

**ASSESSMENT OF THE FEASIBILITY OF  
DEBT-FOR-NATURE SWAPS IN INDONESIA**

**Prepared for the US Agency for International Development  
under the Indonesian Natural Resources Management/EPIQ Program**

**Task Order No. OUT-PCE-806-96-00002-00  
December 14, 1998**

The Natural Resources Management/EPIQ Program's Protected Areas Management team works with BAPPENAS and the Directorate-General for Nature Protection and Conservation (PKA) of the Department of Forestry and Estate Crops to strengthen protected areas management in Indonesia. Work includes promoting partnerships among the private sector, government agencies, NGOs, and local communities; raising conservation awareness; improving conservation financing; and institutional and human resources capacity building.

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**For Conservation International**

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## **I. INTRODUCTION AND BACKGROUND**

### **1.1. Introduction**

As a result of Asia's economic crisis -- which has hit Indonesia particularly hard -- it may now be possible to increase funding for conservation and development through debt-for-nature swaps. The 69% depreciation of the rupiah since July 1997 has made it difficult for the Indonesian government and private sector to service its massive US\$138 billion debt burden.<sup>1</sup> In the wake of the economic crisis, the Government of Indonesia (GOI) has also been forced to slash budgets for national parks management by 30% in the FY 1998/99 budget, which represents a 60% reduction in real terms. The growing need for additional funding for conservation can now be linked to debt relief through debt-for-nature swaps.

The combination of reduced protection and increased economic pressure on protected areas is causing an environmental crisis that is threatening Indonesia's unique biodiversity.<sup>2</sup> Although debt-for-nature swaps are not a solution to the current debt crisis in Indonesia, they can be one way to increase funding for conservation in response to crisis conditions. Already stressed by the 1997/98 drought and unprecedented forest fires, the social devastation caused by the crisis -- growing poverty and unemployment -- has placed increased pressure on protected areas, particularly those in close proximity to highly populated areas.

This report summarizes the results of a study designed to explore the feasibility of implementing debt-for-nature swaps in Indonesia. Beginning with a brief overview of debt-for-nature swaps, the report analyses Indonesia's debt profile and current status, government policy relative to potential debt-for-nature swaps, potential sources of funding for swaps and concludes with a summary of the feasibility of three types of debt-for-nature swaps. Since it is hoped that this feasibility report will be the first phase in developing an initial, replicable debt-for-nature swap, the report also contains recommendations for a follow-up strategy.

The United States Agency for International Development (USAID) commissioned the report through the Natural Resources Management 2 (NRM 2) Program. The report was prepared by a consulting team led by Conservation International (CI) and consisting of Marianne Guérin-McManus, Team Leader; Melissa Moye, Financial Consultant (Development Alternatives, Inc.); Ian Bowles, Policy Advisor; Jatna Supriatna, Indonesia Liaison; and Fumiko Fukuoka, Japan Liaison.

The consulting team is particularly grateful to Dave Heeson and Holly Ferrette with USAID Indonesia and Ben Stoner with USAID Global Bureau, Jim Tarrant, Reed Merrill and Elfian

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<sup>1</sup> In July 1997, the rupiah was valued at 2,400 per US dollar. At the height of the crisis, the rupiah depreciated to over 16,000 per US dollar. Recently, the rupiah has appreciated, but it still remains depressed compared to pre-crisis levels.

<sup>2</sup> The Wall Street Journal, "Desperate Indonesians Attack Nations Endangered Species", (October 26,1998), p. 1, provides striking evidence of attacks on wildlife. Also see: Merrill, Reed and Effendi, Elfian, "Indonesia's Economic Crisis and Its Impact on Protected Areas Management," (Jakarta: October 1998).

Effendi of NRM2 who facilitated research in Jakarta, as well as David McCauley of IRG in Washington D.C.. The law firm of White and Case also deserve special mention for their valuable contribution to research conducted in Japan. This report represents a collaborative effort among conservation organizations experienced in debt-for-nature swaps, including CI, The Nature Conservancy (TNC) and the World Wildlife Fund (WWF), whose staff members made substantial contributions, both as members of the consulting and review teams and through their assistance with research and meetings.

The report was reviewed by a team consisting of Kirk Talbot (CI), Sheldon Cohen (TNC), Ben Stoner (USAID) and Jamie Resor (WWF). The review team's comments have been incorporated into the report.

## 1.2. Overview of Debt-for-Nature Swaps

*A debt-for-nature swap (or conversion) is defined as the cancellation of debt in exchange for a commitment to mobilize domestic resources for the environment.*

The debt crisis in Latin America in the 1980s led to the introduction of the debt-for-nature swap, a financial mechanism which has enabled developing countries to reduce external debt while increasing support for conservation both through enhanced protection for biodiversity and through increased funding for conservation activities such as park management, research and assistance for neighboring communities. In the context of this report, the potential for three types of debt-for-nature swaps has been explored. A Glossary of Terms, including terms indicated in bold in the report, is provided in Annex D.

### 1.2.1. Three-Party Debt-for-Nature Swaps of Public Debt

Most of the debt-for-nature swaps concluded to date by conservation organizations have been three-party swaps involving external commercial debt owed by sovereign governments (**public debt**).<sup>3</sup> Some three-party swaps have also involved the purchase of non-concessional bilateral debt from export credit agencies in Europe.

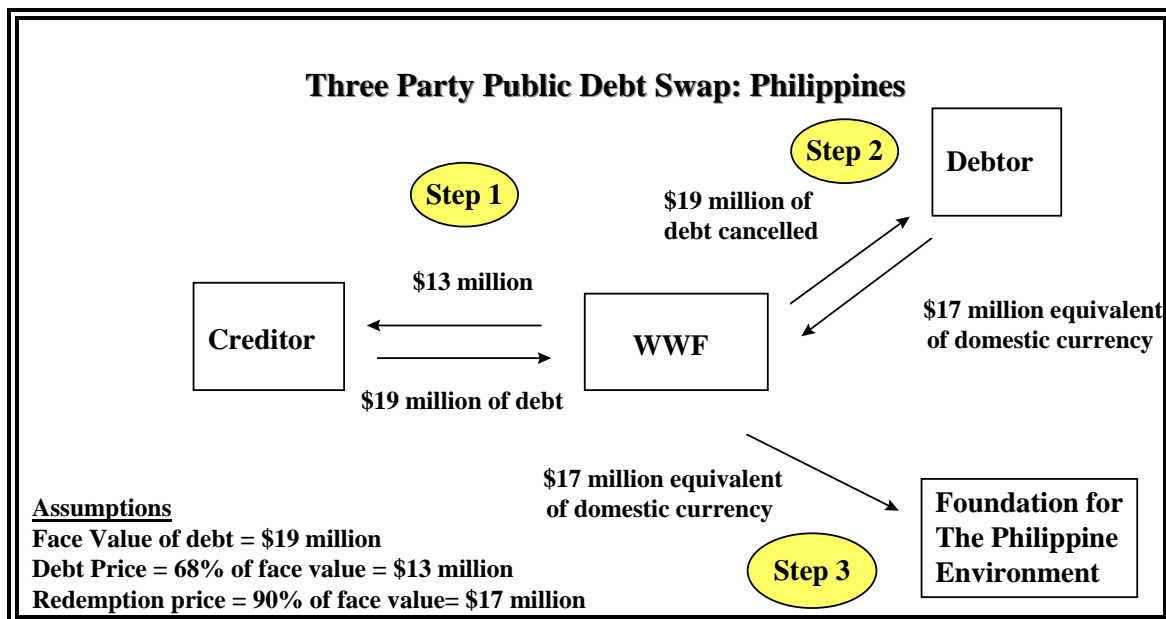
The first step in a three-party debt-for-nature swap is for a "**conservation investor**" to negotiate for the purchase of public external debt at a **discount** from **face value** (with funding raised from donor governments or private donors) or to solicit debt donations from a creditor. At the same time, the conservation investor negotiates separately with the debtor government for cancellation of the debt in exchange for a commitment to fund a conservation project or to provide enhanced protection for an area with high biodiversity value. In the third step, the conservation investor implements the project with the allocated local currency funding, often in collaboration with local beneficiary organizations which have field experience in project implementation.

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<sup>3</sup> The first debt-for-nature swap was agreed between Conservation International and the Government of Bolivia in 1987. Since then, Conservation International, IUCN - the World Conservation Union, the Missouri Botanical Garden, the Nature Conservancy and the World Wildlife Fund have all implemented debt-for-nature swaps. United Nations agencies (UNICEF, UNHCR), universities and research institutes have also swapped debt for social sector funding through **debt-for-development swaps**.

Normally, the debtor government continues to monitor expenditures related to debt conversion in order to ensure that the debt conversion agreement is respected.

Three-party debt-for-nature swaps involving public debt have been implemented in at least 17 countries world-wide. For example, in 1993, with US\$13 million in funding provided by USAID, the World Wildlife Fund was able to purchase US\$19 million in commercial debt owed by the Government of the Philippines, which represented a **purchase price** of 68% of face value. In exchange for cancellation of the debt, the Government of the Philippines agreed to pay Philippine pesos and peso notes valued at the equivalent of US\$17 million (or a **redemption price** of 90% of face value). The conservation funds generated were used to assure long-term funding for the environment through the creation of an endowment for the Foundation for the Philippine Environment.



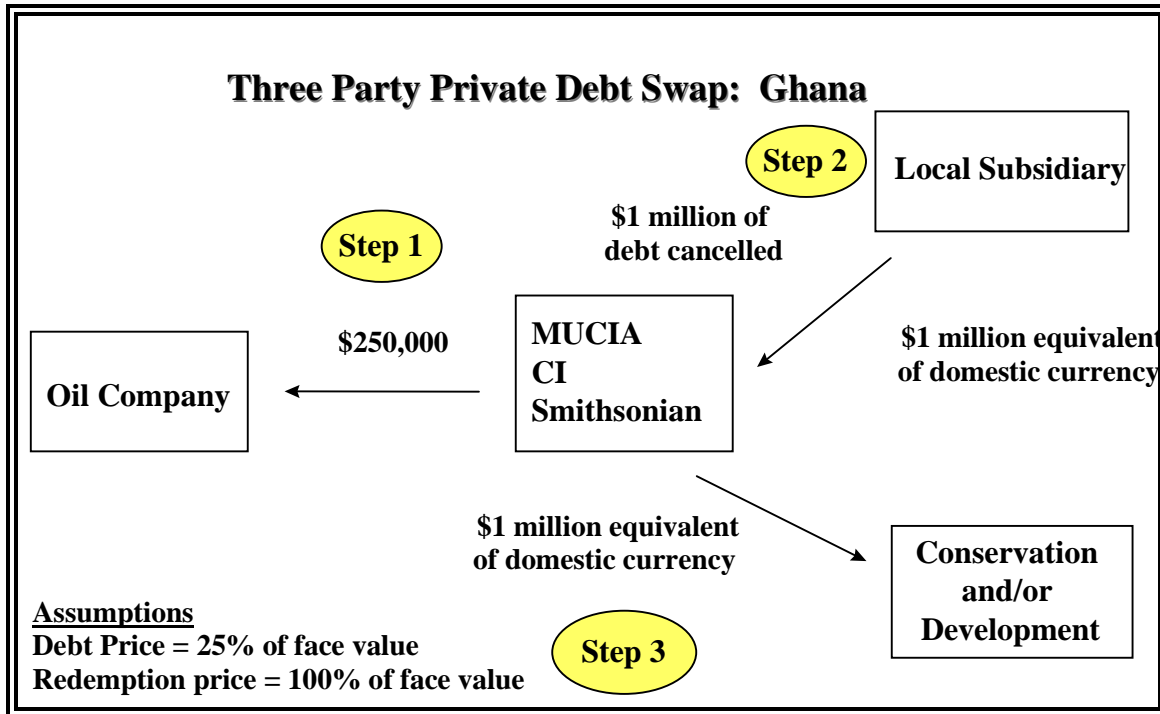
### 1.2.2. Three-Party Debt Swaps of Private Debt

In a three-party debt-for-nature swap involving debt owed by private debtors, the mechanism is the same as described above; however, the debt conversion proceeds (cash or another asset) are paid by the private debtor to the conservation investor or other designated beneficiaries. In a "**private-to-private**" swap the government of the concerned country would play a limited or no role in the swap, except in cases of the transfer of an asset that requires government authorization, such as land or real estate.

Most private-to-private swaps have taken place in the private sector involving swaps of **debt-for-equity**. There are, however, a few examples of debt-for-nature and development swaps



involving purchases of blocked currency from local subsidiaries of multinational companies. In 1992, a consortium of non-profit organizations, including Conservation International, the Midwest Universities Consortium for International Activities (MUCIA) and the Smithsonian Institution paid US\$250,000 to an international oil company in exchange for payment of US\$1 million equivalent in local currency. This conversion of blocked currency financed the creation of the Kakum National Park which protects one of the few remaining tropical forests along the southern coast of West Africa. The conversion also financed eco-tourism through the restoration of historic sites associated with the colonial history of the region.



### 1.2.3. Bilateral Debt Swaps

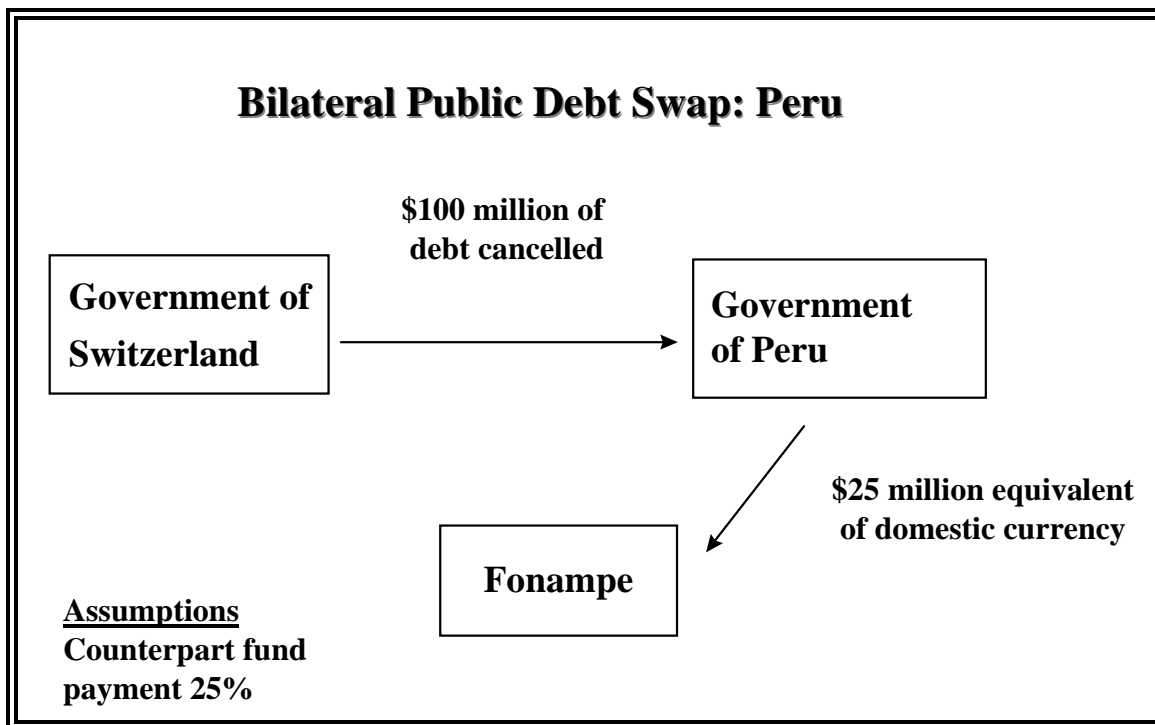
In a bilateral debt swap, a creditor government cancels debt in exchange for a debtor government setting aside funding for an agreed purpose(s). The amount of local currency generated usually reflects a discount rate relative to the face value of the original debt which is subject to negotiation between the two countries. In some cases, payment has also been made with no discount.<sup>4</sup>

Several bilateral creditors have debt conversion programs which provide for the conversion of Official Development Assistance (ODA) debt and sometimes for **buy-backs** of publicly guaranteed export credits or even commercial debts. The negotiation of bilateral debt swaps

<sup>4</sup> Both France and Sweden have negotiated swaps involving 100% repayment in local currency.

requires coordinated action among relevant government agencies within the two governments and often involves the participation of conservation organizations and other local agencies as intermediaries and/or beneficiaries. The introduction of bilateral debt swaps, particularly in Latin America, has led to the establishment of **conservation trust funds** which have been capitalized through bilateral debt swaps involving bilateral creditors/donors such as Canada, Switzerland and the USA.

It is estimated that close to US\$1 billion has been generated for conservation through bilateral debt swaps.<sup>5</sup> For example, Peru was able to negotiate bilateral debt swaps with six of its bilateral creditors (Canada, Germany, Finland, the Netherlands, Switzerland and the USA). The discount rate applied to the face value of debt for these conversions was close to 75% (which is equivalent to paying 25% of the original face value of the debt). Much of the funding has been channeled through Peru's National Trust Fund for Protected Natural Areas (FONANPE). Some bilateral creditors prefer swaps that benefit social and productive sectors as well as conservation.



### 1.3. The Economic Rationale: Why Swap Debt for Nature?

<sup>5</sup> Curtis, Randall, "Bilateral Debt Conversion for the Environment, Peru: an Evolving Case Study," (Montreal: October 17, 1996).

The feasibility of implementing debt-for-nature swaps depends on satisfying the diverse interests of the parties to a swap. In order to complete a debt swap, the creditor, debtor, conservation investor and donor, who may all be parties to the swap, need to be sufficiently motivated to participate in the swap.

- The **creditor** (bank, commercial supplier, export credit agency, aid agency) must be willing to donate or sell debt because it believes that the benefits of reducing debt through debt conversion outweigh the benefits of waiting for uncertain future repayment. With the exception of aid agencies, which can be creditors as well as donors, and value the conservation benefit of swaps, most creditors are motivated primarily by the desire to recover some portion of a debt that they perceive as unlikely to be repaid at full face value.

In some cases, private creditors may also value potential tax benefits or good publicity related to debt donations. There may also be incentives for a creditor to sell debt in order to "exit" from a country by eliminating its exposure for that country. A creditor might also adopt an exit strategy for smaller amounts in cases where the administrative costs of keeping a loan on its books outweigh any potential prospect for repayment. If a creditor has already written off or provisioned for a bad loan, debt sales can be viewed as a recovery which has a positive impact on the creditor's financial position.

- The **debtor** (government or private sector) needs to be interested in and able to provide local currency or another asset of value to conservation in exchange for cancellation of the debt. The debtor is primarily interested in retiring its debt in local currency at the highest possible discount from face value (or inversely, at the lowest possible price). A debtor government will also be interested in the potential for increased investment in conservation. A private sector debtor is likely to be interested in a swap only if it is able to achieve repayment terms more advantageous than those it might have reached through direct negotiations with a creditor.
- In the case of three-party debt-for-nature swaps, the **conservation investor** (not-for-profit organization, research institute, academic institution, United Nations agency, conservation trust fund or foundation) is interested in leveraging funding for conservation by capturing the difference between the price and other costs it incurs to purchase debt and the additional conservation benefit (in the form of cash, bonds, enhanced protection for biodiversity or another asset) derived through the swap.
- **Donors** who provide funding for debt swaps will be interested in leveraging aid dollars for an identified conservation project while promoting economic growth through debt reduction. Normally, donors are involved in approving the financial terms of debt swaps and continue to monitor project performance as they would for any donor-funded project. Donors also appreciate the potential debt swaps offer for channeling aid funds through non-governmental actors which can result in increased decentralization, accountability and transparency in management of project funds.

## II. EXTERNAL DEBT PROFILE OF INDONESIA

### 2.1. Indonesia's Debt Burden

The debt crisis in Indonesia, like in most affected Asian countries, differs from previous debt crises in developing countries in that private sector debt rather than public sector debt is at the origin of the crisis. In spite of its considerable size, public sector debt played little role in provoking the crisis and has only become more significant recently as the GOI seeks to respond to the economic crisis. With increased demands on the government budget, including contingent liabilities related to bank restructuring and obligations of state enterprises, the government's capacity to service its debt has become strained.

**Table 1**  
**Who owes what to whom**  
(External debt in US\$ billions, March 1998)

<b>Debtor</b>	<b>Amount</b>
<b>Public Sector</b>	<u>65.56</u>
<b>Government</b>	54.39
<b>State Enterprises</b>	11.18
<i>State banks</i>	5.61
<i>Corporates</i>	5.57
<b>Private Sector</b>	<u>72.46</u>
<i>Private banks</i>	8.00
<i>Corporates</i>	64.46
<b><u>Total external debt</u></b>	<b><u>138.02</u></b>
<b><u>Memo items</u></b>	
<i>Debt owed by:</i>	
Corporates <sup>b/</sup>	70.03
<i>Bank credit</i>	64.60
<i>Domestic securities</i>	5.43
Bank	13.61
<i>Interbank lines</i>	12.83
<i>Domestic securities</i>	.78
a/ As of July 8, 1998.	
b/ Includes state enterprise debt	
Source: Bank Indonesia	

World Bank, "Indonesia in Crisis: A Macroeconomic Update" (Washington, DC: July, 1998)

In March 1998, Indonesia's external debt totaled US\$138 billion, with US\$72 billion (52%) owed by the private sector and US\$66 billion (48%) owed by the public sector. Compared to other Asian countries, Indonesia's debt burden was already relatively high prior to the crisis. In 1998, Indonesia was reclassified by the World Bank as a severely indebted middle-income country because of an increase in Indonesia's ratio of present value of debt to exports (reaching 236% in 1996), which is one measure of a country's potential capacity to service its debt.<sup>6</sup> The impact of the crisis is shown in Indonesia's ratio of external debt to Gross Domestic Product (GDP) which is estimated to have increased from 64.5% of GDP in 1997 to 162.7% in 1998.<sup>7</sup>

## **2.2. Profile of Private Debt Owed to Private Creditors**

One of the root causes of the current economic crisis in Indonesia was the rapid growth in private external debt in recent years. Strong macroeconomic fundamentals in Indonesia attracted foreign capital, mostly in the form of commercial bank loans denominated in hard currency with average maturities of only 18 months.<sup>8</sup> Since most of the private external debt was unhedged, the steep depreciation of the rupiah made it impossible for most Indonesian corporate borrowers to service their external debt. Defaults on domestic bank debt (often denominated in dollars) revealed the vulnerability of the Indonesian banking system.

Of the US\$72 billion in private debt, US\$ 63 billion is owed by corporate debtors, with most of the debt owed to foreign banks. Japanese banks account for 38% of total foreign bank lending. Japanese bank exposure is understated by this figure because Japanese bank lending to Japanese trading companies operating in Indonesia is not reported as foreign lending. Outstandings for top Japanese trading companies are shown in Table 2. After Japan, European banks (Germany (11%), France (8%), UK (8%)) have the largest exposure to the Indonesian private sector, followed by American banks (8%).<sup>9</sup>

### **2.2.1. Private Debt Restructuring**

Progress on private debt restructuring in Indonesia has been slow as both debtors and creditors have been reluctant to recognize the reality that economic conditions are unlikely to improve enough in the near future to enable debtors to service their debt. Instability in the value of the rupiah has also made debt renegotiation difficult. Some debtors may also have taken advantage of the situation to delay negotiations on debt restructuring in order to avoid repayment.

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<sup>6</sup> World Bank. "Global Development Finance 1998," (Washington, DC: 1998), p.66. Indonesia was previously classified as a moderately indebted middle-income country.

<sup>7</sup> International Monetary Fund, "Annual Report 1998," (Washington, DC: 1998), p.30.

<sup>8</sup> World Bank, "Indonesia in Crisis: A Macroeconomic Update," (Washington, DC: July 1998), p. 1.8.

<sup>9</sup> Asian Wall Street Journal, "Why Indonesia Never Got a Debt Deal," (October 26, 1998), p. 1.

**Table 2: Japanese Private Corporations' Loans to Indonesia  
(as of March, 1998)**

	Investment	Lendings	Guarantee	Total	Hedge Rate	Trade credit, (unit 100 mil yen)	
						Trade Credit	Hedge Rate
Marubeni	400	761	1,262	2,463	45.1	410	68.3
Ito-chu	306	778	848	1,932	15.0	264	72.7
Nissholwai Corp.	247	1,043	425	1,715	69.3	410	68.3
Mitsui & Co., Ltd.	453	371	742	1,566	49.0	894	80.6
Sumitomo	276	241	958	1,475	22.2	900	66.7
Mitsubishi Corp.	163	373	808	1,344	51.5	400	75.0
Tomen	193	245	352	790	14.2	413	25.7
Nichimen	45	81	255	381	0.5	125	64.8
Kanematsu	73	79	144	296	12.2	188	15.4

*Published: Sept. 5*  
*Source: "Shuken Toyokeizai"*

There is increasing evidence that debtors and creditors are coming to the negotiating table, but most of the debt restructuring agreements reported to date have been for corporations with sufficient hard currency export earnings to enable them to stretch out repayment over a few years. There is growing recognition that for many corporate debtors, agreement can only be reached if some degree of debt relief -- a **haircut** -- is offered. So far, the largest creditor group, Japanese banks, have been reluctant to consider haircuts, a factor which may stall debt renegotiations. Creditors recently received a reality check when PT Astra, a large holding company and manufacturer of automobiles, announced that it was suspending debt service payments and offering a debt restructuring proposal to its creditors.

Since the crisis began in Indonesia, the GOI has introduced a series of measures designed to facilitate debt restructuring efforts which are being negotiated on a case-by-case basis between private creditors and private debtors. The most recent effort, the **Jakarta Initiative (JI)** was launched on September 9, 1998. JI establishes a framework for corporate debt restructuring which sets forth voluntary guidelines for negotiations between debtors and creditors and will introduce legal reforms and expedited GOI action to facilitate debt settlements. On November 2-3, the World Bank sponsored a JI conference that brought together 1200 creditors, debtors, financial and legal experts and government officials.

In an earlier effort, on June 4, 1998, the GOI and Indonesia's foreign bank creditors agreed to the **Frankfurt Agreement**, which provides for the following measures.<sup>10</sup>

- A scheme to repay interbank debts over 4 years.
- An arrangement to maintain trade finance facilities at April 1998 levels of about US\$4.5 billion.
- A framework to restructure corporate external debt through the creation of the **Indonesian Debt Restructuring Agency (INDRA)** which will introduce a program to protect debtors from foreign exchange risk and guarantee creditors US\$ repayment (as long as rupiah payments are made). Debtors participating in INDRA must already have concluded restructuring agreements with minimum terms for repayment of over 8 years with a 3 year grace period. So far, INDRA is not fully operational and until debt settlement agreements are reached, debtors will not be able to sign up for the scheme.

The GOI has also introduced a number of legal reforms, the most important being the amendment of the **bankruptcy law**, which resulted in the creation of a new commercial court in August 1998. The private sector has expressed some skepticism regarding the effectiveness of the new commercial court although it is probably too soon to judge whether the court will be a credible threat in motivating debtors to renegotiate their debts. Early cases have not inspired confidence and creditors are less likely to give the court the benefit of the doubt in light of evidence of past corruption in the Indonesian judiciary.

Beginning in January, 1998, the GOI extended a sovereign guarantee for deposits and liabilities of the banking system. The **Indonesian Bank Restructuring Agency (IBRA)** has recently been created to restructure the banking system through liquidation, restructuring and recapitalization of Indonesian banks. As a result of the bank bail-out, the GOI will be seeking repayment from domestic banks which received liquidity support. The GOI has become a major creditor of the banking system and will become the primary shareholder in many Indonesian companies which are offered by holding companies in settlement plans for failed banks. In the coming months, IBRA's Asset Management Unit will be disposing of assets, some of which may be of interest to conservation investors because of their conservation value (e.g., forest concessions).

Although it is hoped that the JI will jumpstart debt restructuring negotiations, so far, both creditors and debtors have been lukewarm about debt restructuring initiatives which have failed to inspire full confidence. From the GOI side, implementation has been delayed partly due to the lack of qualified personnel. In the current political environment, with parliamentary elections scheduled for June 1999, there is a high degree of uncertainty regarding future GOI commitment to measures taken now.

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<sup>10</sup> A bank steering committee, consisting of Bank of Tokyo-Mitsubishi, Chase Manhattan Bank and Deutschebank, represented the 800 creditor banks.

### 2.2.2. Availability of Private Debt for Purchase or Donation

It is possible to purchase Indonesian corporate bonds and notes, which are lightly traded in the secondary debt market. There have already been cases where corporate borrowers have bought back their own debt or third parties have purchased debt for **debt off-set** transactions. There is little evidence that Indonesian private sector loans are changing hands, but assuming that debt restructuring negotiations move forward, this situation is likely to change. The price (or inversely the haircut) cited for Indonesian debt varies widely depending on the type of debt considered, and the debtor and the creditors involved. In the future, debt prices are also likely to fluctuate depending on economic and political conditions in Indonesia.

The rating agency, Standard and Poor's, rates Indonesian corporate bonds from CCC (currently vulnerable) to D (payment default).<sup>11</sup> Reflecting the different credit ratings, prices for traded Indonesian corporate debt range from 5 to over 100% depending on a number of factors related to the perceived credit-worthiness of corporate borrowers, which already takes into account country risk. According to debt traders, some general trends can be noted:

- Prices for Indonesian traded debt generally track the performance of the Indonesian stock market and rupiah.
- Bank debt trades at low prices because of current difficulties in the banking sector.
- Debt owed by borrowers associated with the Suharto regime trades at lower prices because of perceptions that this debt is less likely to be repaid.
- Debt for corporations with strong export earnings and foreign assets trade at higher prices.
- Recent political developments had little impact on the market which had already factored political risk into market pricing.

Since debt restructuring negotiations are only just beginning in many cases, it may be too soon to predict accurately an appropriate price for purchasing Indonesian private sector loans for debt conversion transactions. Debt purchases would be subject to negotiation between the conservation investor and the creditors with different terms for purchase possible, depending on the creditor's perspective regarding the haircut that they are willing to accept. A number of factors are likely to have an impact on future prices for Indonesian bank loans, as follows:

- The more "pain" inflicted on creditors in the form of delayed payment, the larger the haircut that they may be willing to consider.
- Smaller creditors without a presence in Indonesia may be more willing to accept larger haircuts in order to avoid further costs related to debt restructuring and exit a troublesome situation. Larger creditors with on-going relationships are more likely to consider creative

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<sup>11</sup> Standard & Poor's, "AsiaFocus," (New York: October 1998).



ways (e.g. equity stakes in debtor companies) to resolve debt problems with debtor companies since they expect to continue operating in Indonesia.

- It is generally agreed that American and European creditors may be prepared to accept larger haircuts (in the 30-50% range) in exchange for immediate settlements. American and European banks are more likely to adequately provision for and recognize non-performing loans.
- In contrast, Japanese banks will be constrained by their own financial problems and accounting rules from considering haircuts. However, Japanese sources cited the possibility of haircuts in the 10-40% range.

### **2.3. Legal Issues Related to Conversion of Indonesian Debt**

The loan agreements governing Indonesian sovereign and private sector debt do not include debt conversion clauses, which have been included in consolidated loans for Latin American debt restructurings. **Syndicated loan agreements** usually contain restrictions on **prepayment** and/or **sharing clauses** which must be reviewed in determining the debt's suitability for conversion. Prepayment provisions require prepayment of all lenders under the agreement on a ratable basis. A sharing clause ensures that, if one lender receives a disproportionate payment under the loan, that payment will be shared ratably with the other members of the syndicate.

In the absence of legal provision for debt conversion in loan agreements, it could prove to be difficult to seek waivers from all lenders participating in a syndicated loan agreement unless a mechanism could be worked out through creditor committees that are established for a particular debtor. As a result, it may be easier to convert smaller multi-lender, single-lender and traded debt where there are no legal restrictions or the smaller number of creditors make waivers easier to obtain.

### **2.4. Tax Status for Debt Donations**

In some cases, it may be possible to convince creditors to donate debt for debt-for-nature swaps because of tax benefits resulting from donations to charitable organizations. As described below, these advantages can be substantial for US creditors; however, for Japanese creditors, the advantages are more limited.

#### **2.4.1. Tax Status for US Debt Donations**

The US Tax Code has been clarified regarding the tax advantages of debt donations. Internal Revenue Ruling 87-124, issued in November 1987, confirms that US institutions that donate debt to a US non-profit 501(c)(3) organization may receive two tax benefits: 1) a bad loan loss deduction for any loss between the debt's original face value and its fair market value at the time of the donation, and 2) a charitable contribution deduction equal to the fair market value of the proceeds generated as a result of the conversion.

These deductions allow a donating institution to reduce its taxable income and, thus, its US taxes. Generally, charitable contribution deductions may be taken against domestic source income, while bad loan loss deductions are apportioned between domestic source and foreign source income. As potential donors will prefer to take deductions against their domestic source income, there is some incentive for a donor of debt to value the charitable contribution deduction more highly than the bad loss deduction in order to allocate more of the deductions resulting from a donation against its domestic source income.

#### **2.4.2. Tax Status for Japanese Debt Donations**

In the case of a transfer of assets for consideration, if the amount of consideration is less than the face value of the assets (such as the sale of debt at a discount), the seller (Japanese bank) would be able to account for the loss for income tax purposes, but only to the extent that the discounted price paid reflects the fair market value of the debt in international markets. The latter condition would have to be demonstrated to the Japanese tax authorities. The difficulty arises because of the assumption in Japan that there is no market for bad loans and hence the difficulty of establishing that fair market value can be less than full price. However, some Japanese experts are confident that if a contract between the seller and creditors clearly stipulated that the transferring price is the market price, reflecting an established secondary market for Indonesian debt, there is a strong possibility that the loss incurred by the seller would be considered deductible by the Japanese tax authorities. This could arguably provide the needed incentive to Japanese banks to consider selling their debt at a discounted price.

Under Japanese corporate tax law, contributions made by a corporation outside the scope of its business and without consideration are considered a "donation" and as such do not qualify the corporation for a tax deduction. However, an exception to the rule would involve receiving "designated donation" status from the Ministry of Finance. Such qualification arises from being "widely solicited" by the public and from being earmarked to "improve public interest such as promoting education, science, enhancing culture and social welfare". Under that condition, the full amount of a donation would be deductible. Japanese experts believe that such a status would be easiest to obtain if the donor is already a public interest institution established as an auxiliary body of one of the governmental agencies.

### **2.5. Profile and Current Status of Public Debt**

#### **2.5.1. Public Debt Burden**

Of the US\$65.56 billion in public sector debt, US\$54.39 billion is owed by the Republic of Indonesia (central government) and US\$11.18 billion is owed by state enterprises.<sup>12</sup> Both bilateral and commercial debt owed by GOI could be eligible for debt swaps. Multilateral debt has never been the subject of debt swaps, and given the role of multilateral institutions in

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<sup>12</sup> World Bank, "Indonesia in Crisis: A Macroeconomic Update," (Washington, DC: July 1998), p. 2.3, based on Bank Indonesia data.

financing Indonesia's economic recovery, it is highly unlikely that multilateral debt would be swapped in any case.

### **2.5.2. Profile of Public Debt Owed to Bilateral Creditors**

Bilateral debt totaled US\$45.2 billion at end-1996. With 58% of total bilateral outstandings, Japan is by far Indonesia's largest bilateral creditor. Other large bilateral creditors in order of importance are Germany, USA, France, Netherlands, UK, Australia and Canada.

**Paris Club Agreement:** On September 23, 1998, the GOI reached agreement with 17 Paris Club creditors for a major reorganization of Indonesia's public external debt.<sup>13</sup> With the exception of Japan and Australia which will provide new money, most participating creditors will reschedule debt service principal payments falling due within a two-year period. Indonesia's Paris Club agreement is considered an exceptional treatment designed to respond to Indonesia's financing gap in meeting the current economic crisis, and, as such, does not reflect standard rescheduling terms typically offered by Paris Club creditors. Bilateral creditors are currently in the process of negotiating bilateral agreements with Indonesia which should be completed by the end of 1998.

The agreement reschedules debt service payments totaling US\$4.2 billion falling due from August 6, 1998 until March 31, 2000 for loans to the central government (debt owed by state enterprises is excluded). Official development assistance (ODA) service payments totaling US\$1.2 billion will be repaid over 20 years with a five-year grace period. Export credits of US\$3.2 billion will be repaid over 11 years with a three-year grace period. Public sector debt due commercial banks will be refinanced at new higher interest rates.

Since 1990, Paris Club agreements have generally included a "**swap clause**" which allows for the conversion of 100% of ODA debt and limited amounts of non-concessional debt on a voluntary basis. Because Indonesia's Paris Club agreement was granted on an exceptional basis, Paris Club creditors did not contemplate including a Paris Club swap clause for Indonesia. Although Indonesia's agreement does not include a swap clause, there is no prohibition against Paris Club creditors unilaterally providing debt relief or conversion in the absence of a Paris Club swap clause. However, as described below, some Paris Club creditors are unwilling to consider swaps of Paris Club debt in the absence of a Paris Club swap clause.

### **2.5.3. Availability of Debt for Purchase or Donation: Bilateral Debt**

Most bilateral creditors would only consider debt-for-nature swaps for Indonesia based on a formal proposal from the GOI (for bilateral swaps) or from a potential purchaser of debt (in the case of debt sales programs conducted by export credit agencies). In reviewing the potential for debt-for-nature swaps involving bilateral debt, selected creditors of Indonesia were contacted on an informal basis, with particular attention focused on Indonesia's larger creditors and creditors

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<sup>13</sup> Seventeen countries participated in negotiations for the "Agreement of the Group of Official Creditor Countries of Indonesia": Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, the Republic of Korea, Spain, Sweden, Switzerland, the UK and the USA.

that have participated in debt swaps in the past through official debt conversion programs. Since many of the bilateral creditors have not yet begun considering the possibility of debt swaps for Indonesia, the results summarized below should be considered preliminary indications of creditor policy.

**Belgium:** Indonesia is unlikely to be eligible for a debt-for-aid swap involving debt owed to Belgium because Indonesia is not one of Belgium's 25 priority countries for development assistance. At present, Belgium's export credit agency, the Office National du Dueroire, would not be interested in selling Indonesian debt because Dueroire expects full repayment of debt owed by Indonesia.

**Canada:** Canada's Debt Conversion Initiative for Environment and Development in Latin America, which is administered by the Canadian International Development Agency (CIDA), has converted ODA debt in 6 countries in Latin America. CIDA has not been a major funder of the environment in Indonesia, but is currently putting together a new aid package, which will focus on government reforms and the social safety net.

Since debt service payments on ODA loans are credited as reflows to CIDA, the rescheduled debt service payments will represent a net loss to the Canadian aid budget, making it problematical to grant debt relief. Nevertheless, Canadian officials did not exclude the possibility of a future swap, although it is unlikely at this time.

**Germany:** Germany is only willing to consider debt swaps (debt sales, debt-for-environment, poverty reduction and education) for countries that have a swap clause in their Paris Club agreement.

**France:** Through the Libreville Fund, France has converted debt for middle-income countries in Africa. The French Treasury also authorizes debt sales, usually for debt-equity swaps. France would need a formal request from the GOI in order to consider any sort of swap involving Indonesia.

**Japan:** Because of legal restrictions, the Government of Japan is not prepared to write-off developing country debt. Instead, Japan has provided long-term rescheduling terms and new money for debt servicing through Trade and Development Board grants, which are estimated to have effects similar to debt write-offs.<sup>14</sup> In the case of Indonesia, Japan has agreed to provide new money equivalent to debt servicing needs for the first year covered by the Paris Club agreement. Under the "Miyazawa Plan", announced in September 1998, Indonesia could also be eligible for up to US\$7.5 billion of a US\$30 billion rescue package. At the recent APEC Summit, Japan and the US announced a US\$5 billion package of measures to address debt restructuring.

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<sup>14</sup> In the case of the **Heavily Indebted Poor Countries Initiative (HIPC)**, Japan provides rescheduling of up to 40 years with 16 years grace, which is estimated to be equivalent to the 80% debt reduction often required by Paris Club members for HIPC countries.

Japanese government officials expressed interest in learning more about the debt-for-nature swap concept, although they made it clear that Japan would be unable to be involved in bilateral debt swaps that involve a write-off of debt (e.g. redemption would have to be at 100%). At present, debt-for-nature swaps are not considered a priority for Japanese policy-makers (Ministry of Finance). In order for Japan to participate in debt-for-nature or development swaps, it would be necessary to obtain high-level political support.

The "US-Japan Common Agenda for Cooperation in Global Perspective" provides a forum for exploring innovative partnerships that the US and Japan can undertake together through collaboration in both the public and private sectors. In collaboration with the US Government, American conservation organizations are exploring the possibility that the Common Agenda could provide a framework for US-Japan cooperation relative to debt-for-nature and development swaps.

**Switzerland:** Through the Swiss Debt Reduction Facility, Switzerland has established debt-for-development conversion programs in at least 18 countries worldwide. Indonesia is not currently a priority country for the Swiss Government for either ODA or debt refinancing; however, NGO and Swiss Government representatives did not rule out the possibility that priorities could change in the medium-term depending on developments in Indonesia.

**UK:** The Department for International Development (DFID), has had limited experience with debt swaps.<sup>15</sup> In the case of Indonesia, DFID would be interested in exploring the idea as long as any approach would be in line with broader development goals of the British government. In the absence of a Paris Club swap clause, Indonesian non-concessional debt is not eligible for debt sales conducted through the Export Credits Guarantee Department's debt conversion program.

**USA:** USAID has extensive experience with debt swaps and is interested in exploring the idea with respect to Indonesia, as their financing of this study demonstrates. In addition, the passage of the Tropical Forest Conservation Act (TFCA) by the US Congress in July 1998 offers the possibility of debt relief for debtor countries of the United States in exchange for project funding for tropical forest conservation. While the Enterprise for the America's Initiative (EAI) was restricted to Latin America, the new initiative may offer an opportunity for a bilateral debt swap to help conserve tropical forests in Indonesia.

The US Treasury hopes to appropriate anywhere between US\$20 to US\$125 million in the FY 1999 Budget for the implementation of the TFCA world-wide; however a more conservative view is that funds will not be available until FY 2000. The answer should become clearer in 1999 when the new US Congress convenes. In addition, a no-cost option (buy-back) can be considered by the Clinton administration without Congressional approval and could conceivably be available sooner.

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<sup>15</sup> Although it was not called a debt swap at the time, several years ago, the Overseas Development Administration (the precursor to DFID) canceled concessional loans owed by India in exchange for the Indian government providing local currency funding for the equivalent of about £100 million for forestry projects.

As a middle-income country with significant tropical forests, US\$677 million in USAID-Direct Loan debt and US\$611 million in PL-480 debt owed by Indonesia to the US could conceivably be eligible for the TFCA, assuming that Indonesia qualifies under the act's eligibility requirements.<sup>16</sup> The first step would be for the GOI to make a formal request to the US Treasury for consideration under the TFCA. Eligibility requirements are described in Annex B, which provides more information about the TFCA. One of the eligibility criteria is the level of "democratization" of the recipient country, although there are some preliminary indications that progress towards democratization would be enough to qualify Indonesia under the TFCA.

The US conservation community has been actively working with the US Congress and the US Treasury in assisting the authorities to develop priorities for the TFCA. A matrix is being developed that will set priorities among countries owing PL-480 or USAID debt based on the biodiversity value of the tropical forests (CI hotspots, WWF Global 200 will be used), managerial ability of the recipient governments and other local institutions to handle swaps, particularly through local conservation trust funds or foundations which could be used to channel the debt conversion proceeds, as called for in the law. It is expected that Indonesia will be considered a priority country.

#### **2.5.4. Profile of Public Debt Owed to Private Creditors**

At end-1996, Indonesia's public sector debt owed to private creditors totaled about US\$12 billion. The Republic of Indonesia's traded debt consists of the following two obligations:

- **US\$400 million Yankee bond:** issued in 1996 and matures on August 1, 2006, with a coupon of 7.75%. The bid price for the Yankee bond has ranged from a low of 46.28 to a high of 82.01 between May and November 1998 (recently priced in the 70s).
- **US\$300 million Euro Floating Rate Note:** US\$ 227.5 million outstanding, issued in 1986 and matures on February 20, 2001, interest on coupon set at LIBOR plus 0.1875% (with a 5.25% minimum). According to traders, this note is rarely traded.

#### **2.5.5. Availability of Debt for Purchase or Donation: Public Debt Owed to Private Creditors**

The legal and tax issues discussed above for private debt would also be relevant to three-party swaps involving public debt owed to private creditors. About US\$5 million in Republic of Indonesia Yankee bonds are traded each day on the secondary debt market. As indicated above, debt owed by the Republic of Indonesia to banks is treated through Indonesia's Paris Club agreement. One GOI official asked whether state enterprise debt could be swapped. For specific transactions, it would be interesting to investigate this possibility further, particularly relative to the state forestry company, INHUTANI, and for state enterprises that are being privatized.

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<sup>16</sup> Source for debt data: US Treasury. USAID direct loan debt as of December 31, 1998 and PL-480 debt as of April 30, 1998.

### **III. GOVERNMENT OF INDONESIA POLICY**

The GOI will play a key role in negotiating swaps involving conversion of public sector debt. Given the GOI's involvement in encouraging private sector debt restructuring and banking system reform, the GOI may also play an indirect role in stimulating private-private swaps, perhaps through the JI process. GOI authorization should not be necessary for private-private swaps, except in the case of swaps that result in the transfer of ownership of a public asset (e.g., forest concessions).

#### **3.1. Institutional Issues and Policy Developments**

Based on experience in other countries, the lead government agencies in swaps of public sector debt will be government agencies involved in debt management, planning and macroeconomic policy, which in the case of Indonesia would be the Coordinating Ministry of Economy, Finance and Trade, the Ministry of Finance, the National Development Planning Agency (BAPPENAS), and Bank Indonesia. These agencies would need to work closely with sectoral ministries, such as the Ministry of Forestry and Estate Crops and the Ministry of Environment, to establish priorities for allocating funding for debt conversion. In the forestry sector, the Directorate for Nature Preservation and Conservation (PKA) is the government agency best qualified to advise on priorities for debt-for-nature swaps.

Most government officials interviewed had limited knowledge of the debt swap concept. As called for in the terms of reference, to the extent possible, briefings and information were provided to a wide range of government officials in the course of meetings in order to inform the GOI about other countries' experiences with debt-for-nature conversions. Two briefings were presented to Ministry of Forestry and Estate Crops personnel.

In other countries, an inter-agency debt conversion committee has proven to be the most effective mechanism for developing and reviewing debt conversion proposals, and for formulating government policies and regulations on debt swaps. At this stage, the GOI has not expressed policy on debt-for-nature or debt-for-development swaps. GOI officials expressed the need for coordinated inter-agency action to consider debt-for-nature swaps, and Herman Haeruman suggested that BAPPENAS could play a role in this regard.

A few recent developments may have an impact on future government policy relative to swaps.

- On September 30, 1998, the Minister of Forestry and Estate Crops issued a decree for the formation of a Debt-for-Nature Swap Working Group which will consider the feasibility of debt-for-nature swaps. The Working Group will sponsor a workshop in December 1998 to discuss the concept with a wide range of public and private sector stakeholders.
- In the context of the Jakarta Initiative, the government is in the process of amending government regulations related to limited liability companies in order to facilitate debt-equity swaps. Accounting and tax policy relative to haircuts is also being revised. In conversations with individuals associated with JI (government officials, legal and financial advisors), the

possibility of the JI facilitating contacts for debt-for-nature swaps was raised and should be the subject of further discussion.

### **3.2. Fiscal and Macroeconomic Issues**

Unlike most severely indebted countries with structural adjustment programs, GOI fiscal prudence is causing donor funds to be disbursed slower than planned. As a result, the GOI budget deficit for 1998 is not expected to reach 8.5% of GDP as targeted in 1998. More than one source interviewed suggested that debt conversion might offer a mechanism to assist the GOI in channeling donor funding intended to address the economic crisis and particularly social safety net issues. A World Bank representative raised the possibility of using structural adjustment lending to finance debt swaps and suggested that an amount as high as US\$500 million could be of interest for social sector and conservation swaps.

Another donor recommended exploring the possibility of funding the GOI contribution to swaps through the Reforestation Fund (which has already collected hundreds of millions in US\$). Although, new reforestation fees are going directly to the state budget, no decision has been made relative to previously collected funds, the status of which is expected to be audited in the near future.

It will be important that the GOI analyze the financial terms, debt reduction benefits and macroeconomic impact, as well as the benefit for conservation. Since technically the GOI has never been in default on its external debt, the GOI will need to analyze whether engaging in swaps would have an adverse impact on the GOI's credit rating for sovereign borrowing which could affect the future cost of borrowing in international markets.

Although inflation has sometimes been a problem for debtor countries engaging in swaps, the size of the Indonesian economy relative to the size of potential swaps is so large that swaps are unlikely to have a significant impact on inflation.<sup>17</sup> In the event that inflation becomes a concern for a large swap, the GOI could consider ways to mitigate inflationary effects, for example, by issuing bonds as well as paying in cash.

### **3.3. Political Risk**

In debt swaps involving public debt, both conservation investors and donors will be concerned about GOI performance risk under a debt-for-nature swap. For example, in a worst case scenario, a new government could repudiate a debt-for-nature swap concluded by the previous regime. A more likely scenario, is that payment of debt conversion proceeds can be delayed or diverted. In light of the current political instability and competing priorities, the biggest challenge for conservation investors and donors will be to focus GOI decision-makers' attention on the possibility of debt-for-nature swaps.

The newly announced "Asian Growth and Recovery Program" provides for a new facility for political risk insurance to be implemented by bilateral and multilateral guarantee agencies.

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<sup>17</sup> Most sources predict that inflation will be close to the 80% target for 1998.





## **IV. CONSERVATION PRIORITIES FOR DEBT-FOR-NATURE SWAPS**

### **4.1. Defining Priorities**

It is beyond the scope of this report to review conservation priorities that could be financed through debt-for-nature swaps. Ideally, Debt-for-nature swaps should fund already defined priorities where funds may not have been available in the past. Debt swaps that attract new money for new projects, thereby generating additional funding, are generally preferred over swaps that use existing funding.

In other countries, debt-for-nature swaps have funded diverse activities. Although priorities for debt-for-nature swaps have not yet been explored in-depth in Indonesia, a number of ideas emerged in the course of research for this report, as follows:

- There is strong interest in developing long-term sustainable sources of funding for specific parks, regional groups of parks and the national park system. Conservation investors are actively pursuing the potential for financing mechanisms, such as debt-for-nature swaps, conservation trust funds and carbon sequestration, to generate additional funding for parks.
- National-level conservation organizations are particularly interested in exploring potential sources of funding for community forestry initiatives.
- In order to establish priorities for private-to-private debt swaps, TNC has commissioned a study that will map forest concessions with high biodiversity value that could be purchased through asset sales and/or debt swaps.

In many meetings in Indonesia, the fact that conservation takes second place to crisis-related priorities was often cited as a reason to consider the possibility of broadening the scope of debt swaps beyond the debt-for-nature concept. For debt-for-nature swaps to be feasible, particularly on a bilateral basis, it may be necessary to integrate conservation with development goals or to package swaps focusing both on the environment as well as poverty alleviation, employment generation and/or economic growth

At the project design level, it is important that the design of the debt-for-nature swap take into account the funding needs of the project envisaged. For example, since large amounts of local currency can be generated by a swap, the project should be able to absorb funding quickly enough so that in a high-inflation environment, such as Indonesia's, the leveraging effect of the swap is not diminished by loss in purchasing power. In a similar vein, in negotiating financial terms for a swap, the risk of foreign exchange depreciation will need to be taken into account and a hedging strategy should be reflected in the transaction structure of the swap.

Donor interest in financing projects through debt conversion is a main factor in the feasibility of a debt-for-nature swap. However, the interest of many funding sources often depends on an actual determination that a transaction is feasible. Most of the time, donors will come to the table only once it is clear that the country is in a position to open a "debt swap window." In a typical "build it and they will come" approach, a number of creditors and foreign aid agencies have

expressed their interest but would only commit funds in the event that a specific transaction could take place. In addition, the interest of many bilateral agencies will depend on the evolution of the economic and political situation in Indonesia.

Although this feasibility study did not contemplate that research would be conducted regarding identification of conservation investors active in Indonesia who would be prepared to effect debt conversions, international conservation organizations such as CI, TNC and WWF are experienced in debt conversion and eager to implement debt-for-nature swaps in Indonesia, working with local partner organizations. In meetings conducted by NRM2 with potential conservation investors, national-level organizations such as the Indonesia Biodiversity Foundation (KEHATI) and WALHI have also expressed interest in exploring the potential for debt-for-nature swaps.

One advantage of debt swaps is the opportunity to decentralize funding to beneficiaries who typically have less access to funding, such as local communities and non-governmental organizations (NGOs). In addition, significant numbers of organizations focusing on poverty relief and social and health causes that have little experience in debt conversion, could be assisted in pursuing opportunities.

## V. FEASIBILITY OF IMPLEMENTING DEBT-FOR-NATURE SWAPS

The above sections have addressed the perspectives of the different parties involved in a debt-for-nature swap. In order to assess the feasibility of swaps, it is necessary to evaluate all of the elements to see whether in the final analysis the terms of a swap make the transaction attractive enough for the different parties to conclude a debt-for-nature swap. The following terms of a debt-for-nature swap are subject to negotiation.

- Conservation project to be funded
- Purchase price for debt
- Redemption price for debt conversion
- Form of payment, including:
  - cash
  - local currency bonds
  - enhanced protected status
  - policy reforms
- Applicable exchange rate for payment
- Schedule for payment:
  - lump sum
  - tranche payments over time
- Tax treatment for debt conversion proceeds
- Transaction costs

### 5.1. Feasibility of Three-Party Debt-for-Nature Swaps Involving Private Debt

Unlike swaps involving public sector debt, the feasibility of private-to-private debt-for-nature swaps will depend almost entirely on the attractiveness of financial terms negotiated with the creditor and the debtor and the resulting benefit for conservation.

**Private creditor:** As discussed above, private creditors in Indonesia are in the early stages of renegotiating debt. If they can get a better deal from a conservation investor than they might be able to negotiate with a debtor, they may be willing to consider selling to a conservation investor. At this stage, it is probably too early to expect debt donations except in exceptional circumstances. Most of the creditors interviewed believed that swaps could be possible, but as discussed above, certain categories of creditors and types of debt would be more likely candidates for swaps. It seems less likely that Japanese creditors would be interested in swaps unless additional incentives were provided through changes in the tax treatment of debt donations or unless Japanese creditors changed their expectations regarding haircuts possible in debt restructuring settlements.

**Private debtor:** It is questionable how many Indonesian debtors will have sufficient resources and/or the will to perform under a debt conversion agreement. A debt swap will be attractive to a debtor if they can pay less, stretch out payment terms through tranche payments or bonds, and pay in rupiah rather than hard currency. Debtors will have access to foreign exchange protection

from INDRA under negotiated debt settlements. A debt swap would need to offer foreign exchange protection at least as attractive as that offered by INDRA. One GOI official noted that smaller debtors might have the most to gain from a debt swap since they have less capacity to negotiate with creditors and limited resources to pay for legal and financial assistance; however, smaller debtors may also pose the greatest credit risk in private-to-private debts swaps.

**Conservation investor:** In exploring private-to-private swaps, conservation investors will need to be vigilant in analyzing the credit risks inherent in purely private swaps, particularly in light of the limited prospects for enforceability of debt conversion agreements in the event of a default (most sources questioned ranked enforceability of contracts in Indonesia at one, on a scale from one to ten). The conservation investor should explore techniques for credit enhancement, such as conditional debt purchases, escrow arrangements, guarantees and insurance.

TNC is actively researching prospects for private-to-private swaps of debt for rights to forest concessions held by private debtors. Some large debtors hold title to forest concessions and will be forced to dispose of these assets in order to pay their debts, particularly holding companies which also have liabilities related to the bank bail-out. Such a swap would require GOI involvement because of the GOI's role in allocating and regulating forest concessions. Apparently, in the past, it has been possible to change the status of production forests to protected areas by ministerial decree. In considering swaps for forestry concessions, it will be important that the terms of forestry concessions (currently up to 20 years, but averaging closer to 9 years) are sufficiently long to make the swap worthwhile. In addition, financing will be required to manage newly created protected areas, and perhaps, even to compensate the GOI for lost royalties, although ideally an agreement for the GOI to forego royalties should be reached. Current anticipated forestry sector reforms are likely to improve prospects for private-to-private swaps for forestry concessions by lengthening the terms and transferability of concessions.<sup>18</sup>

In light of the resurgence of nationalism in Indonesia, it will be important to ensure that swaps avoid giving the impression that debt is being swapped for sovereignty over natural resources. Recent controversy over potential transfer of IBRA-managed assets raises the question of how debtors are selected for donor-funded debt-for-nature swaps. In order to avoid the impression that certain ethnic groups are being favored over others, one donor recommended that debtors be "selected" for swaps through market-based mechanisms.

## **5.2. Feasibility of Three-Party Debt-for-Nature Swaps Involving Public Debt**

**Private creditor:** Feasibility issues are the same as for private debt, except that creditors may have different perceptions regarding the appropriate haircut for public debt (it would be about 30% based on current pricing for Indonesia's Yankee bond).

**Public debtor:** As discussed above, the GOI's position on debt-for-nature swaps is not yet clear. To some extent the feasibility of swaps will depend on government officials understanding the

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<sup>18</sup> GOI, "Indonesia, Supplementary Memorandum of Economic and Financial Policies," (Jakarta: October 19, 1998), p. 10.

benefits of the mechanism and deciding that conservation is enough of a priority that government resources should be dedicated to debt-for-nature swaps.

**Conservation investor:** Concerns regarding government performance risk and political risk are discussed above.

### 5.3. Transaction Costs

For a conservation investor to analyze whether three-party swaps are feasible, it is essential to conduct a cost-benefit analysis in order to determine the minimum size for a swap and the gain from the swap necessary to make it worthwhile. Even in the case of debt donations, there will be transaction costs that need to be considered. Transaction costs related to swaps can include fees for financial and legal advisors, banking fees and debtor government commissions on swaps. A broker, who can also act as a financial advisor for a swap, will often add a percentage to the price of the debt that the broker is purchasing on behalf of the conservation investor in order to cover his costs. Typically, the percentage charged can vary between 1.5 % and 5% of the face value of the debt.

Transaction costs also include less easily quantifiable expenses, such as the conservation investor's staff time for preparing financial reports and obtaining all the necessary approvals in the debtor country. Significant human resources may also need to be dedicated to undertaking the protracted negotiations which are often necessary to consummate a debt swap in a country for the first time. In some cases, negotiations have taken up to two years to close. The costs of undertaking debt swaps tend to diminish as a country has more experience with swaps -- this was the case for countries like Mexico, Nigeria and the Philippines, which have had long-standing debt swap programs and active markets for their debt.

Transaction costs in Indonesia may be high initially until a more active secondary market develops for Indonesian debt and conversion procedures are better known to all the parties involved. It should be relatively easy to identify financial and legal experts that can engineer a swap in Indonesia. Such advisors are already beginning to advise both debtors and creditors regarding debt-equity transactions in Indonesia.

### 5.4. Feasibility of Bilateral Debt-for-Nature Swaps

**Bilateral creditor:** As discussed above in Section 2.5.3, some bilateral creditors are not currently considering bilateral swaps for Indonesia; however, they may re-evaluate their priorities as the situation in Indonesia evolves. From the bilateral creditor's perspective, the following factors are likely to affect a particular bilateral creditor's willingness to engage in bilateral debt swaps for Indonesia.

- If the creditor country already has an official debt swap program or has experience with bilateral debt swaps, the creditor will be more likely to consider debt swaps for Indonesia.
- In the event that there is an official program, Indonesia will need to meet eligibility criteria for the program. For example:

- the lack of a Paris Club swap clause may be a negative factor for some creditors;
  - democratization issues are likely to be important in the case of Indonesia, including governance, corruption and human rights concerns.
- Since Indonesia's Paris Club rescheduling is considered an exceptional treatment, Paris Club creditors expect full repayment from Indonesia. Therefore, the creditor's decision to engage in a debt swap will be motivated more by the desire to contribute additional funds for conservation or another social goal than by financial considerations.
  - If Indonesia is considered a priority country for a bilateral creditor/donor which already has substantial commitments to assist Indonesia, particularly in the environmental sector, then the creditor will be more likely to consider a bilateral debt-for-nature swap.
  - In light of the current crisis, bilateral creditors may be more likely to consider debt swaps which benefit not only conservation but also address crisis-related issues, such as poverty alleviation, employment generation and economic growth.
  - If economic conditions worsen in Indonesia, bilateral creditors are more likely to consider bilateral debt swaps for Indonesia.

**GOI:** From the GOI perspective, bilateral swaps are more likely to be feasible under the following conditions

- The GOI will be more likely to implement swaps if policy makers at all levels have a better understanding of the advantages and disadvantages of swaps and of how to implement swaps.
- Swaps will also be more feasible if the debt-for-nature concept is championed by high-level actors who make swaps a priority in national policy-making.
- Amounts proposed in swap programs need to be sufficiently large to attract the GOI's attention.
- Priorities for swaps should reflect current government priorities, as discussed above.
- The financial terms for bilateral swaps will need to be attractive for the GOI.
- If the GOI perceives that bilateral swaps will not have an adverse impact on the GOI's future ability to raise funds in international capital markets, the GOI will be more likely to consider debt swaps.

## VI. CONCLUSIONS AND RECOMMENDATIONS

### 6.1. Summary of Conclusions

Based on over 100 interviews in Indonesia and discussions with Indonesia's creditors during the months of October to November 1998, the consulting team has concluded that debt-for-nature swaps are likely to be feasible in Indonesia. Although debt-for-nature swaps are not an answer to the current economic crisis, they can raise additional funding for conservation and enhance protection for biodiversity in Indonesia. Given current donor and government priorities, debt-for-nature swaps are more likely to be implemented if swaps not only finance conservation, but also respond to crisis conditions by funding the social safety net and fostering environmentally sustainable economic growth.

Since the GOI's policy on debt-for-nature swaps has not yet been developed, three-party swaps involving private sector debt are more likely to be feasible at the present time than swaps involving public sector debt. Nevertheless, the potential for bilateral swaps involving public creditors is high for selected creditors, such as the United States. In addition, other bilateral creditors/donors may be more interested once the GOI has expressed interest.

### 6.2. General Recommendations

To increase the feasibility of debt-for-nature swaps in Indonesia, the consulting team has developed the following recommendations directed at the parties that could be involved in debt-for-nature swaps.

- **PRIVATE CREDITORS:** Private creditors should consider sales of debt and debt donations for debt-for-nature swaps in the course of debt restructuring negotiations. Creditors should review their portfolios to identify corporate borrowers with assets of conservation value, which may be suitable candidates for swaps. Creditor committees should consider including a debt-for-nature swap option as part of a menu offered to creditors in a particular debt settlement.<sup>19</sup>
- **PRIVATE DEBTORS:** Private debtors should consider debt conversion in the course of debt restructuring negotiations. Through the JI, it may be possible for debtors to make contact with conservation investors.
- **GOI**
  - **Build capacity in analyzing debt swap operations in order to develop a coherent debt swap policy.** As discussed above, establishment of a mechanism for inter-agency coordination is critical to consideration of the diverse development, environmental and financial aspects of debt-for-nature and development swaps. The GOI can request that donors and conservation investors provide technical assistance in order to build GOI capacity for implementing swaps. For the negotiation of

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<sup>19</sup> Both Bolivia and Zambia have included debt-for-development swap options in their commercial debt buy-backs.



specific transactions, the GOI may need to call on the services of specialized debt swap advisors.

- **Request that bilateral creditors consider bilateral debt swap operations for Indonesia.** In the event that the GOI is interested in pursuing bilateral debt swaps with its bilateral creditors, the GOI should request that bilateral creditors/donors consider debt-for-nature and development swaps. In light of the adoption of the Tropical Forest Conservation Act, the GOI should give high priority to making an official request to the US Treasury for Indonesia's consideration, since countries expressing interest first are likely to be considered first.
  - **Facilitate three-party debt-for-nature swaps through the JI by assisting conservation investors in making contact with creditors and debtors, and by ensuring that JI reforms will facilitate the introduction of debt-for-nature swaps.** Introductions can be made through the JI. The GOI can also assist conservation investors by providing information about possible assets held by debtors that have high conservation value.
- **BILATERAL AND MULTILATERAL DONORS:**
    - **Capacity Building and Technical Assistance.** Both bilateral and multilateral donors should consider ways that they can help facilitate swaps through meeting GOI and conservation investor capacity building needs, providing assistance for financial and legal advisory fees and creating an enabling environment for swaps.
    - **Provide funding for three-party debt-for-nature swaps.** The most important thing that donors can do at this point to contribute to the feasibility of debt-for-nature swaps is to provide a conditional commitment for donor funding for conservation investors interested in identifying and negotiating three-party debt-for-nature swaps. Donor funding would be conditional on the conservation investor negotiating financial terms acceptable to the donor and funding a project of interest to the donor. Donors can also consider providing guarantees or political risk insurance that might facilitate closing a swap.
    - **Consider Indonesia's eligibility for bilateral debt swaps.** Bilateral creditors with bilateral debt swap programs should consider whether Indonesia could be eligible for bilateral debt swaps.
    - **Assist the GOI in identifying sources of fiscal revenue that might fund a swap.** Given the role of donors in Indonesia's structural adjustment program, it is critical that donors assist the GOI in planning for fiscal resources that can be allocated for bilateral swaps or for three-party debt swaps involving public debt.

- **CONSERVATION INVESTORS:**

- **Develop a coordinated advocacy strategy for debt-for-nature swaps.** Although conservation investors may wish to work on three-party debt swap transactions independently, it is in the conservation community's interest to coordinate their advocacy strategy for swaps relative to donors and the GOI. As demonstrated in advocacy for the TFCA and the Swiss Debt Reduction Facility, conservation investors can play a key role in encouraging both donor and debtor governments to support swaps.
- **Actively pursue three-party debt-for-nature swap transactions.** Conservation investors will need to develop debt swaps that are attractive to all parties and seek donor funding in order to implement them.
- **Assist the GOI and donors in designing bilateral debt swap operations.**
- **Work with local counterparts and organizations active in the social sector to educate them about the debt swap mechanism.**

### **6.3 Recommendations for a Follow-up Strategy for NRM2/USAID**

NRM 2/USAID have already contributed to the feasibility of debt-for-nature swaps in Indonesia by raising awareness among potential conservation investors and the GOI regarding the mechanics and potential benefits of debt-for-nature swaps. It is recommended that this effort should now be intensified in adopting the following follow-up strategy.

#### **6.3.1. Short-Term Actions**

On a short-term basis, there are many specific actions that NRM2/USAID can take in order to improve the prospects for debt-for-nature and development swaps. Although awareness-raising is important, NRM2/USAID's single most important contribution would be to actually provide funding for an initial, replicable swap. The consulting team recommends that the following actions be implemented in the short-term (one to three months).

- Produce information packet on debt-for-nature swaps in English and Bahasa.
- Conduct additional research on debt statistics, including debt owed by state enterprises.
- Identify Indonesian champion(s) at high-level to spearhead advocacy campaign for debt-for-nature swaps.
- Brief GOI at all levels of government regarding the rationale for debt-for-nature swaps and the mechanics of debt swaps.
- Support formation of a GOI inter-agency working group.

- Brief representatives of key opposition parties regarding the debt-for-nature swap concept.
- Sponsor a priority-setting exercise to identify conservation and development priorities for debt-for-nature and development swaps.
- Provide the GOI with information about the TFCA and conduct a preliminary review of Indonesia's potential eligibility for the TFCA.
- Consider collaborative action with other bilateral and multilateral donors to establish a debt swap facility either for bilateral swaps or for three-party swaps.
- Consider concerted action with Japan on debt-for-nature swaps in the context of the Common Agenda.
- Enter into a dialogue with JI and IBRA representatives in order to assist conservation investors in identifying debt that might be suitable for debt-for-nature swaps and in facilitating contacts with debtors and creditors.
- Assist conservation investors in identifying sources of financial and legal assistance for implementing debt-for-nature swap transactions.
- Encourage conservation investors to actively pursue three-party debt-for-nature swap transactions and consider conditional funding commitments for conservation investors that submit proposals to USAID.
- Explore vehicles for credit enhancement, including Overseas Private Investment Corporation (OPIC) guarantees, that might facilitate the implementation of debt-for-nature swaps.
- Consider ways that the US Government can encourage three-party debt-for-nature swaps through existing or planned US Government support for corporate debt restructuring (e.g. OPIC guarantees).

### **6.3.2. Medium-Term Actions**

In the medium term, the consulting team recommends that NRM 2/USAID implements two types of debt-for-nature and development swaps (three to nine months):

- a US\$500 million bilateral swap facility with US participation ensured through the TFCA or other USAID funding.
- USAID funding for three-party DNS implemented by conservation investors, selected by USAID on the basis of their project proposal.
- Host a donor meeting to consider funding commitments for debt-for-nature swaps.



## **ANNEX A - DEBT RESTRUCTURING AGREEMENTS AND INITIATIVES**

**ρ - THE FRANKFURT AGREEMENT**

**ρ - THE JAKARTA INITIATIVE**

**ρ - PARIS CLUB AGREEMENT**

## **ANNEX B - SUMMARY OF TROPICAL FOREST CONSERVATION ACT**

## **SUMMARY OF THE TROPICAL FOREST CONSERVATION ACT**

### **Introduction:**

Since the inception of the Enterprise for the Americas Initiative (EAI) in 1991, the United States has converted a total of US\$875 million face value of debt owed by several Latin American countries into local currency funds of US\$154 million to support environmental and child survival programs. Although no funds have been appropriated by the US Congress since 1994, the volume of US debt available for conservation may soon rise to higher levels with the passage of the "Tropical Forest Conservation Act" (TFCA) in July 1998 which, along the lines of the EAI, will offer the possibility of debt relief to many tropical debtor countries of the United States in exchange for project funding for tropical rainforest conservation. While the EAI was restricted to Latin America, the new initiative may offer new opportunities for funding, policy reforms and increased conservation awareness in Indonesia.

### **Background:**

Both the EAI and the TFCA are US government programs led by the US Treasury and State Department, USAID and other agencies, in partnership with some private sector members. With regard to the TFCA, it is expected that USAID will play a key role in that it has practical expertise in the implementation of the EAI and on the functioning of the local trusts, since in countries with USAID presence, the US representatives on local trust funds are senior USAID managers.

### **EAI Summary:**

EAI was created to address official debt burdens in Latin America and Caribbean countries, while helping local NGOs and communities to address environment, child survival and child development. It permits debt reductions of official debt and no-cost to the US debt buy-backs or third-party swaps. To this day, seven countries (El Salvador, Jamaica, Colombia, Bolivia, Uruguay, Argentina and Chile) have had \$1.63 billion of debt treated, reduced by \$875 million, leaving a new debt of \$752 million and EAI trust funds totaling \$154 million. EAI trust funds are controlled and managed by a Board of Directors in the host country. The EAI is overseen by a presidential appointed private/public Board of 11 members.

### **TFCA Summary:**

The new act amends and expands the EAI to all low and middle income countries (per capita GNP below \$8,956) in the world that have USAID and or PL-480 debt, as of 1/1/98, and that have tropical rainforests of importance because of their size or biodiversity. Oversight will be provided by an expanded Enterprise for the Americas Board (EAB) bringing the total to 15 members (4 new members: 2 government entities and 2 private entities).

## **Eligibility Criteria** (see Section 805 for exact language)

### ◆ Political criteria:

- democratically elected government
- government does not support terrorism
- government is cooperating on drug control
- government is not grossly violating human rights

The State Department leads a formal inter-agency process, involving USAID, Treasury, the United States Trade Representative (USTR) and the Economic Bureau to determine whether the political criteria are being met. There is language in the law that indicates that this assessment will be done on a case by case basis, and, there are indications that any adequate progress made toward democratization as well as confidence in the government leading such progress will be taken into account. Although the country may run into some problems in relation to the qualifying political factors such as "democratization", it is widely accepted among the different parties that, if a transaction makes good political sense, non-compliance with a specific political factors should not be an issue. The approval process could however be held off by an agency with a concern over, for example, the non-compliance with standard protection of intellectual property rights. This was the case in Peru and, for this reason, USTR blocked their buy-back effort for a while. Nevertheless, it would be easy to assess whether this is going to happen: agencies are usually willing to state in advance whether or not they foresee any stumbling block.

### ◆ Macro economic criteria:

- agreement or progress toward an IMF standby arrangement, structural adjustment facility, or similar mechanism
- receipt of structural or sectoral adjustment loans from the World Bank, if needed
- implementation of major investment reforms or demonstrable progress toward an open investment regime
- agreement with commercial lenders on debt restructuring

### ◆ Forest criteria:

- the country must have at least one tropical forest that is globally outstanding in terms of its biodiversity or that represents a large intact block of forest on a regional, continental or global scale.

The US conservation community has been actively working with the US Congress and the US Treasury in assisting the authorities to develop priorities for the TFCA. A matrix is being developed that will set priorities among countries owing PL-480 or USAID debt based on the biodiversity value of the tropical forests (WWF 200, CI hotspots will be used), managerial ability of the recipient governments to handle swaps and the existence of conservation trust funds or foundations which could be used to channel the debt conversion proceeds, as called for in the law. It is expected that Indonesia will be considered a priority country.



## **Debt-reduction mechanisms**

They are similar for the most part to those in the EAI. If funds are appropriated by Congress, a country's loan would be assessed by Treasury at its net present value (NPV), expressed in terms of x cents on the dollar. Part or all of the outstanding debt stock would be treated by issuing a new debt at this calculated NPV payable in 10 to 20 years and bearing a concessional 3% rate of interest. The difference between the NPV of the original debt and the NPV of the new reduced debt is the amount needed to be covered by the appropriation. The 3% interest stream would be diverted by the debtor country into a tropical forest trust fund.

When there are no appropriated funds available, a country can enter into one of two arrangements:

### **Buy-Back**

In a buy-back, a country may pay the US Treasury a lump sum of the NPV of part of their outstanding debt and make a concurrent lump sum payment in local currency into an EAI trust fund equal to 40 % of their debt buy-back price. The country may not use other US government-appropriated funds to pay for the buy-back. Peru recently treated US\$177 million in debt with a US\$57.1 million buy-back payment and with an additional US\$23 million local currency equivalent to a local trust fund.

### **Debt Swap**

A third party may use non-US government appropriated funds in a traditional debt-for-nature or environment swap, paying the US Treasury the NPV for official debt in the same way they would buy commercial debt. The debtor government would then redeem the debt in local currency at an agreed amount.

It is difficult to estimate how Indonesia's debt would be valued. Each loan would have to be valued on a case-by-case basis, taking into account a combination of economic factors and political good will.

### **EAI Trust Funds**

Each beneficiary country that enters into a TFCA agreement is required to establish a Tropical Forest Fund to receive payments of interest on new obligations undertaken by the beneficiary country. However, existing EAI funds or other environmental funds such as Global Environment Facility (GEF) sponsored funds are expected to be used for this purpose. In some cases, some modifications such as the creation of specific sub-accounts will be required.

## **Appropriations**

In the law, appropriations for FY 1999 through 2001 are authorized in the amount of \$200 million for USAID debt treatment and \$125 million for PL-480 debt treatment. The US Treasury hopes to appropriate anywhere between US\$20 to US\$125 million in the FY 1999 budget for the implementation of the TFCA world-wide; however, a more conservative view is that funds will not be available until FY 2000. The answer should become clearer in 1999 when the new US Congress convenes. In addition, a no-cost option (buy-back) can be considered by the Clinton administration without Congressional approval and could conceivably be available sooner.

## **ANNEX C- LIST OF ORGANIZATIONS/INDIVIDUALS CONTACTED**

## **List of Organizations/Individuals Contacted**

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## **ANNEX D - GLOSSARY OF TERMS**

## Glossary of Terms

- **Arrears:** Debt service payments that are not made on time.
- **Bilateral (official debt):** Loans owed to bilateral creditor governments. Official Development Assistance (ODA) loans are owed to aid agencies. Publicly guaranteed loans are owed to export credit agencies.
- **Bilateral Debt Swap:** A debt swap negotiated between a creditor government and a debtor government which results in public external debt being canceled in exchange for counterpart funding for a specific purpose.
- **Conservation Investor:** The conservation investor in a debt-for-nature swap acts as an intermediary to negotiate a debt swap with a creditor and debtor in support of a defined conservation objective. Typically conservation investors raise funds from official or private donors which are then invested in the debt-for-nature swap. Conservation investors have included non-governmental organizations (NGOs), research institutes and universities.
- **Conservation Trust Fund:** Conservation trust funds (in countries whose legal systems are based on British or US models) or foundations (in civil law countries) are funds that legally set aside assets whose use is restricted to the specific environmental purposes set out in a legal trust instrument. The more than thirty environmental funds that have been set up over the past decade aim to provide a long-term source of funding for biodiversity conservation and sustainable development.
- **Debt Buy-back:** Repurchase by a debtor of all or a portion of its debt, usually at a discount from face value. The World Bank and bilateral donors finance commercial debt buy-backs for low-income countries. Some aid agencies finance buy-backs of publicly guaranteed export credits or private debt owed by debtor governments for conversion into local currency funds for conservation and/or development.
- **Debt Conversion Agreement:** A legal agreement between the investor in a debt swap and the debtor for conversion of the debt. In a bilateral debt swap, the agreement is between the creditor government and the debtor government.
- **Debt Conversion Program:** Creditor or debtor country officially sponsored program for the conversion of debtor that generally involves the issuance of debt conversion guidelines.
- **Debt-for-Development Swap:** The cancellation of debt in exchange for funding or another asset to support development objectives (education, health, poverty reduction, etc.) in the debtor country.
- **Debt Donation:** A creditor agrees to donate debt to a conservation or development investor in a debt swap.

- **Debt-for-Equity Swap:** The cancellation of debt in exchange for equity investment.
- **Debt-for-Nature (Environment) Swap:** Cancellation of debt in exchange for a commitment to pay local currency funds, bonds or another asset of conservation value which are used to support conservation or environmental protection activities.
- **Debt Off-set:** Purchase of debt owed by one party which is used to off-set debt owed by another party.
- **Debt Purchase Agreement:** An agreement between an investor in a debt swap and a creditor for purchase of debt. The creditor agrees to **assign** the debt to the investor in exchange for payment.
- **Debt Service:** Payment of interest and principal according to a schedule specified in the loan agreement between the debtor and creditor.
- **Debt Swap (conversion, exchange):** The cancellation of debt, typically at a discount from face value, in exchange for payment of local currency or another asset (bonds, buildings, land, policy reforms). The terms "conversion", "exchange" and "swap" are used interchangeably.
- **Discount (haircut):** Percentage of reduction from the face value of debt. The terms "discount" and "haircut" are used interchangeably. The inverse of the discount is the price at which debt is purchased (debt purchase price) from the creditor or the price at which debt conversion proceeds are paid by a debtor in a debt conversion (redemption price).
- **Face Value:** The original amount owed under a loan or other credit agreement. Also referred to as the **nominal value** of debt.
- **Heavily Indebted Poor Countries (HIPC) Debt Initiative:** Proposed by the World Bank and the IMF and agreed by governments around the world in the fall of 1996, it enables poor countries with good policy performance to escape from unsustainable debt and focus their energies on striving for sustainable development and reducing poverty.
- **Moral Hazard:** Moral hazard refers to the increased hazard that debtors will be encouraged to default if they perceive that other debtors have received debt relief from creditors or are being bailed out by a government or other donor.
- **Net Present Value (NPV):** The NPV of debt is the sum of all future debt service obligations (interest and principal) on outstanding debt, discounted at the market interest rate.
- **Paris Club:** The Paris Club is an ad hoc group of official bilateral creditors that negotiates rescheduling agreements with debtor countries. The French Treasury serves as Secretariat for the Paris Club.

- **Paris Club Swap Clause:** A clause that has been included in most Paris Club agreed minutes (framework agreements between a debtor and its Paris Club creditors) since 1990. The clauses allows for conversion on a voluntary basis of 100% of ODA loans and up to a percentage or dollar limit for non-concessional loans for each bilateral creditor.
- **Pre-payment Provisions:** Prepayment provisions require prepayment of all lenders on a ratable basis under a multi-lender agreement if any lender receives a prepayment under such an agreement or under an unrelated agreement.
- **Public (Official) Debt:** Debt owed by the government of a debtor country, including the central government and state enterprises, whose debt is guaranteed by the government.
- **Purchase Price (for debt):** The price at which debt is purchased from a creditor.
- **Private (Commercial) Debt:** Debt owed to private creditors such as banks or trading companies. Also referred to as commercial debt.
- **Private-to-Private Debt Swap:** Debt swaps involving a private creditor and a private debtor.
- **Redemption Price:** The price at which debt is converted into another asset.
- **Secondary Debt Market:** A market for trading of discounted developing country debt, generally owed to private creditors.
- **Sharing Clause:** Sharing clauses require each lender in a multi-lender agreement to share with other lenders any payment received relative to a loan that is not received on a pro rata basis by all other lenders.

## **ANNEX E - REFERENCES**

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