Statement before the

House Permanent Select Committee on Intelligence

"Putin's Playbook: The Kremlin's Use of Oligarchs, Money and Intelligence in 2016 and Beyond"

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Mr. Chairman, Ranking Member Nunes, and distinguished members of the committee, thank you for this opportunity to share with you our research findings to better understand the origins, development, and eventual weaponization of Russian malign economic influence. To begin to understand these economic tools, it is important to note that:

"*How Russia exerts its influence abroad represents an extension of its own governing model, which operates on state-sponsored corruption, centers on a vast patronage network protected by security affiliates, and penetrates every aspect of society, including the highest levels of government*."[1]

This is a quote from our seminal research published in October 2016, *The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe*. Our second volume, *The Kremlin Playbook 2: The Enablers*, which we have just released, further explores the Kremlin's use of enablers to spread and amplify its economic influence as well as assesses the continuous adaptation of its tactics. For the past four years, CSIS and the Sofia-based Center for the Study of Democracy have analyzed 11 European countries to measure the size of Russia's economic footprint in each country and to observe how the Kremlin has leveraged its considerable economic power to influence or alter domestic politics and democratic institutions, with varying levels of success.

We conclude that Russia operates within a financial gray zone in which illicit financing (including money laundering), shell companies, and complex tax avoidance and evasion schemes are developed and used through intermediaries, patronage networks, and corrupt practices. State-owned and state-affiliated companies in Russia are often used as instruments of influence and cannot be understood as regular business actors given the vertical integration of power between the Russian state and its corporate sector. Transatlantic policymakers have been slow to recognize and acknowledge this crucial difference.

Russia's Economic Governing Model Exported to Europe

Professor Karen Dawisha's book, *Putin's Kleptocracy: Who Owns Russia?*[2] offers the most comprehensive overview of the rise of a particularly virulent form of kleptocracy that we see in Russia today. These kleptocratic practices were integral to the political rise of Vladimir Putin when he served as Deputy Mayor of St. Petersburg, during which he was responsible for overseeing all foreign contracts in the city. Mr. Putin brought this evolving form of kleptocracy with him to Moscow, accompanied by many leading members of his St. Petersburg inner circle, when he was named head of the Federal Security Bureau (FSB) in 1998 and eventually when he became President of the Russian Federation in 2000.

[1] Heather Conley et al., *The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe* (Lanham: Rowman & Littlefield, October 2016), 9.
[2] Karen Dawisha, *Putin's Kleptocracy: Who Owns Russia?* (New York: Simon & Schuster, 2015).

As Dawisha notes, "[m]oney from all kinds of licit and illicit sources flooded out of Russian into a variety of Western banks and offshore accounts in the early 1990s."[3] One very early example of a Russian pattern of behavior and a methodology of illicit financing was described in a report by the German Federal Intelligence Agency (BND) in 1999 which investigated money laundering activities in Liechtenstein in which it was alleged that an unknown Russian-German firm, the St. Petersburg Real Estate Holding Co. (SPAG)—for which Vladimir Putin was listed as a member of the advisor board and the city of St. Petersburg also held shares —was engaged in laundering money from Russia and other sources.[4] Two subsidiaries of SPAG were reportedly involved with the head of the Tambov criminal syndicate. It appeared from court documents that this entity was designed to launder funds and to take profits out of Russia.[5]

Russian kleptocrats skillfully use financial transactions, state-owned and state-affiliated companies, foreign direct investment stocks, corporate service providers, and unclear beneficial ownership schemes as instruments of influence. This financial gray zone has been in the making for decades, aided and abetted, wittingly and unwittingly, by the West. This system is particularly advanced in Europe where the economic linkages and historical ties with Russia are the strongest, but there are spillover effects in the United States which must be addressed.

<u>The Russian Financial Gray Zone</u>

The Kremlin has spent years developing a financial gray zone in which state-owned or affiliated companies actively use the complex financial tools, created by Western financial systems, to achieve their malign goals. Their methods include profit shifting for the purpose of tax avoidance (which is not necessarily illegal) and tax evasion, and egregious laundering of money obtained through corruption, embezzlement, or criminal activities. The Kremlin's potential ties with and use of organized criminal networks have been extensively documented.[6]

These illicit financial flows have been assisted by enabling countries and industries, for example corporate service providers (CSPs; e.g., accountants, lawyers, incorporation agents) which are designed to remain below the threshold of illegality to escape attention and detection. The Kremlin exploits the many tax loopholes and complex incorporation laws many Westerners use themselves, but it uses these instruments to both enrich its inner circle *and* to provide material support to anti-Western and pro-Kremlin political parties and politicians, which can ultimately fuel societal division and erode confidence in democracy. While other state and non-state actors use these instruments as well, Russia is the most egregious state perpetrator today.

The financial figures are simply staggering:

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[3] Dawisha, *Putin's Kleptocracy*, 133.
[4] Ibid, 132.
[5] Ibid, 135-136.
[6] For example, see Stephen Handelman, *Comrade Criminal: Russia's New Mafiya* (New Haven: Yale University Press, 1995).

- $1 trillion: Estimated total Russian private holdings abroad today.[7]
- €12 trillion: The estimated amount of funds that went through the Netherlands in 2009 through trusts and companies that made use of corporate service providers.[8]
- $4.5 trillion: The amount that flows through the Netherlands each year via companies making use of Dutch CSPs, making the Dutch CSP sector about as large as Japan's, despite the fact that Japan's economy is six times the size of the Netherlands'.[9]
- €200 billion: The estimated amount laundered through Danske Bank (a quarter of which originated in Russia).[10]
- $20 billion: The amount European banks spend on financial sector compliance and due diligence each year.[11]
- €600 million: The amount of the fine that Deutsche Bank paid for its role in a $10 billion Russian money-laundering scheme.[12]

But it is the size of the inbound and outbound financial flows (licit and illicit) that has become a powerful tool of Russian malign economic influence. In Italy, Austria, and the Netherlands alone, our research has shown that Russian FDI stocks have expanded over the past decade from just €5.4 billion in 2006 to close to €160 billion at the end of 2017, despite the imposition of EU sanctions. In the Netherlands, Russian companies' assets have jumped from €13.2 billion in 2007 to over €96 billion in 2017 through the use of letterbox companies for tax optimization purposes. Russian assets represented 13 percent of Dutch nominal GDP in 2017. In Montenegro, approximately 13.6 percent of all inward FDI stock originated in Russia in 2016 and tourism, which is counted as trade in services, now accounts for close to 20 percent of the country's GDP.[13]

In addition to size, the concentration of Russian economic influence in specific sectors of a country's economy creates leverage points for the Kremlin. Energy, finance, and real estate are key sectors. Some large European firms in these sectors with access to high levels of political power, such as Austria's energy giant OMV or Italy's UniCredit (the country's largest banking group based on total assets), have important investments in Russia or are involved in joint

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[7] Anders Aslund, "It's time to go after Vladimir Putin's money in the West," *The Washington Post*, March 29, 2018, https://www.washingtonpost.com/news/democracy-post/wp/2018/03/29/its-time-to-go-after-vladimir-putins-money-in-the-west/.
[8] Jeroen Trommelen, "Een geldstroom van 12,000 miljard," *de Volkskrant*, November 15, 2012, https://www.volkskrant.nl/nieuws-achtergrond/een-geldstroom-van-12-000-miljard~b45b118c/.
[9] Rodrigo Fernandez, "Dutch efforts to combat letterbox companies have no effect," SOMO, March 29, 2018, https://www.somo.nl/dutch-efforts-combat-letterbox-companies-no-effect/.
[10] Richard Milne, "Danske Bank charged over €200bn money-laundering scandal," *Financial Times*, November 28, 2018, https://www.ft.com/content/6ae5f7f6-f324-11e8-ae55-df4bf40f9d0d.
[11] Giulia Paravicini, "Europe is losing the fight against dirty money," *Politico*, April 2, 2018, https://www.politico.eu/article/europe-money-laundering-is-losing-the-fight-against-dirty-money-europol-crime-rob-wainwright/.
[12] Jethro Mullen, "Deutsche Bank fined for $10 billion Russian money-laundering scheme," CNN, January 31, 2017, https://money.cnn.com/2017/01/31/investing/deutsche-bank-us-fine-russia-money-laundering/index.html.
[13] "Predrag JELUŠIĆ: Turizam daje petinu BDP-a i čini više od polovine izvoza Crne Gore," *Portal Analitika*, September 27, 2015, http://www.portalanalitika.me/clanak/203071/predrag-jelusic-turizam-daje-petinu-bdp-a-i-cini-vise-od-polovine-izvoza-crne-gore.

ventures and projects with large Russian companies. The Kremlin has at times tried to involve these companies in its web of state-run or -controlled corporations in Russia, offering lucrative projects and joint-ventures. These companies can use these political ties to protect their own economic interest *and* assist the Kremlin, wittingly or not, by convincing policymakers and the public that harm should not be done to this important economic relationship. Their size in the national economy increases their leverage on policy decisions.

In the face of such large financial flows, certain countries' oversight authorities and their limited capabilities can get overwhelmed by the complexity and multi-jurisdictional nature of potential illicit schemes emanating from Russia. It has become increasingly difficult to disentangle licit flows from illicit activity in the financial sector, and the resources allocated to anti-money laundering at the national level have not kept up with the complexity of the system.

The Unvirtuous and Reinforcing Cycle of Russian Malign Economic Influence

In the first *Kremlin Playbook* report, we detailed what we called an "unvirtuous cycle" of malign influence that the Kremlin uses to influence and direct decision-making in Central and Eastern Europe. It does so through networks of economic and political patronage across the region and follows two tracks: one through economic influence in strategic sectors of a country's economy, which can in turn provide political influence; and the other through political influence, which can later deepen and protect Russian economic influence. Corruption allows both influence tracks to become highly intertwined.

Because Russian economic presence concentrates in strategic sectors, particularly energy, finance, and real estate, there is a reinforcement velocity to this cycle to achieve maximum policy impact. In **energy**, the Russian economic footprint in Bulgaria peaked at around 27 percent of GDP in 2012, and as of 2016, Gazprom was the country's sole natural gas provider. Rosatom, the state-owned nuclear company, has a dominant position in Bulgaria and Lukoil, the major Russian oil company, controlled over 50 percent of the wholesale fuels market in 2016.[14] This dominant economic presence provides the Kremlin with great leverage over the country's budget revenues, and can largely direct the distribution of public procurement contracts or the circumvention of EU law through legal changes.[15]

The **financial** sector in turn provides vital support to large Russian energy infrastructure projects in Italy, for example. Intesa Sanpaolo became an investor in the Blue Stream pipeline in 2000 and provided financing for the first Nord Stream pipeline. In 2017, Intesa provided a €5.2 billion loan to Glencore and Qatar Investment Authority to finance their acquisition of a stake in Rosneft after its "privatization"—an effort by the Kremlin to raise much-needed capital due to

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[14] Ognian Shentov, Alexander Stoyanov, and Maria Yordanova, eds., *State Capture Unplugged: Countering Administrative and Political Corruption in Bulgaria* (Sofia: CSD, 2016), http://www.csd.bg/artShow.php?id=17723.

[15] Ruslan Stefanov and Martin Vladimirov, "Bulgaria and the South Stream Pipeline Project: At the Crossroads of Energy Security and State Capture Risks," *Südosteuropa Mitteilungen* 54 (May– June 2014): 54–72, http://www.csd.bg/artShow.php?id=17256.

Western imposed sanctions. (A Chinese conglomerate later agreed to buy part of that stake and Intesa will thus be reimbursed sooner than planned).[16] The Italian export credit agency, SACE, has also provided support for projects in the oil and gas sector and the metallurgical industry for Italian firms in Russia and has a total exposure of around €5 billion.[17]

Real estate presents an important point of leverage, particularly at the local level. In Montenegro, the state has received close to €25 million in sales taxes since 2006 from this sector. An estimated 70,000 properties belong to Russian owners and Russian businessmen acquired valuable hotels in attractive locations at a fraction of their market value during post-independence privatizations.[18] Some of the most valuable hotels were acquired through shell companies, reinforcing the dependence of some sectors on the financial system. This concentration skews the local tax base and can significantly influence local political forces that rely on these funds.[19]

We Must Fight in the Light

Successive money laundering scandals in Europe have shown that the Kremlin has continually found ways to make economic gains despite the sanctions regime – although many important sanctions exceptions were grandfathered into European sanctions (for example, in 2014 the Viennese branches of Sberbank and VTB Bank were exempted from sanctions and thus retained their operative presence on the European market,[20] potentially enabling a massive influx of Russian FDI to Austria post-2014).

Russian oligarchs have enjoyed the benefits of the Western financial system, our rule of law, and our independent courts—and the West has paid the price. We must immediately remedy this situation.

- Congress should reinforce the importance of the reports provided by the Department of Treasury on U.S. efforts to combat illicit finance relating to Russia (as mandated by the **Countering America's Adversaries Through Sanctions Act** of 2017 (CAATSA)), and ensure these reports are provided every year. The newly introduced **Defending American Security from Kremlin Aggression Act** of 2019 is a strong bipartisan effort to reinforce CAATSA and has important provisions like the specific requirement for

[16] Gianluca Semeraro and Stephen Jewkes, "Intesa Sanpaolo not concerned about Glencore loan for Rosneft," Reuters, April 27, 2018, https://www.reuters.com/article/us-intesasanpaolo-rosneft-glencore-cefc/intesa-sanpaolo-not-concerned-about-glencore-loan-for-rosneft-idUSKBN1HY2IW.
[17] "SACE e Vnesheconombank firmano accordo di cooperazione," SACE, June 16, 2016, https://www.sace.it/media/comunicati-stampa/dettaglio/sace-e-vnesheconombank-firmano-accordo-di-cooperazione.
[18] "Nesterenko: U Crnoj Gori živi do sedam hiljada Rusa," *Vijesti.me*, January 27, 2014, http://www.vijesti.me/vijesti/nesterenko-u-crnoj-gori-zivi-do-sedam-hiljada-rusa-174290 (cache-based source).
[19] Center for the Study of Democracy, *Assessing Russia's Economic Footprint in Montenegro* (Sofia, Bulgaria: Center for the Study of Democracy, 2018).
[20] Miriam Widman, "Austria Shields Russian Banks from E.U. Sanctions," *Handelsblatt Global*, July 31, 2014, https://global.handelsblatt.com/companies/austria-shields-russian-banks-from-e-u-sanctions-5078.

domestic title insurance companies to report information on the beneficial owners of entities that purchase residential real estate in high-value transactions;

- **Money laundering** should be elevated as a priority threat to national security, and the United States should coordinate with European allies on strengthening the international anti-money laundering (AML) architecture. This includes elevating the risk of corporate service providers in illicit finance and money laundering activities, enforcing customer due diligence requirements, and increasing penalties for non-compliance. **Ultimate beneficial ownership** information is a key element in targeting money laundering networks and Russian malign actors who game the system by remaining anonymous, and Congress should redouble efforts to establish transparency in this realm (including through limiting the use of nominee directors);
- Reports provided to Congress by the executive branch relating to Russian economic influence and its enablers should make full use of disclosure to increase the reputational penalty for harboring Russian illicit funds ("name and shame");
- Congress should closely review the sanctions regime and address the key loopholes that allow for the evasion of sanctions, from bilateral exemptions to grandfathered deals. U.S. investment visas also offer a potential door for Russian funds to enter the United States and corrupt our financial system, and they must be put under closer scrutiny. European allies must be involved in similar efforts against the so-called "golden visas";
- The **Global Magnitsky Act** has proven a strong tool to target kleptocrats and human rights violators, as well as those who assist them, and the United States and European allies should harmonize their use of the Act;
- Finally, Congress has still not taken steps to guarantee reciprocity with countries that have signed intergovernmental agreements under the Foreign Account Tax Compliance Act (FATCA). This reciprocity would enhance information sharing and transparency, which are both crucial in the fight against Russia's malign efforts to evade taxes and hide its investments. The United States has still not approved the OECD's common reporting standards (modeled after FATCA agreements[21]), though they are meant to improve two-way information sharing on tax evasion and avoidance—this must be remedied.

These efforts require strong bipartisan support and cooperation with our European allies, without which Russian malign economic influence will continue to divide the United States from its allies and undermine democratic societies. The cost of removing malign influence from our financial system and enhancing transparency and accountability in our political processes is well worth the long-term benefits of strengthening our democratic institutions as well as ending the Kremlin's unvirtuous cycle of influence and its kleptocratic model's use of Western institutions. All of these efforts must be complemented by continued intelligence sharing with our allies and the disclosure of influence operations wherever they occur.

[21] Laurie Hatten Boyd, "Are Problems Looming for FATCA and the "Reciprocal" IGA?" *The Tax Adviser*, June 1, 2016, https://www.thetaxadviser.com/issues/2016/jun/problems-looming-for-fatca-and-reciprocal-iga.html.

If it is said that "democracy dies in darkness,"[22] then it must be that it thrives in the light. Transparency and accountability rebuild confidence in democratic institutions. Enforcement of the rule of law guarantees trust in our democratic processes. In this fight, democracies win.

[22] Paul Farhi, "The Washington Post's new slogan turns out to be an old saying," *The Washington Post*, February 24, 2017, https://www.washingtonpost.com/lifestyle/style/the-washington-posts-new-slogan-turns-out-to-be-an-old-saying/2017/02/23/cb199cda-fa02-11e6-be05-1a3817ac21a5.