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TASC
Think-tank for Action on Social Change

Ireland, Global Finance and the Russian Connection

TASC Seminar

27th February 2018
National University of Ireland, 49 Merrion Square, Dublin 2. starting at 3.30

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Shadow Banking

- This paper examines aspects of what is termed the 'shadow banking sector'.
- That is firms who often act as banks but are not regulated as a bank;
- In many ways the shadow banking sector is part of the banking sector but 'off balance sheet'.
- This paper concerns firms engaged in financial intermediation that are operating under the Section 110 special tax regime, such as;

i. Financial intermediaries providing finance to connected firms (most firms);

ii. Financing real assets such as aircraft;

iii. Securitization vehicles

Section 110 firms

- **Development of securitization industry long established Government policy:**

  "The Department of Finance and the Irish Revenue will fully engage and consult with industry to enhance the tax framework, including through the annual Finance Bill process, in particular to facilitate areas where Ireland can gain first-mover advantage in developing sustainable business lines" - Department of An Taoiseach (2011)

- **Favorable tax provisions for securitization first introduced in 1991 but limited to firms located in the IFSC.**
- **'Section 110' Taxes Consolidation Act 1997, conferred these advantages on all 'qualifying companies' including FVC's .**
- **One of Ireland's leading law firms (Matheson) states:-**
- **"In recent years Ireland has become the jurisdiction of choice for the establishment of special purpose vehicles (SPVs)".**
- **(PwC) states 'Section 110' is at the heart of Ireland's structured finance regime....it is widely used and internationally regarded".**

Attraction of Section 110 regime

- The ‘special tax regime’ means effective tax rates on profits are zero/near zero because deductions from income are allowed as if the firm were a trading company.
- For example expenses arising from issuing loans/financial instruments, arrangements fees, insurance fees, contingency fees, management charges, portfolio charges, etc. and most important interest paid including profit participating interest.
- This effectively means that profit distributions are treated as a tax deduction, rather than a distribution of after tax profits.
- Such a deduction has been described as “unique” in Irish tax legislation.
- A further main advatage of‘section 110’ firms is that they are regarded as being unregulated.

Russian Connected Firms and the IFSC

- The rest of this paper focuses on 'section 110' firms with a Russian connection operating in the IFSC under 'section 110', over the period 2007-2015.
- The Russian financial system and Russian controlled firms have been at the centre of much recent adverse comment.
- For example a 'Section 110' firm was used to raise $9.28 billion for VEB from 2010-2013.
- The New York Times (27th March, 2015) reported that Mr. Kushner, met the head of the Russian State Development Bank, Vnesheconombank (VEB) in December 2016.
- According to the New York Times: "*the supervisory board is controlled by members of Mr. Putin's government, including Prime Minister Dimitri A. Medvedev. It has been used to bail out oligarchs favored by Mr. Putin, as well as to help fund pet projects like the 2014 Winter Olympics in Sochi*".

Table 1: The Study Population

- **The most recent estimates are that there were 2545 active 'section 110' in 2016.**

Year	New Reg	No. reg ceased	Est. Actives[1]	Central Bank of estimate active[2]	Active identified Stewart and Doyle (2017)[2]
2005	167	80			
2006	257	97			
2007	435	216			
2008	242	115			
2009	140	73			
2010	137	43			
2011	159	39			
2012	130	15			
2013	223	23			
2014	344	42			
2015	423	12	2077*	1642	1331
2016	477	6	2545[1]		
2017	759	1			
Total	3,893	762			

The Study Population

- A total of 125 ‘section 110’ firms with Russian connections were identified from this population.
- Of this 125, 111 had available accounts for all/some of the years 2007-2015.
- 19 of the firms had accounts published but remained dormant or did not trade, resulting in 92 firms that were active for some or all of the period 2007-2015.
- The population of Russian connected ‘Section 110’ firms operating in the IFSC is likely to be much larger than this.
- The web site of Arthur Cox states they have advised on:

  “over 180 Russian LPN, ECP and securitisation structures since 2005”

Source:- www.arthurcox.com/practice_area/debt-capital-markets/.

Some Characteristics of Russian Connected IFSC Firms

- In most cases firms acted as a conduit by raising funds and on-lending these funds to a Russian based entity/corporation.
- A few firms were involved in related activities such as purchasing property mortgages from a Russian bank.
- Of the 113 firms revealing ownership details, 71 were owned by a charitable trust (of which Deutsche International Finance was the trustee for 27), whilst 14 stated they were owned by a trust.
- 7 stated they were owned by a charitable trust or trust but were either consolidated with accounts of another company or controlled by that company.
- 21 firms (19% of the total) stated they were owned/consolidated with another firm, with no intervening trust structure.
- This ownership structure appears at variance with recent comments by the Central Bank of Ireland (CBI) (Barrett et al. 2016):
- *"Unlike FVCs, which are generally non-consolidated vehicles, over half of Irish resident SPVs are consolidated into other entities'*.

Table 2: Aggregate data for the study group

Year	N[1]	Gross assets[1]	Gross Funds raised from other firms[1]	Gross Funds raised on Stock/other markets[1]	Total Funds Raised[1]
2015	62	61.4	0.071	6.56	6.63
2014	72	67.9	6.214	19.58	25.8
2013	72	62.1	0.717	20.04	20.8
2012	59	40.4	2.532	17.54	20.01
2011	48	31.6	1.413	9.95	11.36
2010	45	24.5	3.887	0.98	4.86
2009	45	16.9	0.077	4.72	14.80
2008	46	16.2	0.106	6.4	6.51
2007	41	19.7	0.247	2.48	2.73
Total			15.26	88.26	103.52

Table 2: Trends in Aggregate Data

- Table (2) shows that aggregate assets of identified Russian connected S.110 firms amounted to €61.4 billion in 2015. This total is likely to be an underestimate.
- The size of firm by assets is highly skewed. Four of the firms included, accounted for €27.17 billion of total assets for 2015 (Alfa Bank Issuance, GPB Eurobond Finance, VEB Finance, RZD Capital).
- Funds raised mirrored this trend.
- The amount of market related funds raised fell from 20 billion in 2013 to 6.56 billion 2015, reflecting the impact of sanctions discussed later.
- It is also interesting to note the fall in funds raised from 2008 to 2010 with a recovery in 2011, reflecting market uncertainty and risk aversion during the Great Financial Crash.
- In total Gross amounts raised over the period 2007-2015 amounted to over Eur 103.0 billion.
- Most expenditures incurred are likely to be in London and other financial centres in terms of fees connected with advising on and issuing bonds (0.6% of amount raised).

Table 3: Some Operating Characteristics (omitting firms with negative equity)

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Year	N[2]	Gross assets[2] million	Equity[2] million	Gross interest income[2] million	Gross interest Paid million	Gross interest paid/ Gross assets %	Pre-tax Profit[2] '000s.	Tax charge from P&L [2] '000s.
2015	57	60204.4	8.077	3682.3	4118.4	6.8	49.99	14.451
2014	66	66566.4	1.136	3917.1	4119.4	6.2	58.23	15.316
2013	66	60791.2	0.949	3273.0	3446.4	5.7	68.60	18.578
2012	53	39350.6	1.651	2632.1	2573.9	6.5	53.74	12.822
2011	46	31169.2	0.903	2336.8	2332.5	7.5	26.39	6.891
2010	44	23386.9	0.953	1400.3	1387.1	5.9	26.79	7.473
2009	42	16533.1	1.005	1204.9	1210.1	7.3	-1.13	6.94
2008	43	15547.8	2.098	988.1	990.5	6.4	85.5	17.0
2007	39	19662.1	2.030	722.7	798.1	4.1	493.6	126.0
Total								

Operating characteristics continued

- Table (3) shows that despite large gross income pre-tax profit is very low as are corporate tax payments.
- So that for 2015, gross interest income amounted to €3.68 billion, but pretax profits amounted to just under €50,000, and as a re4sult the tax charge amounted to €14400.
- Most firms reported pre-tax profits of €1000 or under for all years of the study.
- Furthermore as Table (3) shows, gearing (measured on an aggregate basis) is very high, and varies around 0.01% over the period examined.
- The main economic benefits arising from these Russian connected firms, but which generalises across all Section 110 entities, is from domestic expenditures and is discussed next.

Economic Impact

- **A Department of Finance Tax Strategy document stated:**

  "A statute-based 25% rate of corporate tax applies to investment / non-trading income to guard against 'brass-plate' operations with low substance and to reinforce the role of Ireland's corporation tax regime in fostering active, substantial, trading operations here". Department of Finance 2013.
- **However Table (3) shows that despite the large value of assets and interest income, pre-tax profits are low as are corporate tax payments**
- **The main economic impact is from domestic expenditures as shown in Table (4).**
- **Median expenditures by year on administrative costs varied between €18000 and €23000, audit fees from 10000 to € 15000, and fees for tax advice from, 4000 to €6000.**
- **Some local expenditures are not generally disclosed such as legal fees (likely to be the largest item of expenditure) and listing fees.**
- **Table (4) also shows that fees for tax advice are a multiple of the tax charge for all years.**
- **One firm reported one employee for part of the period.**
- **Most expenditures incurred are likely to be in London and other financial centres in terms of fees connected with advising on/issuing bonds (0.6% of amount raised)**

Table 4: Local Expenditures (Euro '000s)

Year	N	Audit Fees	Tax Advice fees	Admin costs
2015	57	714	292	1320
2014	66	789	361	1499
2013	66	819	299	1200
2012	53	709	246	1090
2011	46	613	227	1136
2010	44	554	208	857
2009	42	586	144	839
2008	43	591	174	879
2007	39	411	88	657

Regulatory Issues: Bank Rescues and Bond Write Downs

- Since 2014 the Russian financial systems has been in crisis, with around 300 banks having been shut down by the regulator.
- Many of the banks which encountered difficulties had 'Section 110' fund raising vehicles based in the IFSC (see table 5).
- 26 Section 110 firms were associated with 13 Russian firms that encountered financial difficulties.
- Several of these had associated bond write downs but not all rescues/bailouts led to losses for the bondholders of the IFSC based Section 110 firms.
- The legal advisors to the IFSC based firms were Arthur Cox in all but two cases, with the 'big six' provided auditing services to 20 of these firms.

Table 5: Bank Rescues and Bond Write Downs

Section 110 firm	Russian Firm	Date of collapse/ bailout	Cost of bailout $ billion	Comment
BOM Capital	Bank of Moscow	June 2011	$14 [1]	USBRC combined sanctions list Jan 2017).
B&N Bonds	B&N Bank	Sept. 2017	$6 [2]	
USIB Finance	Bank Uralsib	Nov. 2015	$1.5 loan to bank[3]	Putin ally Vladamir Kogan agreed to buy 82% to avoid bankruptcy
Brunswick Rail Finance	Brunswick Rail			Write down of over 40% on $600 million of loans.
Amaetsu Kherpi Finance Grengam Finance MDM ECP MDM Internat. Funding	MDM Bank			B& N Bank bought MDM in 2015. Acquisition led to the subsequent rescue of B & N bank (Max Seddon, F.T. Sept 20th, 2017).
NBT Finance	Nat. Trust Bank	Dec. 2014	$0.530 [4]	
BKM Finance, OFCB Investments	Otrikie	Nov. 2017	$7.83 [5]	$500 million of of s. 110 loans will not be repaid[6]
Persevet Bank	Persevet Bank	April 2016	$1.19 [7]	
PRBB LPN Issuance Vityaz Three	Probusiness Bank	Aug. 2015	$0.989 [8]	
Promsvyaz Finance, PSB ECP	Promsvyazbank	Dec. 2017	$3.4 [9]	
TFB Finance	Tatfondbank	Nov. 2016	Collapsed [10]	$60 million of bonds written down to zero. Owner owned 65% of loan portfolio[1]
VPB Funding, VPB Finance	Vneshprombank (VPB)	Jan. 2016	$2.2 bil. deficit[11]	Bonds written down
VTB ECP Finance VTB Eurasia, Plus 5 others	VTB	Dec. 2014	$2.6 [12]	USBRC combined sanctions list Jan 2017.

Regulatory Issues: Sanctions

- A number of firms in our study were subject to US/EU economic sanctions.
- The European Parliament stated:

'In early 2014, Russia violated international law by annexing Crimea and allegedly fomenting separatist uprisings in the eastern Ukrainian region of Donbas. The European Union, the United States and several other western countries responded with diplomatic measures in March 2014, followed by asset freezes and visa bans targeted at individuals and entities. In July, sanctions targeting Russian energy, defence and financial sectors were adopted'.

- Nevertheless some firms continued to rise funds on the ISEQ despite connections to Russian firms which appear to be under sanction or have major shareholders under sanction.
- Sanctions on Russian firms/individuals are complex, differ between the EU and US, and are subject to change.
- Table (6) lists these firms that raised funds in the period 2014-2016.

Table 6: Firms raising funds and Sanctions (Euro Millions)

Section 110	Russian Firm	Amount raised in 2014	Amount raised in 2015	Amount raised in 2016	Sanctions
Alfa Bond Issuance	Alfa Bank	197.7	459.3	664.1	Major shareholders on US 'Oligarch list'
Alfa Holding Issuance	Alfa Bank	4756.0	21.9		Major shareholders on US 'Oligarch list'
Expo Capital	ExpoBank	0	18.4		Listed in USBRC combined sanctions list Jan 2017).
GPB Eurobond Finance	Gazprom	3952.1	0		Listed in USBRC combined sanctions list Jan 2017)[1].
MMC Finance	Norilsk Nickel	0	918.5		Shareholders Oleg Deripaska and Vladamir Potanin on new 'Oligarch list'
Peresvet Capital	Peresvet Bank (99.9% owned by Rosneft since bailout)		99.2		Rosneft on EU/US Treasury Sanctions list. Chairman Igor Sechin on sanctions list.

Regulatory Issues: Illegal/Improper Influence

- As noted the Russian financial system and firms based in Russia have become a focus of considerable adverse media comment.
- Table (7) gives some examples of Russian based firms that have featured in recent controversies and IFSC connected firms.
- The Table shows for example, Russian firms with IFSC connected firms, that feature in the ‘Steele Dossier’ which alleges improper influence in the recent U.S. election.

Regulatory Issues: Table 7 :Illegal/Improper Influence

Section 110	Russian Firm	Connections	Source
Alfa Bond Issuance Alfa Holding Issuance	Alfa Bank	"Significant favours continue to be done in both directions, primarily political ones for Putin and business/legal ones for Alpha" – Steele Dossier	Steele Dossier p. 25-26 Executives on 'oligarch list'
Bom Capital	Bank of Moscow	Taken over by VTB Bank in 2011. The Financial Times states that the takeover followed "police raids on Bank of Moscow and the homes of its senior executives last week as part of a criminal investigation into the alleged embezzlement of Rbs. 1 bn ($449 m.) from bank of Moscow"	Catherine Belton, 'VTB in Bank of Moscow victory', Financial Times February 26, 2011.
Eurochem Global Investments	Eurochem	Widespread reports concerning improper and illegal activities regularly undertaken by EuroChem, its owner, Andrey Melnichenko, and/or those associated with them".Source: Complaints filed by International Mineral Resources	Eileen Sullivan et al NYT July 14 2017
Peresvet Capital	Peresvet Bank	Peresvet debt was downgraded on 24^{th} Oct 2016, following appointment of an administrator by the RCB. Preceded by the disappearance of the chief executive and a report by Fitch that "roughly half of Peresvet's capital — had been issued to companies and individuals with "no real assets".	https://themoscowtimes.com/news/head-of-russian-bank-controlled-by-church-disappears-reports-5575.
Renaissance Consumer Funding	Renaissance Capital	Connected to Murdered lawyer Magnitsky, who was investigating fraud.	Daily Telegraph 13^{th} April, 2017
Rosneft Internat. Rosneft Internat. Finance Plus 3 more	Rosneft	The CEO (Sechin) is described as part of a group of all powerful businessmen "perceived in Russian society to be above the law and answerable only to the Kremlin" and a "powerful arm of Russian foreign policy".	Referred to in Steele Dossier p. 30 Henry Foy, F.T. March 1st 2018.
Sibur securities	Sibur Holding	Leonid Mikhelson subject to sanctions. Described as a "company with crony connections"	Irish Times Feb. 27 2018.
VEB Finance	VEB (Vneshecono mbank)	Dec. 2017 meeting between Chief executive of VEB, Russian ambassador to US, Kushner and others	Reported not to be a bank, but rather an agent of the State[1.] NYT June 4^{th} 2017
VPB Funding	Vneshprom-bank	The $2.2 billion deficit in its balance sheet follows an investigation by the RCB that "Former managers may have stripped the bank's assets for investments in real estate, expensive vehicles and financial instruments"	Griffin and Brennan, 2016,

The Regulation of ‘Section 110’ firms

- Section 110’ benefit from very favorable tax concessions.
- Regulation has been described as light touch regulation/unregulated.
- These firms were first required to submit a ‘notification’ to revenue that they were ‘section 110’ firms in Feb. 2003.
- The 2016 Finance Act requires firms to “inform the Revenue Commissioners in writing of its intention to be a section 110 company within 8 weeks of acquiring qualifying assets of 10 million”
- The Minister Finance stated that companies that have notified revenue that they are a “qualifying” company are required to submit corporate tax returns within 9 months of the year end P. Q 4705-4711, Jan. 31st 2018.
- Revenue do not collect information on the value or type of qualifying asset.
- Data on assets (loans and debt securities)is collected by the CBI.
- The CBI does not require any information on how these loans and funds provided by debt instruments were used (CBI, 2016a, pp. 14-15).
- A similar requirement exits for SPV’s (CBI, 2016b, p. 4).

Some Implications

- One implication is that regulators cannot assess the destination of loans or debt proceeds to individuals or companies.
- The Russian Central Bank (RCB)recently announced that Promsvyazbank a recently nationalised bank, would become a “special-purpose bank for serving military-industrial-complex businesses”
- One ‘section 110’ firm, PSB-ECP is connected to this bank.
- All SPVs had a common business model which involved raising funds, often via the Irish Stock Exchange and i on lending these funds to a Russian based firm.
- Ownership is in most cases by a charitable trust.
- This is often described as an ‘orphan structure’ (OS) but given as noted earlier that expenses are in most cases stated in the accounts to be paid by the recipient of the loan, the ownership structure should be more accurately described as an “orphan structure with a very generous benefactor” or OSB for short.

Corporate Governance in Practice

- Administrative functions are performed by a 'corporate service provider (CSP) as 'section 110' firms have no employees, or fixed assets – a common definition of a 'brass plate' firm..
- Table (8) shows that a single Corporate Service Provider (CSP) may provide services for over 1500 firms. Including several hundred 'section 110' firms
- CSP's also provide directors (who are paid by the CSP and not the firm).
- Table (9) shows that current directorships held by one individual may be over 100.
- The implication of CSP's providing corporate services to a large number of companies and providing directors to firms who have no employees, is that governance by directors as assumed in the companies acts cannot take place.
- Ownership in many cases is by a 'charitable trust' also means that owners do not exercise control
- Rather control is exercised elsewhere
- The location of control and purpose of control is one issue that arises from the lack of transparency in the ownership and operation of 'section 110' firms and other SPV's.

Table 8: Governance in Practice, the role of Corporate Service Providers

Name of provider	Section 110 firms identified	Russian connected section 110 firms identified	Total including s. 110' firms[1]
Deutsche International Corporate Services	580	27	840
TMF Administration Services Limited	224	17	743
MFD Secretaries Limited	178	1	1611
Link IFS Limited (formerly Capita International Financial Services/AIB International Financial Services)	109	8	702
Tudor Trust Limited	112	0	1118
Cafico Secretaries Limited	39	30	39
AIB International Financial Services Limited/Link IFS Limited/Capita International Financial Services Limited	109	0	701
Intertrust Finance Management (Ireland) Limited/Structured Finance Management Limited	154	0	240

Table 9:
Multiple directorships and the performance of fiduciary duties

Name	Total current directorships	Total no. Russian Connected S110s directorships	Associated CSP
Jonathan Law	132	2	Link IFS Limited
John Hackett	128	10	TMF
Roddy Stafford	127	9	Deutsche CSP
Christian Currivan	85	11	Deutsche CSP
Eimir McGrath	53	27	Deutsche CSP
Rodney O'Rourke	45	21	Cafico Secretaries

Conclusion

- This study has identified corporate governance issues and risks associated with Russian connected firms operating in the IFSC.
- Finance raised has fallen dramatically since the introduction of sanctions.
- This is likely to be a result of a regulatory activity in countries other than Ireland.
- The fall in activity has considerable implications for the fee income of some firms providing for example legal services.
- More important implications arise from the size of assets and lack of transparency about their source and use of funds.
- Given their low economic impact, and governance issues it is difficult to justify both the current very valuable tax concessions available to 'section 110' firms and their relatively light touch regulatory regime.