internal control, as well as applicable laws and regulations. (Basel Committee on Banking Supervision 1997.)

<sup>8</sup> Bank Indonesia Regulation No. 3/23/PBI/2001 regarding amendment of PBI

No. 3/10/PBI/2001 regarding know your customer principles.

<sup>9</sup> Bank Indonesia's circulation letter No. 5/32/DPNP regarding the Guideline for the Implementation Standard of Know Your Customer Principles, December 2003.

<sup>10</sup> Bank Indonesia's circulation letter No. 5/32/DPNP regarding the Guideline for the Implementation Standard of Know Your Customer Principles, December 2003.

<sup>11</sup> Letter of the Head of PPATK, No. 3/712/PPATK, 23 December 2004 to all providers of financial services.

<sup>12</sup> Bank Indonesia Regulation (PBI) No. 3/10/PBI/2001 regarding implementation of KYC Principles in June 2001. Bank Indonesia issued PBI No. 3/23/PBI/2001 to improve PBI No. 3/10/PBI/2001 in December 2001, and Bank Indonesia Circular Letter No. 6/37/DPNP regarding Assessment and Imposition of Sanctions in regard to the application of KYC principles and other requirements pertaining to the Law on Money Laundering Crime, 10 September 2004.

<sup>13</sup> Article 5, Government Regulation No. 57/2003 regarding special protection of reporting parties and witnesses.

<sup>14</sup> Article 41, Law No. 25/2003.

<sup>15</sup> Article 17a, Law No. 25/2003, anti tipping-off.

<sup>16</sup> Article 1.7, Law No. 25/2003.

<sup>17</sup> The Corruption Index of 2004 by The Political and Economic Risk Consultancy, a Hong Kong-based risk consultancy.

<sup>18</sup> A 'politically exposed person' (PEP) applies to individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or government, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves (FATF Money Laundering, Glossary: FATF 40 Recommendations).

<sup>19</sup> Articles 26 and 27, Law No. 25/2003.

<sup>20</sup> A public prosecutor needs a letter signed by the Attorney General or the Head of a Provincial Prosecutor's Office and a judge needs a letter signed by the Head of the Panel of Judges hearing the case concerned.

<sup>21</sup> Explanation of Article 3, paragraph 1, Act No. 25/2003.

- <sup>22</sup> Article 38, Law No. 25/2003.
- <sup>23</sup> Media Indonesia, 28 May 2004.
- <sup>24</sup> Articles 1 to 4, PP No. 57/2003 regarding procedure for special protection for reporting parties and witnesses of money laundering crimes.
- <sup>25</sup> Article 35, Act No. 25/2003.
- <sup>26</sup> Some international initiatives have been introduced recently to use the anti money laundering regime to stop forestry crimes. The European Union has led the initiative in Europe to criminalise illegal logging so that the proceeds of these activities can be subjected to money laundering legislation (Marijnissen 2003). In a more promising initiative, in its 2004 typology workshop in Brunei Darussalam, the Asia Pacific Group (APG) on money laundering agreed to address the illegal logging issue and requested the Indonesian Financial Intelligence Unit (PPATK) to lead the development of a special working group on illegal logging at the APG level. The APG is a regional cooperative group of Pacific and Asian countries that works to combat money laundering. Countries of the APG include the USA, China, Japan, Singapore, Malaysia, Indonesia and Australia.
- <sup>27</sup> FATF Recommendation No. 26.
- <sup>28</sup> Articles 44, 44A and 44B, Act No. 25/2003.
- <sup>29</sup> By October 2005, PPATK can only submit 7 (seven) reports related to illegal logging to the Police. None of these reports has been processed to the court.

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