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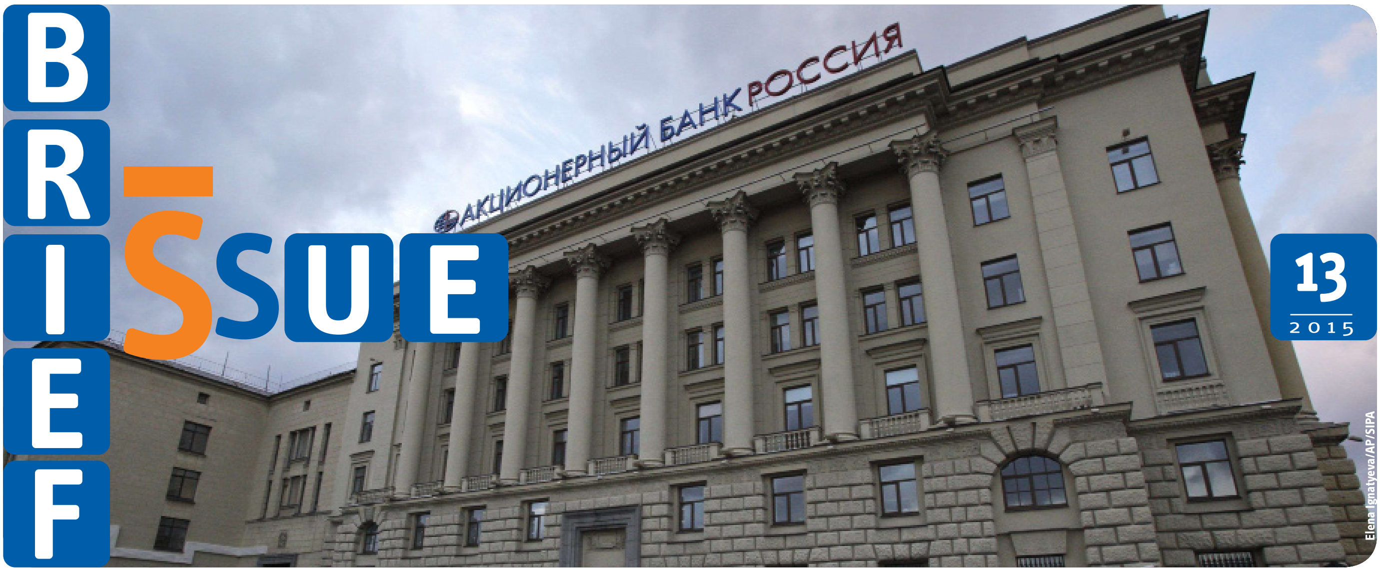

Sanctions against Russia:
Evasion, compensation and overcompliance

by Cameron Johnston

In the popular imagination, sanctions are akin to arrows at an archery range: fired by archer A, they fly in a regular arc to hit 'target' B with varying degrees of accuracy. Attractive as this model may be, however, it does scant justice to the reality of how sanctions work. For targets are less like static archery butts than live game, ducking and weaving to avoid projectiles. In Russia, these feints have taken a variety of forms, including exploiting loopholes, altering share structures and using tax havens with the aim of concealing beneficial ownership. If sanctions do not change direction in the course of their flight, they will miss their target or simply deliver glancing blows.

But the archer is no sadist. Inflicting pain on the target is a means to an end, the end being a change of behaviour on the part of a third player, the state. If close allies of an autocratic leader see their fortunes endangered by erratic behaviour, they might apply pressure to change his foreign policy. The problem, of course, is that he too is a dynamic actor. As fast as the sender can inflict pain, the leader can deliver analgesics in the form of new contracts, thereby buying his allies' continued loyalty. If his economy is not growing, however, the autocrat cannot make the pain disappear altogether: he can only displace it onto others, exacerbating tensions between competing factions. Therein lies the danger.

Some sanctions hit the bull's-eye, others go astray. Sanctions also sometimes overshoot their mark or veer off in crosswinds to hit individuals and companies which are innocent of any wrongdoing. These companies may find it more difficult to access capital markets, struggle to recapitalise their debts and cut back on investment, hampering economic growth. These three themes, evasion, compensation and overcompliance, are all visible in the case of Russia.

Evasive measures

Bank Rossiya offers a case study in how companies close to the Kremlin succeeded in evading sanctions, at least for some time. Bought in 1991 by close allies of Vladimir Putin, including Yuri Kovalchuk, it expanded rapidly in the 2000s by buying state assets at knock-down prices to become the 17th largest bank in Russia at the start of 2014. Described by the US Treasury as 'the personal bank for senior officials of the Russian Federation', it was the first Russian entity to be blacklisted when the US introduced sanctions on 20 March 2014.

As an investigation by *The Economist* showed, the bank protected its subsidiaries by exploiting loopholes in the sanctions legislation. Until March 2015, it held a controlling stake (51%) in the insurance company, Sogaz. But with sanctions looming, it transferred 2.5% of its shares to a newly created subsidiary. As a result, Sogaz was not listed, because, under the rules as they then stood, a firm owned by multiple targets could not itself be listed unless one of those targets individually held a 50% stake. The US Office for Foreign Assets Control (OFAC) closed this loophole in August 2014, so that the combined shares of targeted entities became the deciding factor, but before it could do so, Bank Rossiya acted again.

On 11 August 2014, just before the new rules took effect, Bank Rossiya transferred a portion of its shares in Sogaz to a subsidiary of Gazprom, a company which is not subject to full sanctions. The stakes of fully sanctioned entities therefore added up to less than 50% and Sogaz avoided sanctions.

Second, Russian targets have sought to shield their subsidiaries by relinquishing (or at least appearing to relinquish) ownership. Half of the shares in Gunvor, one of the world's largest oil trading firms, were until March 2014 owned by another Putin loyalist, Gennady Timchenko. On the very day that he was blacklisted by the US, however, Timchenko sold all his shares to his Swedish business partner. He is also reported to have sold his stake in the Finnish airliner Airfix and in airport business terminals in St Petersburg and Moscow. The suspicion, of course, is that although ownership changes on paper, the previous owners continue to control the company in practice. The case of Russian National Commercial Bank (RNCB) shows how this might be achieved.

At the start of 2014, RNCB was a small subsidiary of the Bank of Moscow and the 587th largest bank in Russia. But it took advantage of Russia's annexation of Crimea to expand rapidly, to the extent that by January 2015, it had 200 branches on the peninsula and was providing financial services to the regional authorities. How did it evade sanctions, then, after its parent company was blacklisted in July 2014? The answer is that it concealed beneficial ownership. Since RNCB was sold in March 2014 and changed hands again in early 2015, it appeared to be independent of Bank of Moscow. In reality, the two banks were as connected as they ever were, since Bank of Moscow's directors continued to negotiate on behalf of their erstwhile subsidiary.

Keeping it in the family

As well as altering share structures and concealing beneficial ownership, targets may protect their assets by passing them on to family members, with the hope, perhaps, of resuming control when sanctions are lifted. Hartwall Arena, a music venue in Finland, was one such asset. Until 2014, it was half owned by Timchenko and half by the Rotenberg brothers, childhood friends of President Putin. Since all three of them were soon to be blacklisted, the venue's future appeared to be in doubt. In the event, Arkady and Boris Rotenberg saved it by transferring all of their shares to Boris's son, Roman, and arranging for Timchenko to sell Roman a 0.5% stake. Sanctioned individuals now owned only 49.5% of the arena, allowing it to continue operating unimpeded.

Arkady Rotenberg repeated the trick later on in 2014. *Bloomberg* reported in October that he had transferred TPS Real Estate Holding, a company that builds shopping malls, to his son Igor. He also announced that he had disposed of his stake in OAO Mostotrest, Russia's largest builder of roads and railways, only for the very same Igor to appear on company documents as a 26% shareholder. Because the family members of sanctioned individuals are legally obliged to declare that they are related to 'politically-exposed persons', however, and banks often give them a wide berth, it is not clear whether this tactic always works.

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Despite all this ducking and diving, however, Russia's wealthiest men incurred stinging losses in 2014 due to the combined effect of falling oil prices, structural economic problems and Western sanctions, with the twenty richest losing a combined total of $62 billion. But although Putin's inner circle became poorer in absolute terms, they grew stronger in relative terms as the president rewarded loyal acolytes with a larger slice of a shrinking pie.

Let the good times roll...

Bank Rossiya once again exemplified the trend. On 10 April 2014, an obscure body called the Market Council voted to transfer financial business related to Russia's wholesale electricity market from Alpha Bank to Bank Rossiya in a deal that promised rich rewards for the sanctioned bank. The business is worth 4 billion roubles a year, only slightly less than Bank Rossiya's total net profit in 2013. All the evidence suggests, meanwhile, that the decision was taken at highest state levels. Igor Sechin, head of Rosneft and long-time friend of Putin, is chairman of the board, while the loser in this deal, Alpha Bank, is headed by an oligarch who has made no bones about his desire to diversify his portfolio away from Russia.

Putin has bought the loyalty of sanctioned oligarchs by channelling existing business in their direction but his 'foreign adventures' have also opened up new opportunities for faithful acolytes, not least in Crimea. The departure of virtually all Ukrainian banks from the peninsula after March 2014 opened up a vacuum, which Bank Rossiya helped to fill. It opened the first four of thirty projected branches in June 2014, while Timchenko's Volga Group announced last May that it had bought a further 17 branches from a European bank.

Rossiya was not the only bank to benefit from the state's growing involvement in tenders and takeovers. SMP bank, which is majority owned by the Rotenberg brothers, was invited in May 2014 to take over three struggling competitors, Mosoblbank, Investment Republican Bank (Inresbank) and Finance Business Bank. To that end, it secured a large loan at a very favourable rate of interest and later appealed to the Deposit Insurance Agency for further funding.

And although the much-vaunted pivot towards China is unlikely to materialise any time soon, the grand infrastructure projects required to bring it about will line the pockets of Putin's inner circle. Arkady Rotenberg is set to benefit most from the construction of the Power of Siberia gas pipeline to China, just as his company Stroygazmontazh cashed in on the annexation of Crimea. It recently won a huge contract to build a 19km bridge across the Kerch Strait, which separates Crimea from mainland Russia.

It would appear, then, that sanctions have sped up the concentration of resources in the hands of a coterie of Putin loyalists. *Bloomberg* reports that between March and December 2014, firms connected to Gennady Timchenko and Arkady Rotenberg won 309 billion roubles (around $8.1 billion) in government contracts, 12% more than in the whole of 2013. In a country in which the state can make or break a person at will, a businessman's absolute wealth matters less than his position in the pecking order. By cementing his allies' position at the top of the food chain, Putin calculated correctly that they would swallow sanctions without demanding a change of course. Whereas a few public figures have openly criticised government policy, most notably former Prime Minister Yevgeny Primakov and former Finance Minister Alexei Kudrin, no one at the top has voiced any opposition.

But although Putin's strategy has been effective in the short term, it might prove dangerous in the long run. In times of growing scarcity, Putin will try to feed his followers by starving their rivals. Last October, the state expropriated Vladimir Yevtushenkov's oil company Bashneft amid rumours that it would be transferred to Rosneft. Yevtushenkov was placed under house arrest and saw 90% of his wealth evaporate in the space of twelve months.

If Russia's economic crisis deepens, as now seems likely, Putin might be tempted to carry out further expropriations, alienating some oligarchs and stoking tensions between competing clans.

Overcompliance and its effects

If sanctions (and the Kremlin's responses to them) mean different things for different oligarchs, their effects on lending and business deals have been more clear-cut. The recent contretemps between Mikhail Fridman and the UK government reveals the potential for sanctions, like errant arrows, to damage the interests of businessmen who are not beholden to sanctioned parties.

Meanwhile, the steep decline in Western lending to Russian businesses, including ones that are not subject to sanctions, is likely to slow down economic growth in the medium to long term.

Sanctions alone cannot explain why Western lending to Russia has dried up but they certainly played their part. Russian businesses secured $38 billion in dollar-denominated loans in 2012, and $52 billion in 2013, but only $9.5 billion in 2014. It is not only sanctioned firms that are feeling the freeze. ING bank pulled out of a loan to Techsnabexport JSC, a nuclear fuel exporting company in September, even though this subsidiary of Rosatom (State Atomic Energy Corporation) is not included on any blacklist.

Where Russian companies nevertheless did succeed in finding funding, they often had to sign up to more stringent conditions. Techsnabexport later secured a loan from Deutsche Bank, but only for $150 million, not $500 million, and for three, not five years. In May 2014, international creditor stipulated that Russian firms would have to repay their debts immediately if they or their shareholders fell under sanctions.

But why did Western banks turn off the tap so indiscriminately in 2014, when sanctions are supposed to be precise, targeted instruments? Lower growth prospects were no doubt a factor but fear of the US Treasury's Office for Foreign Assets Control (OFAC) played a part as well. Under so-called 'extraterritoriality clauses', OFAC has the power to prosecute any firm with a US branch that trades, wittingly or unwittingly, with a sanctioned entity. It does not hesitate to wield this power, as the prosecution of BNP Paribas demonstrates.

Multinational firms doing business in Russia therefore have to invest in the complex due diligence required to ensure that their Russian counterparts are not linked to sanctioned entities. Even if they find that a deal is technically legal, they might still hesitate. 'If you're dealing with a company that may be 33% owned by designated parties, I would sweat a little bit', said OFAC's Deputy Director at a Dow Jones conference in April 2014. Such veiled threats may well have worked. Kroll, a corporate investigations company, reported in December that requests for due diligence work were tailing off, suggesting that many firms had decided to avoid the Russian market altogether.

And individual companies have been tainted by their association with Russia, despite having few links to the Kremlin. In March 2015, the UK government announced that it would try to block Mikhail Fridman's takeover of Dea, the oil and gas arm of the German company RWE. Dea extracts oil and gas from the North Sea and the UK authorities voiced concern that future sanctions against Russia might endanger North Sea supplies. This explanation struck many observers as odd because, although Fridman is Russia's second richest man, he is fiercely independent and has resisted Putin's calls to invest the proceeds from the sale of TNK-BP in Russia.

Large state-owned behemoths like Rosneft can weather the economic storm for a while by tapping into the National Welfare Fund – but smaller companies in Russia's shrinking private sector have no such luck. And although financial cooperation with China is on the rise, Sinologist Alexander Gabuev argues that 'in the short term, China cannot become a real alternative to Russia to replace the West as a source of capital'. Sanctions therefore act as a brake on future economic growth and may change the Kremlin's calculus in the medium to long term.

Dynamic targets, dynamic instruments?

These complex patterns of evasion, compensation and overcompliance serve as useful reminders that sanctions often work differently in practice than in theory. States that are likely to be hit by Western sanctions will not allow individual targets to suffer and become critics of government policy. But the measures such states take to compensate targets may well open up new divides among ruling elites and store up problems for the future.

Moreover, the example of Russia shows that so-called 'targeted sanctions' are less targeted than senders might acknowledge them to be. This is not necessarily a bad thing. Sanctions have indirectly harmed Russian companies that are not included on any blacklist – lamentable perhaps, but a small price to pay if they help to rein in Putin in Russia's near abroad.

Cameron Johnston is a Junior Analyst at the EUISS.

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