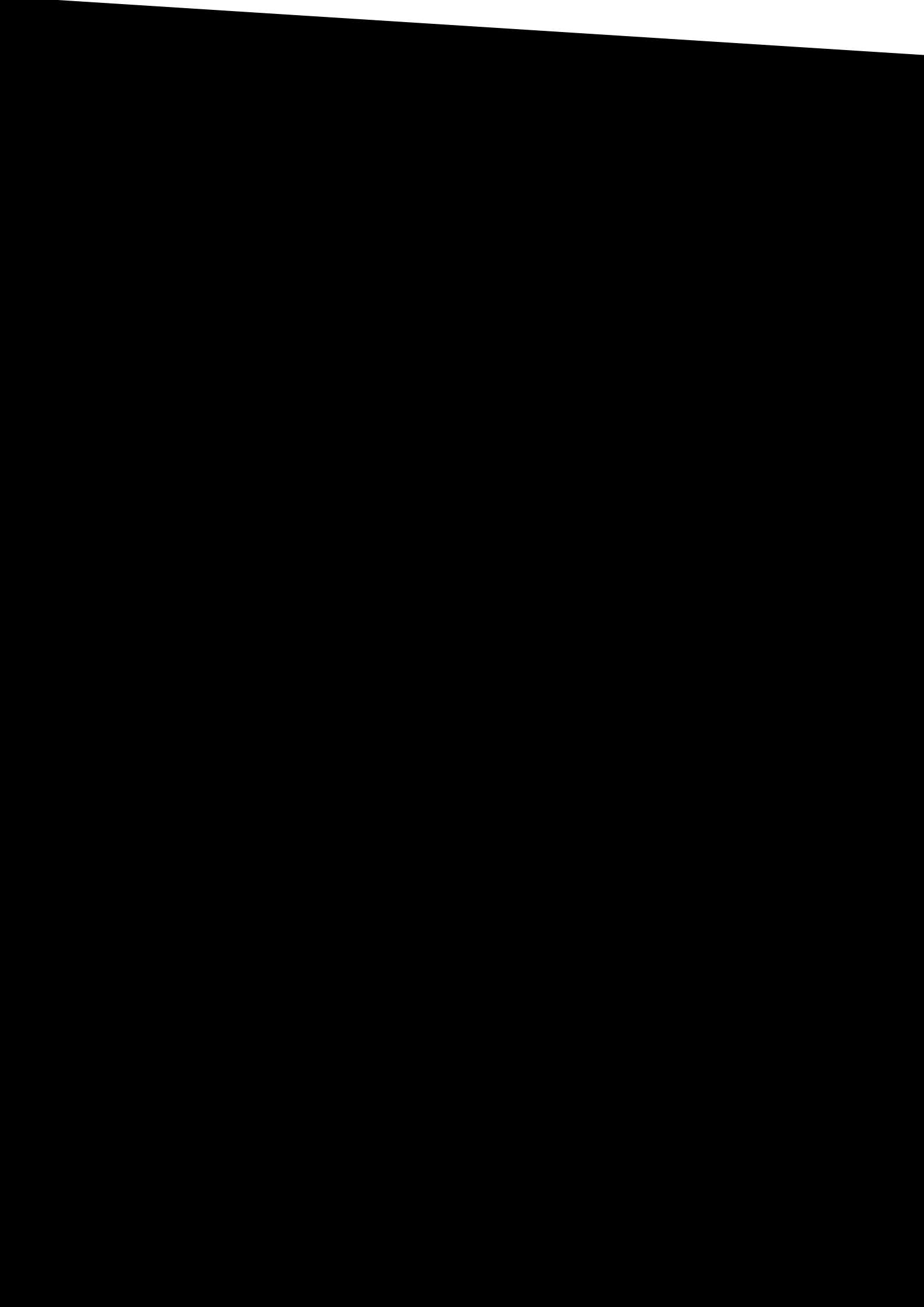


FIT FOR INTERNATIONAL FINANCIAL MARKETS?

A CLOSER LOOK AT VTB GROUP'S PRACTICES

BY THE FOUNDATION FOR FIGHTING
CORRUPTION AND THE RUSSIA STUDIES
CENTRE AT THE HENRY JACKSON SOCIETY





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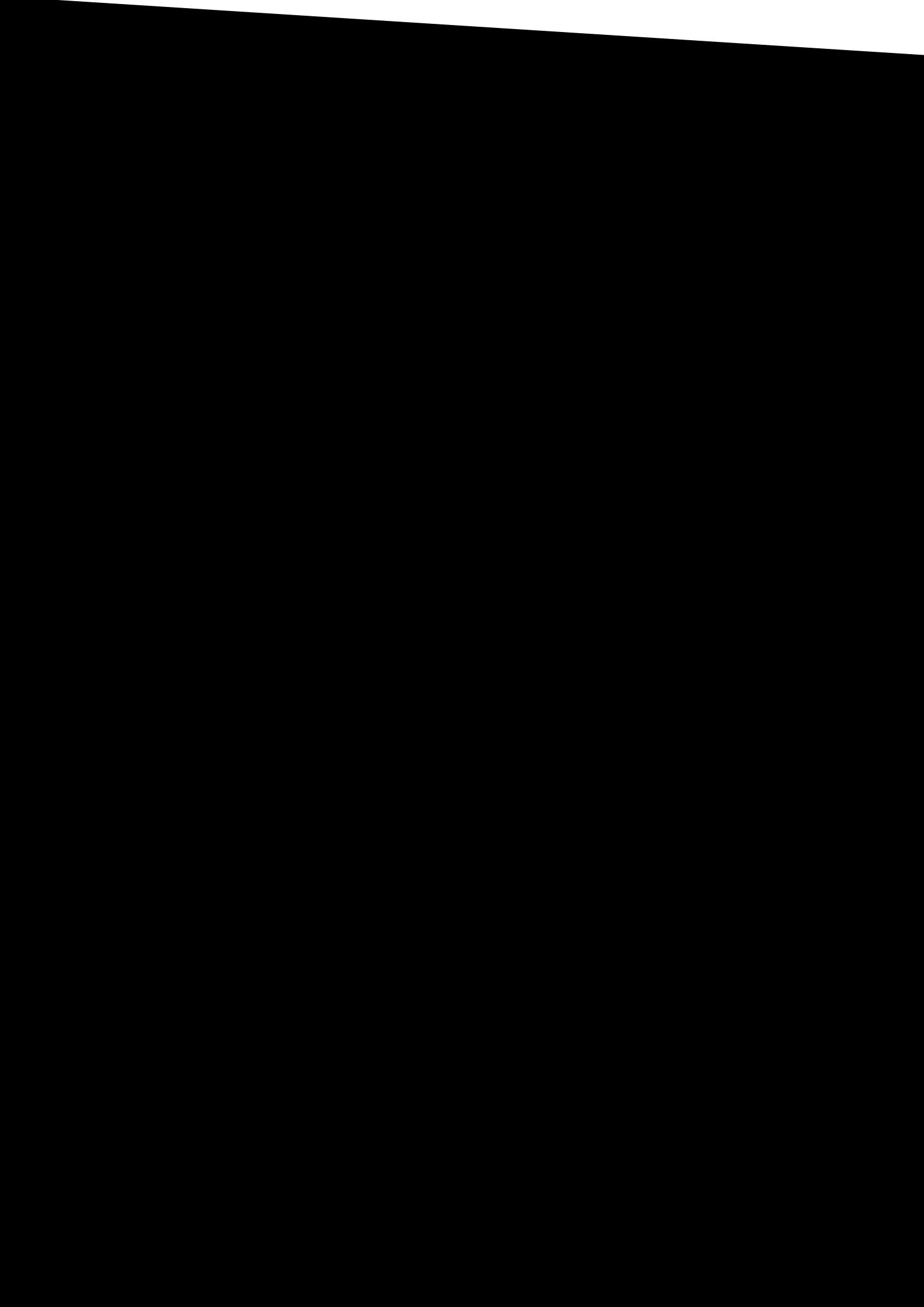
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Contents

Executive Summary	6-7
Introduction	8
The Bank	10
History	10
Structure	10
Mismanagement	12
The Bank of Moscow takeover	12
Shares buyback	13
Drills	14
Marshall Capital	15
Fyodor Khoroshilov	17
Russian Commercial Bank Management buyout	19
Conclusion	20

Executive Summary

- A pattern of mismanagement and questionable business practices by the VTB Group—and specifically VTB Bank—should raise serious concerns about the viability of the financial institution for investors and the banking sector as a whole, and the potential hazards that it brings to the European financial markets.
- Born from Soviet state-owned Gosbank and rebranded as VTB in 2006, VTB Bank offers a wide range of services, including deposit taking, commercial lending, support of clients' export/import transactions, foreign exchange, securities trading, and trading in derivative instruments. The company's operations are conducted in both Russian and international markets, and it has a presence throughout the Commonwealth of Independent States, Europe, Asia and Africa.
- VTB's flagship holding company, VTB Bank, reported a record net profit in 2011 and has seen its assets balloon from \$6.3 billion to a staggering \$200 billion in just ten years. The bank employs nearly 68,000 people worldwide and maintains a presence in 19 countries, and is the 67th largest bank in the world.
- VTB's deeply entangled relationship with the Russian government, which owns 75.5 per cent of VTB Group, also appears to have distorted the company's practices—arguably influencing decisions to meet the political expediency of Russian President Vladimir Putin.
- There are several high-profile incidents which suggest mismanagement at VTB, including inadequate due diligence in VTB's takeover of the Bank of Moscow in 2011. Some observers have accused the bank of using a subsequent government bailout of the Bank of Moscow as a way of recapitalising the bank whilst increasing control of Russia's banking sector.
- When VTB Group went public in May 2007, its chief shareholder — the Russian government — sought to encourage ordinary Russian citizens to become minority shareholders. The stock sale was dubbed the "People's IPO," by Vladimir Putin, who called the bank's shares a "stable" investment. The day after the IPO, the price began to slip and subsequently plummeted.
- At the same time as Putin's political fortunes were rocked by the large-scale public protests in February 2012, VTB was induced to buy back the minority shares, leaving out institutional shareholders and revealing the inordinate influence of Putin's own political needs on the operations of the company. The episode suggests that VTB functions more as an extension of the Russian government rather than protecting shareholder value.
- VTB appears to have done insufficient due diligence on a leasing transaction which left it embroiled in litigation and saddled with a defaulting loan of \$650 million with inadequate security to cover much of the loan.

- At present, there is a significant amount of ongoing civil litigation over VTB deals gone awry, including a lawsuit involving the sale of Russian dairy farms for which VTB extended almost a quarter of a billion dollars in credit to a company whose collateral was apparently worth less than 1/5th as much. A High Court Justice in the UK found that “It is not clear from the evidence presently available what, if any, due diligence was carried out by or on behalf of either VTB Moscow or VTB...”
- At the very least, this episode implicates the bank in a failure to undertake proper due diligence and revealing a continued willingness to make risky investments. VTB has been mired for years in litigation in the UK in an attempt to recoup its money from this deal.
- VTB has also faced allegations by former loan recipients of VTB Bank that senior bank executives possibly hid details of their conflicting business interests from VTB's Credit Committee.
- There is evidence that key managers of VTB Group appeared to help themselves to the assets of a subsidiary company at a bargain-basement price at a time when VTB's average shareholder was losing money through the so-called “People's IPO.”
- These incidents paint a picture that should be of significant concern to investors, policymakers and international regulators.

Introduction

On the surface, the story of the VTB Group appears to be one of great success, representing one of Russia's strongest accomplishments in the transformation from a centrally planned Soviet system to a modern, competitive market economy.

The group's flagship holding company, VTB Bank, reported a record net profit in 2011 and has seen its assets balloon from \$6.3 billion to a staggering \$200 billion in the past ten years. The bank employs nearly 68,000 people worldwide and maintains a presence in 19 countries. In 2007, it was the first Russian bank to make an initial public offering, which led to investments from major European and US financial institutions. It is now ranked among the top 70 banks in the world.

These developments appear to be cause for celebration—but a closer look at some of the bank's transactions reveals a far more troubling picture.

Over the years, VTB Bank and various subsidiaries of the VTB Group have repeatedly found themselves embroiled in financial scandals. Taken individually, these episodes can be interpreted as isolated breaches in various outposts of the group's widespread holdings. But when viewed in context, VTB's activities call into question its management, oversight and good banking practices.

While some of the starkest examples of alleged malfeasance or poor decision-making have surfaced publicly, the bank's management appears to have made little effort to reform bank procedures or even explain how such questionable actions happened in the first place.

In most countries with modern banking systems, a performance record of this kind would likely trigger a wide-ranging regulatory review, internal audits and even the ousting of the bank's leadership. Yet it seems that due to VTB's deeply entangled relationship with the Russian government — it is more than 75 per cent state-owned — no such review appears to ever have been initiated, no reforms have been started and the bank's leadership remains unchanged. In fact, in April 2012, VTB Bank's Supervisory Council announced that it was extending the term of Bank Chairman Andrei Kostin for a further five years.

The bank maintains that following its 2007 IPO "...it became more transparent,"¹ as independent directors were appointed and an audit committee and investor relations division were created. But while the bank grew exponentially — through the creation of new investment and hedge fund divisions and hostile takeovers of other institutions — oversight seems to be lacking.

Nor is this problem now confined only to Russia. VTB's presence in global markets has grown swiftly — particularly in Europe — posing risks that, if allowed to continue unchecked, could cause further damage.

In London, VTB's investment arm, VTB Capital, has already seen its presence grow dramatically since setting up shop in the former home of the prestigious Lloyd's bank in 2008. VTB Capital has also expanded its operations in New York, Hong Kong and Dubai, defying international trends at a time when much of the banking industry has suffered

1. "The Energy of Success: New Horizons," VTB, available at <http://www.vtb.com/we/today/>

greatly. This has arguably been achieved as a result of improperly scrutinised business practices.

The threat posed by questionable transactions is no longer simply confined to higher levels of the banking system. In April of this year, VTB's retail division reported a substantial rise in deposits by ordinary citizens to its subsidiaries in France and Germany. In 2011 alone, VTB took in the equivalent of \$712 million in deposits from pensioners in both countries — with 40,000 accounts in Germany totaling 400 million euros.

VTB insiders alleged that the bank frequently exploits Russia's looser regulations by offloading riskier debts from European subsidiaries to VTB Bank in Moscow through sub-participation agreements, thereby sidestepping regulations within the European Union.

"VTB makes great efforts to get the most out of this flexibility," said one former bank executive who spoke to the authors on condition of anonymity. "The European subsidiaries have little risk on their books, but the threat of large-scale default remains."²

The Russian Federation has a well-earned reputation for government meddling in business affairs to further political objectives. The spectacular growth of VTB now gives the Kremlin an additional lever to exert influence in global financial markets.

Those who follow the bank's activities closely are well aware of the Kremlin's manipulation of VTB.

"VTB is a very good reflection of how business in Russia occurs today, which is on the one hand state ownership and on the other, direction by individuals who are much more concerned about their own wealth than about the benefit to the country or the owners of the institution,³" according to one banking insider, who spoke to the author on condition of anonymity.

This situation has not gone unnoticed by the world's leading rating agencies, which have routinely scored VTB's credit ratings very low (Fitch: Individual "C/D"; Moody's: Financial Strength "D-"). Last year, Fitch reported that it based VTB's sub-par score on "concerns regarding [the bank's] profitability and balance sheet integrity, franchise management, operating environment or prospects."⁴ There is significant evidence to suggest that international financial regulators should monitor the activities of VTB Group closely.

While investors have good reasons to be wary of the bank, international financial regulators should be more concerned.

2. Interview with the authors.

3. "Fast VTB Growth Raises Eyebrows", by Howard Amos, The Moscow Times, 19 January 2012, available at <http://www.themoscowtimes.com/business/article/fast-vtb-growth-raises-eyebrows/451249.html>

4. Offering of 1,046,054, 133, 732 Shares in the form of Shares and Depositary Receipts," VTB, 12 February 2011, available at http://www.vtb.com/upload/iblock/1a9/VTB_Prospectus_20110214.pdf

The Bank

In order to better understand the risks presented by how the VTB Group's business practices, it is important to understand the bank's history and structure.

HISTORY

VTB was born in 1990 out of the ashes of Gosbank, or Russia's State Bank, which had served as both the central bank of the Soviet Union and the principal bank in the country since the 1930s. Facing economic collapse, Soviet leader Mikhail Gorbachev broke the monolithic Gosbank into several smaller pieces, one of which was Vneshtorgbank, or the Bank of Foreign Trade. Its main purpose was to service Russia's foreign economic transactions and facilitate the integration of the USSR into the world economy. Vneshtorgbank remained in state hands—nearly 100 per cent held by the Bank of Russia.

Following several reorganisations, Vneshtorgbank was restructured as an open joint stock company in 1998, at which point the bank set its sights on expansion into Europe. In 2002, the Russian government took over direct control of Vneshtorgbank from the Bank of Russia, and President Vladimir Putin handpicked Kostin, a former Soviet diplomat with a doctorate in economics, to serve as chairman. Under his guidance, the bank pushed into retail lending and began acquiring other private and state-owned competitors. It also expanded its operations beyond Russia's borders, absorbing smaller banks in Ukraine, Georgia, Armenia and Belarus. In 2006, the bank began rebranding to change its name to the simpler VTB, and was officially renamed VTB Bank the following year. Soon thereafter VTB also became the first Russian bank to be publicly traded.

The economic crisis of 2008 took its toll on the bank's stock price and it has never again approached the level it reached at its IPO. Currently the stock is trading at roughly 50 per cent of its high.

STRUCTURE

The main shareholder of VTB Bank is the government of the Russian Federation, which holds 75.5 per cent of the bank's shares. An additional 17.6 per cent of the bank's shares are held as global depository receipts traded on the London Stock Exchange under the ticker symbol VTBR. The remaining shares were originally distributed among minority shareholders, many of the small stakeholders who purchased shares on the MICEX and RTS exchanges in Russia in what was dubbed the "People's IPO," when the bank went public in 2007. Those small stakeholders were recently allowed to indirectly sell their shares back to the bank at the initial offering price, as described in further detail in a later section of the "Shares buyback" section of this report. At the Russian government's initiative, the bank offered a scheme that made discrimination between the bank's shareholders legally possible.⁵

VTB is Russia's second largest bank and the 67th largest in the world. The bank offers a wide range of services, including deposit taking, commercial lending, support of

5. "Putin instructed VTB consider buy-back for minorities," RBK, 2 February 2012, available at <http://top.rbc.ru/economics/02/02/2012/636052.shtml> (translated from Russian)

clients' export/import transactions, foreign exchange, securities trading, and trading in derivative instruments. The company's operations are conducted in both Russian and international markets, and it has a presence throughout the Commonwealth of Independent States, Europe, Asia and Africa. The bank serves as the backbone of the VTB Group, an international financial network with over 30 banks and financial companies in 19 countries.

VTB Group's other major holdings include:

RUSSIA:

- VTB 24
- VTB Leasing
- TransCreditBank
- The Bank of Moscow
- VTB Capital Asset Management
- VTB Development
- VTB Real Estate Ltd.
- VTB Insurance Ltd.
- MultiCarta Ltd.

CIS:

- VTB Bank (Ukraine), VTB Bank (Armenia), VTB Bank (Belarus), VTB Bank (Azerbaijan), VTB Bank (Kazakhstan)

EUROPE:

- Russian Commercial Bank (Cyprus) Ltd.
- VTB Capital plc.
- VTB Bank (Austria), VTB Bank (France), VTB Bank (Germany)

Insiders say that despite employing more than 68,000 people, the VTB Group operates almost like a one-man operation, with Kostin, while obviously not micro-managing every deal, making all the major decisions and his top deputy, Yuri Soloviev, putting them into action. The rest of the group's managers would then follow suit.

"Nothing is done without Kostin's approval," one former high-ranking bank employee told the authors on condition of anonymity. "This is fine if the decisions are all brilliant, but of course they are not always and it shows in the share price. This clearly is not the best approach to management."⁶

6. Interview with the authors.

Mismanagement

VTB has been plagued by a series of scandals in recent years. The following are some of the more notable episodes of alleged mismanagement.

1) THE BANK OF MOSCOW TAKEOVER

In early 2011, VTB moved to acquire the Bank of Moscow, Russia's sixth largest financial institution. The purchase, VTB argued, was a wise strategic move that would allow it to enhance its retail banking presence and make further inroads in its effort to take on Russia's largest financial institution, Sberbank. Yet almost immediately after VTB began its takeover of the Bank of Moscow, alarming details about the state of the Bank of Moscow's books began to emerge that would ultimately lead to the biggest government bailout in Russia's history.

The Bank of Moscow first opened its doors for business in 1995, when then-Moscow Mayor Yuri Luzhkov tapped Andrei Borodin to create a bank controlled by the city government. However, when President Dmitry Medvedev unceremoniously sacked Luzhkov in 2010 in a political shake-up, the future of the Bank of Moscow came into question.

Months later, with full government backing, VTB swooped in to take over the bank, buying out the city's stake of 46.5 per cent for \$3.7 billion, as well as an additional minority stake held by the Capital Insurance Group.

It was only after VTB took formal control of the Bank of Moscow that it discovered a gaping hole in the bank's books. VTB claimed to have suddenly found billions of dollars in questionable loans made to businesses with close ties to the bank's senior managers, and that almost half of the Bank of Moscow's loan book was under threat of default.⁷ Faced with the Bank of Moscow's imminent failure, which regulators feared could trigger a cataclysm equivalent to the collapse of Lehman Brothers, the Russian central bank stepped in with a \$14 billion bailout in state-backed loans at well below the market rate of interest.⁸ It was the largest bailout in Russian history; equivalent to approximately 1 per cent of the country's economic output.

To examine VTB's accounts, one would be hard pressed to determine the scope of the damage. VTB was able to create an apparent \$5 billion paper profit out of this transaction. The bulk of the rescue package came in the form of a ten year government loan at 0.51 per cent interest per year. The loan proceeds were then invested in government securities yielding 8 per cent per year.⁹ While this created the appearance of a windfall for VTB, the Central Bank of Russia in reality had underwritten one of the most generous recapitalisation programmes in the world.

In the aftermath of the Bank of Moscow takeover, unrelated criminal charges were brought against Borodin and another former Bank of Moscow manager, Dmitry Akulinin,

7. "Russia's Banks: Collateral Damage," by Catherine Belton and Neil Buckley, The Financial Times, 22 September 2011, available at <http://www.ft.com/cms/s/0/5d80855c-e50f-11e0-9aa8-00144feabdc0.html#axzz25P4gRDpA>

8. "Regulators Provide \$14 Billion Bailout for Bank of Moscow," by Andrew Kramer, The New York Times, 1 July 2011, available at <http://www.nytimes.com/2011/07/02/business/global/02ruble.html>

9. Ibid.

in connection with a \$443 million loan in 2009 that is alleged to have ended up in an account controlled by Luzhkov and his wife, Baturina.¹⁰ Borodin and Akulinin fled the country and were forced to sell their 20 per cent stake at a cut-rate. Accusations immediately began to abound that VTB had failed to perform proper due diligence before the purchase, with catastrophic consequences. Borodin has insisted the deal was just a Kremlin-backed power-grab to seize a coveted asset.¹¹ He claims that the hole in the Bank of Moscow books never existed and was created as a way to funnel government money to VTB, perhaps to cover deficits in VTB's own balance sheet. Alternatively, he argued that the accounting discrepancy was created to undervalue his share in the company, enabling VTB to buy it at a rock-bottom price. Borodin also pointed out that there was no way the government would not have been aware of an accounting shortfall of that size, as a team of central bank employees had worked inside the Bank of Moscow since it received a small amount of state support during the 2008 financial crisis.

VTB claims that the Bank of Moscow's cozy relationship with Moscow City Hall while Luzhkov was mayor resulted in a failure to properly regulate its operations. VTB has further insisted that the deal was a purely "strategic" purchase, and said that politics had nothing to do with it. Assuming that this is all true, it remains unclear how VTB managed to miss such a major accounting discrepancy that almost immediately rendered its multi-billion dollar investment worthless. Even more puzzlingly, if the allegations against Borodin and his management team are true, why has no one been charged in this affair? More than a year later, there is little sign that any sort of real criminal investigation has even been launched.

The takeover has also stirred concerns of government meddling in the market for political purposes, further consolidating the Russian banking sector in state hands. Some observers have suggested that the expansion of the state share will hamper the growth of private banks, as government institutions have access to considerably cheaper credit than private banks.

2) SHARES BUYBACK

When VTB Group went public in May 2007, its chief shareholder — the Russian government — sought to encourage ordinary Russian citizens to become minority shareholders. With much fanfare, the stock sale was dubbed the "People's IPO" by President Vladimir Putin, who called the bank's shares a "stable" investment.¹² Ordinary Russians, many of whom lost billions in multiple bank collapses and stock market scams in the 1990s, were reassured by Putin's seal of approval, and more than 130,000 people lined up with bags filled with rubles to buy shares at the initial offering price of 13.6 kopecks.¹³ Individual investors bought up nearly \$1.6 billion worth of the stock, and the sale ultimately netted the bank \$8 billion in what was the biggest IPO in the world that year.¹⁴

The day after the shares were sold, the price began to slip. When the global economy sank into crisis in 2008, VTB's stock price plummeted, hitting rock bottom at 1.9 kopecks

10. "Bank of Moscow Chief Flees as Police Prepare Charges," RIA Novosti, 5 April, 2011, available at <http://en.rian.ru/business/20110405/163383372.html>

11. "Russia's Banks: Collateral Damage," by Catherine Belton and Neil Buckley, The Moscow Times, 22 September 2011, available at <http://www.ft.com/cms/s/0/5d80855c-e50f-11e0-9aa8-00144feabdc0.html#axzz25P4gRDpA>

12. "VTB Bank Raises \$8 Billion in Biggest IPO This Year," by Todd Prince, Bloomberg, 11 May 2007, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afIKQJ5xQ_7g

13. Ibid.

14. Ibid.

in March 2009.¹⁵ Since that time, the stock has never traded above the initial price and the investment was a huge failure for most small stakeholders.

In February 2012, average shareholders received some extraordinary news. While seeking to return to the presidency for the third time after four years as prime minister, Putin found himself faced with the largest public protests in Russia in nearly 20 years. In what was widely regarded as an effort to shore up political support, Putin ordered VTB to launch a share buyback from the bank's smaller shareholders at the original price of 13.6 kopecks.¹⁶

The rules were simple: only those who had purchased the shares during the IPO were eligible, with a maximum amount of 500,000 rubles worth of shares allowed.

The deal left institutional investors howling, as the share ceiling excluded them from benefiting from the sale. Dismissed as "straightforward populism,"¹⁷ the move reinforced the notion among investors that VTB functioned more as an extension of the Russian government rather than a business interested in protecting shareholder value.

One observer noted, "Over the years we have seen considerable evidence supporting the view that VTB is more a state vehicle than a profit-oriented or shareholder-oriented business, and the government now seems to be acknowledging this," said Rinat Kirdan of Aton Capital.¹⁸

Former Finance Minister Alexei Kudrin called the buyback "...a negative precedent," that infringed on the equal rights of shareholders.¹⁹ Richard Hainsworth, General Director of the rating agency, RusRating, agreed, saying that government intervention should only be reserved for a true crisis, not a political one.

"In this situation it's inappropriate. In the future, if the government backed any company such as Sberbank of Gazprom, if their profits go below what the market is expecting, the government might jump in and that will distort the market as a whole," he said.²⁰

In the end, 74,302 small shareholders, or roughly 65 per cent of the total targeted group, turned in their shares.²¹ The deal cost VTB 24 — the bank's retail division that had been tasked with handling the buyback — \$385 million. Bank officials said that most of those who did not take advantage of the offer had such small stakes that they couldn't bothered with the paperwork.

The buyback made it clear that the Kremlin views VTB as an enterprise that can be used to fix political problems. Not only does this create distortions in the larger economy, it should give potential institutional shareholders pause before investing in VTB.

15. "VTB Group Drops the Most This Year on Minority Buy Back Plan," by Jason Corcoran, 7 February 2012, available at <http://www.bloomberg.com/news/2012-02-07/vtb-group-drops-the-most-this-year-on-minority-buyback-plan.html>

16. "Putin Tells VTB To Pay For Share Buyback," Reuters, 6 February 2012, available at <http://www.reuters.com/article/2012/02/06/vtb-idUSL5E8D62P020120206>

17. "Putin VTB Buyback Plan is Deemed Political Interference," Bloomberg, March 2, 2012

18. "Putin VTB Buyback Plan Deemed Political Interference," by Jason Corcoran and Leon Lazaroff, Bloomberg, 1 March 2012, available at <http://www.bloomberg.com/news/2012-03-01/putin-buyback-plan-for-vtb-denounced-as-political-interference.html>

19. "VTB Buyback 'Bad Precedent' — Kudrin," RIA Novosti, 5 April 2012, available at <http://en.rian.ru/business/20120405/172634035.html>

20. "VTB Share Buy-Back Not Without Its Problems," RT, 7 February 2012, available at <http://rt.com/business/news/vtb-buy-back-689/>

21. "VTB 24 to Spend \$385M on People's IPO Reversal," by Irina Filatova, 18 April 2012, available at <http://www.themoscowtimes.com/business/article/vtb-24-to-spend-385m-on-peoples-ipo-reversal/456917.html>

3) DRILLS

In July 2007, VTB Leasing, a subsidiary of VTB Bank, became embroiled in a much-publicised incident involving 30 pieces of drilling equipment that resulted in the bank losing at least \$160 million.

The details of the transaction are stunning. The equipment, purportedly intended for an arctic oil drilling project in northern Siberia, was purchased on 26 July, 2007 from a Chinese manufacturer, Sichuan Honghua Petroleum Equipment Co., Ltd., by a Cyprus-registered company called Cluseter Limited. The price was \$10 million per rig, for a total of \$297 million. Cluseter sold the equipment on the same day to VTB Leasing for \$15 million apiece — or a total of \$457 million, representing a markup of \$160 million. Including customs and transportation costs, the deal totaled \$650 million. Contracts drawn up for both ends of the deal are nearly identical, with the same delivery terms to a small village in the Yamalo-Nenets Autonomous District — the only difference being the purchase price.²²

There is evidence that more questions ought to have been asked about the deal from the beginning. First, the drill rigs in question appear to have had technical limitations that would have made them inappropriate for wells whose depth requires higher bearing capacity, such as those found in northern Siberia.²³ Following delivery, the oil exploration company for which the drill rigs were intended, Well Drilling Corporation Ltd., subleased them to another firm, Severnaya Ekspeditsia, which declared bankruptcy soon thereafter.²⁴ VTB Leasing was forced to go to court to get the rigs back.

It has been reported that the Well Drilling Corporation's board members included St Petersburg businessman Shota Boterashvili and his wife. Boterashvili has described himself as a chief advisor to Kostin, VTB's president, and has served on the supervisory board of VTB Georgia.²⁵ This appears to be a prima facie conflict of interest.

VTB Bank never disclosed details of the failed deal in its accounting and it only became publicly known after being exposed in the media. It was only then that Kostin acknowledged the deal and confirmed that some top managers at VTB Leasing had been fired.²⁶ Despite these revelations, the losses never appeared in the bank's required financial disclosures, and the bank's supervisory council never responded to shareholder complaints.

4) MARSHALL CAPITAL

In 2007, VTB Bank and VTB Capital agreed to finance the sale of six Russian dairy farms by a company called Nutritek to a company called RAP. To that end, the bank granted RAP a loan of \$225 million. RAP defaulted on the loan within a year.²⁷ A subsequent investigation revealed startling problems with the transaction. It became apparent that

22. Both contracts of sale (from Sichuan Honghua Petroleum Equipment Co., Ltd. to Cluseter Ltd., and from Cluseter Ltd. to VTB Leasing) are available at: <http://henryjacksonsociety.org/wp-content/uploads/2012/09/OilDocuments.pdf>

23. Vedomosti via The Moscow Times, 23 July, 2010, available at <http://www.themoscowtimes.com/business/article/vtb-finds-lessee-for-scandalous-oil-rigs/410881.html>

24. Ibid.

25. National Bank of Georgia Fact Sheet, available at http://www.nbg.gov.ge/uploads/banks/vtb/nbg3.2.2vtb30.06.2007_2eng.xls

26. "Russia's Campaigner Against Corruption," The National, 25 January 2010, available at <http://www.thenational.ae/news/world/europe/russias-campaigner-against-corruption>

27. VTB Capital PLC v Nutritek International Corp., Marshall Capital Holdings Ltd., Marshall Capital Llc. And Konstantin Malofeev, High Court of Justice, Chancery Division, Case No. HC10C04611, 29 November 2011, paragraph 1, available at: http://henryjacksonsociety.org/wp-content/uploads/2012/09/VTB_v_Nutritek_judgment.pdf

both Nutritek and RAP were actually owned by the same person — Konstantin Malofeev — through separate subsidiaries of his company, Marshall Capital Partners.²⁸ This fact had been largely obscured by the creation of an elaborate series of shell companies. It was also revealed that at the time of the sale, Nutritek had highly overinflated the value of the dairy plants.²⁹ When all was said and done, the bank found itself in possession of a series of dairy facilities worth no more than \$35 million.³⁰ VTB has since been mired in years of litigation in the United Kingdom to try to get its money back. So not only had the bank extended nearly a quarter of billion dollars in credit on the basis of collateral worth less than one-fifth as much, it had financed a deal in which Malofeev had effectively sold his own company to himself, pocketing nearly \$200 million in the process.

VTB alleges that it was misled throughout the process and that the criminal and civil liability rests solely in Malofeev's hands. But it is apparent that there were many failures on the bank's part, leading the Hon Justice Arnold of the High Court of Justice, Chancery Division in London to note in a November 2011 ruling that, "It is not clear from the evidence presently available what, if any, due diligence was carried out by or on behalf of either VTB Moscow or VTB to verify the assertions" made by the parties to the deal.³¹

In reality, court documents demonstrate that the bank did little to check the veracity of Nutritek and RAP's claims, despite numerous red flags appearing throughout the transaction.

At one point early on, Konstantin Tulupov, VTB Bank's then-director of its Investment Business Acquisition and Leverage Finance Team in Moscow, assured lawyers working on behalf of the bank that everything was fine with the deal.

"Marshall Capital controls Nutritek, and the potential purchaser is controlled by a group of individuals with whom, MarCap assures, you can't have any conflict of interest," Tulupov wrote in an email later entered into the court record.³²

The lawyers responded that this was an evasive answer and that further checks would need to be made, although it appears no further questions appear to have been asked.

Three months later, Malofeev explained to Tulupov that the deal was a "friendly transaction," and that many of Nutritek's senior managers would move over to RAP to help assist in the transition. Tulupov later testified that it became apparent that the sellers and the buyers knew each other well, but it did not occur to him that the two companies were under the common control of Marshall Capital.³³

It was then decided to set up the loan with VTB Capital in London as the "Lender of Record," but with VTB Bank in Moscow as the ultimate underwriter of the loan—something Tulupov later testified was a common practice within the bank.

About a month before the first tranche of the loan was transferred to RAP's accounts, VTB Bank's Credit Committee approved the transaction, stating that it was declaring RAP's credit "Quality Category 1" after "...taking into consideration the good financial situation of the borrower."³⁴

28. VTB Capital PLC v Nutritek International Corp., Marshall Capital Holdings Ltd., Marshall Capital Llc, and Konstantin Malofeev, High Court of Justice, Chancery Division, Case No. HC10C04611, 29 November, 2011, paragraphs 7-10, available at http://henryjacksonsociety.org/wp-content/uploads/2012/09/VTB_v_Nutritek_judgement.pdf

29. Ibid., paragraph 60

30. Ibid., paragraph 56

31. Ibid., paragraph 38

32. Ibid., paragraph 23

33. Ibid., paragraph 16

34. Ibid., paragraph 26

Days later, it was discovered that RAP had been set up months earlier as a special-purpose vehicle solely created for the dairy plant transaction.

Two weeks later, VTB's credit risk department urged caution, ruling that the structural risk for the deal was "potentially high," and the financial risk "high."

"The historical balance sheets (unaudited management figures) ... indicate that the price being paid for the company appears to be at a level significantly above the book value of the assets," the department found.³⁵

Despite all the suggestions that the deal might not be entirely sound, VTB Bank disbursed the first tranche of the loan — amounting to \$208.5 million — to RAP's accounts on 28 November, 2007.³⁶ The second, smaller, tranche was received the following April. In November 2008, RAP went into default and no further payments were ever made.³⁷ It wasn't until over a year later that VTB Bank moved to seize RAP and its parent companies, only to realise that they were effectively worthless.³⁸

How such a sizable loan could be made with such little attention to due diligence is astounding.

5) FYODOR KHOROSHILOV

The remarkable case of Fyodor Khoroshilov, a former top manager of state oil giant Sibneft, came to light in 2009 when VTB filed a series of lawsuits in Russia and the United Kingdom against Khoroshilov claiming he had stopped repaying several large bank loans made to him for oil exploration in northern and central Siberia.³⁹

The total amount owed was at first not entirely clear, owing to the complexity of the structure of the loans extended by both VTB Bank and its Cyprus-based subsidiary, the Russian Commercial Bank. But after years of drawn-out legal action, it was revealed in May 2011 in a London court that Khoroshilov and his companies, Obneftgas, Talon Enterprises and Techneftinvest, had defaulted on a stunning \$1.5 billion in bad loans.⁴⁰

Soon after filing suit against Khoroshilov, VTB claimed it discovered that the basis for extending him such a massive amount of credit — namely six exploration licenses from fields he promised would yield billions of dollars worth of oil — turned out to be false. While Khoroshilov did indeed have the license to drill, he had submitted false audit reports of how much oil actually was believed to be underground, inflating the estimates by as much as ten times, VTB alleged. Khoroshilov had used the exaggerated figures repeatedly to gain more credit, which he secured by utilising the earlier loans as collateral. It was only after Khoroshilov had stopped paying that any of his claims were ever checked.⁴¹

It was later discovered that Khoroshilov had amassed an impressive array of assets including villas in France and Italy worth over \$20 million, a 115-meter yacht, the Giant

35. *Ibid.*, paragraph 37

36. *Ibid.*, paragraph 53

37. *Ibid.*, paragraph 55

38. *Ibid.*, paragraph 56

39. *Russian Commercial Bank (Cyprus) Limited v Fedor Khoroshilov, Talon Enterprises Limited and OOO Obneftegas*, High Court of Justice, Queens Bench Division, Case No. [2011] EWHC 1721 (Comm), May 7, 2011, paragraph 3, available at: <http://henryjacksonsociety.org/wp-content/uploads/2012/09/KhoroshilovCourtJudgment.pdf>

40. *Ibid.*, paragraph 22

41. *Ibid.*, paragraph 24

1, a private Boeing 737-73Q, shopping centers in Tyumen and a \$400,000 Maybach 62.⁴² At the request of the Russian Commercial Bank, the International Arbitration Court in London ordered that Khoroshilov's assets be seized until the court case was settled.

The initial court proceedings painted a picture of Khoroshilov as having used his credentials as a respected and connected oilman to bilk VTB out of hundreds of millions of dollars. But as the case has dragged on in courts in various jurisdictions, a more nuanced picture has emerged which suggests VTB may not have been an entirely innocent victim of Khoroshilov.

For instance, Khoroshilov presented evidence that undercut VTB's argument that the oil wells in question were highly overvalued. A report submitted to the London court from Texas-based oil well appraisers, DeGolyer & MacNaughton, valued the holdings at \$4.2 billion — nearly three times the value of the loans.⁴³ The judge in the case said there was no reason to dismiss the figure provided by a "leading specialist in the field," who valued assets according to internationally accepted standards. Court papers also show that in 2010, Khoroshilov and VTB came close to an agreement to allow a Hong Kong investment firm, Cosmopolitan International Holdings, to buy up the debt and a large stake in Technefinvest, one of Khoroshilov's holdings. However, Khoroshilov alleged that VTB Deputy President and Management Board Chairman Andrei Puchkov personally intervened in the negotiations in order to freeze Khoroshilov out of the process and ultimately kill the deal. Khoroshilov also told the court that, in 2009, Puchkov had threatened to fabricate charges against him that would lead to a criminal investigation unless he transferred total control of his companies to VTB. The bank strenuously denied that allegation.⁴⁴

Khoroshilov made another accusation against the bank involving a deal in which Technefinvest bought out a minority investor — a Cypriot company named Pancia Ltd. — at the request of VTB and the Russian Commercial Bank as part of an earlier round of debt restructuring in 2006. In court papers, Khoroshilov said investigators working for him had discovered that the bulk, if not all, of the \$114 million Technefinvest paid Pancia for its 20 per cent stake, ended up in the pocket of Puchkov and other bank officials.⁴⁵

"Mr Puchkov was the ultimate recipient of the \$114 million," Khoroshilov's lawyers charged. "The arrangements about Pancia were kept secret from the bank's Credit Committee, perhaps because Mr Puchkov did not want the bank to know about his connections to Pancia."⁴⁶

If one accepts VTB's version of events, it simply means the bank was duped out hundreds of millions of dollars by failing to ask basic questions before handing over vast sums of money. If Khoroshilov's story is true, it would mean that not only did VTB and its subsidiaries squander \$1.5 billion, but some managers engaged in potentially criminal activity — pocketing kickbacks and engaging in a strong-arm effort to take over a potentially lucrative oil company.

42. "И Виллы, и Яхту," *Vedomosti*, 28 September 2009, available at <http://www.vedomosti.ru/newspaper/article/2009/09/28/214832>

43. *Russian Commercial Bank (Cyprus) Limited v Fedor Khoroshilov, Talon Enterprises Limited and OOO Obneftegas*, High Court of Justice, Queens Bench Division, Case No. [2011] EWHC 1721 (Comm), 7 May 2011, paragraph 47-54, available at: <http://henryjacksonsociety.org/wp-content/uploads/2012/09/KhoroshilovCourtJudgment.pdf>

44. *Ibid.*, paragraph 21

45. *Ibid.*, paragraph 72

46. *Ibid.*, paragraph 47-54

6) RUSSIAN COMMERCIAL BANK MANAGEMENT BUYOUT

Buried on page 92 of VTB's 2009 Consolidated Financial Statement is an interesting paragraph detailing the issuance of 3,333,333 new shares of the bank's subsidiary in Cyprus, the Russia Commercial Bank.

The report stated that in the first quarter of that year, the shares were sold to "...a private company, which is controlled by the key management of the [VTB] Group."⁴⁷ The shares were sold at a price of \$11.71 each, for a total of \$39 million. According to the report, the private company now owned 40 per cent of "...the share capital of Russian Commercial Bank."⁴⁸

However, on page 52 of the same report, the bank admitted that on 24 September of that year, the Russian Commercial Bank issued a dividend of \$15.6 per share. That meant that within seven months, VTB managers recouped their investment, but also turned a profit of \$13 million.⁴⁹

Perhaps it was just a well-timed and savvy investment, but observers in the Russian press could not help but wonder if the VTB Group managers, who profited so handsomely from the deal, simply helped themselves to the assets of the company at a bargain-basement price. The truth may never be known, which was little consolation to the bank's small shareholders who had lost half their investments on VTB's much-touted "People's IPO."

This transaction should be of particular interest to regulators in the European Union as the Russian Commercial Bank is licensed and registered in Cyprus and is thus a full-fledged European bank bound by European banking and corporate governance laws as well as anti-money laundering legislation.

47. VTB Bank, Notes to the Consolidated Financial Statements – 31 December 2009 and 2008, p 92, available at <http://henryjacksonsociety.org/wp-content/uploads/2012/09/2009IFRS.pdf>

48. Ibid.

49. VTB Bank, Notes to the Consolidated Financial Statements – 31 December 2009 and 2008, p 52, available at <http://henryjacksonsociety.org/wp-content/uploads/2012/09/2009-vtb-ifrs-reportg1d.pdf>

Conclusion

The suggestions raised by these episodes should be sufficient to give any investor or financial regulator pause. The events described in this report have all occurred only in the past five years – since the bank went public and loudly proclaimed it would adhere to international banking standards. But it should be noted that these only represent what has become publicly known, raising deep concerns about what lies beneath the surface at the VTB Group.

First of all, this report ought to raise serious questions regarding VTB's commitment to prioritising shareholder value, as illustrated by the accounts of inadequate risk management and politically driven decision making.

Second, as the bank is majority-owned by the state, the true brunt of the scale of any financial catastrophe which could result from questionable practices would ultimately be borne by the Russian taxpayer. The government's outsized role and influence in the bank's operation has already largely distorted Russia's financial markets, creating an unfair competitive market and stifling the development of private financial institutions. In a conversation with the authors, one leading economist described the bank's relationship with the government as a "deep contradiction," with VTB often behaving as both a commercial and government bank at the same time.

But the real concern now is how much this "deep contradiction" will affect foreign financial markets as VTB spreads internationally. Europe can scarcely afford to take risks in its banking sector after four years of an economic crisis borne of chronic mismanagement and insecure investment strategies— a crisis which may yet culminate in the withdrawal of one or more countries from the European Union. The Russian government has never had qualms about exerting its leverage using state-run institutions to further its political objectives. Indeed, one only need to look at the repeated standoffs over gas prices in recent years that have led to Russia to cut off the supply to wide swaths of Europe in the dead of winter as an example. Additionally, with VTB's success in attracting larger numbers of small depositors in Europe, the risks can only multiply.

VTB Capital is obligated to meet the standards of corporate governance set by UK regulatory agencies. But as stakeholders in several of the bank's past transactions have sued each other in British courts, the Financial Services Authority should be aware, if it is not already, of the serious allegations made against VTB as a whole, for which full and transparent accountings have yet to be given.

It is also crucial that international banking regulators take a closer look at VTB's activities and judge for themselves whether the bank is fit to continue doing business in their respective markets.





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