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Meltdown of Russia's Offshore Banking Haven in Cyprus

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The Cypriot financial meltdown has rocked Moscow. Russia provided Cyprus in 2011 with a 2.5 billion-euro ($3.2 billion) low interest loan and believed the European Union and the International Monetary Fund (IMF) should join in the bailout of a euro-zone member nation. Until now, the Russian authorities apparently did not see any immediate danger, recently announcing an intention to press the Cypriots to disclose information about Russian bank accounts as part of President Vladimir Putin's announced policy of "deoffshoreization" of the Russian economy to curtail corruption and illegal capital outflow (Kommersant FM, March 11).

Over the weekend (March 15–17) the entire Cypriot banking system was closed down and will continue to be closed at least until next week, as the local parliament rejected a bailout package negotiated by the EU Commission and the IMF that involved an up-to-ten-percent levy on bank accounts and deposits, including those from Russia. Putin and Prime Minister Dmitry Medvedev accused the EU of acting irresponsibly and unilaterally, without consulting with Moscow, and of attempting to confiscate Russian property (RIA Novosti, March 18). The Russian business community was equally irritated. Multi-billionaire turned politician Mikhail Prokhorov demanded that Russia must be an equal partner with the EU in deciding the future of Cyprus's financial system and that the Russian Commercial Bank (RCB) of Cyprus (a fully Russian-owned subsidiary of the state-controlled banking giant VTB) must become the backbone of a revived Cypriot banking system. (Vedomosti, March 20).

Cyprus has been used as an offshore financial haven by Russian companies and wealthy Russians to avoid high corporate taxes at home as well as to legalize billions obtained in kickbacks and other illegal or shady activities. Some of this wealth has been reinvested: Cyprus officially owns some 40 percent of the total foreign capital invested in Russia. The Russian economy to a large extent is controlled by shell holding companies registered in Cyprus, which—as a "foreign" EU investment—gives them additional protection from arbitrary actions by the notoriously corrupt Russian bureaucracy. Shell companies in Cyprus thus avoid the taxation of dividends and allow for the free movement of capital to a seemingly safe destination (Vedomosti, March 19).

Publicly, Putin has been largely silent up to now about the Cypriot banking crisis, but

Medvedev has been openly unnerved, threatening to sue the Cypriot authorities and the EU for the losses encountered by Russians "because of their actions." Medvedev also threatened to denounce the 1998 Double Tax Agreement between Russia and Cyprus, effectively terminating the island's offshore status for Russian companies (RIA Novosti, March 20). Surely, the Kremlin could indeed achieve its announced goal of "deoffshoreization," if it really wanted to. In fact, Putin's friends and associates (including Medvedev) are exempt from "deoffshoreization." Speaking to reporters, Medvedev explained that lots of fully legitimate financial operations were going through Cyprus and that "Russian government structures" were using Cyprus for its offshore banking services. According to Medvedev, "the volume of Russian illegitimate business going through Cyprus is grossly exaggerated" (RIA Novosti, March 20).

According to Moscow sources, the state-controlled natural gas monopoly Gazprom, where Medvedev was for some time board chairman, has a large euro deposit in RCB—at present frozen. Medvedev has promised that he will discuss the Cyprus problem and demand explanations from the EU Commission's top brass, who will be in Moscow this week for a Russia-EU summit. Medvedev has threatened "to possibly rethink" Russia's long-term policy of support of the euro if the terms of the "inadequate" Cyprus bailout are not rewritten. In Russian, the word "inadequate" (neadekvatnost) is the equivalent of "nutty." At present some 40 percent of Russia's overall $522 billion worth of foreign currency reserves are held in euro-denominated assets (Interfax, March 21).

Russia has been using the Cypriot banking system as a financial clearing house for brokerages and for export-import operations (legitimate as well as fake ones, intended for money-laundering and capital outflow). Russian oligarchs use Cyprus to do business, while parking their massive yachts and buying estates in the French Rivera and equally flashy places. But many other wealthy Russians of lesser caliber have been buying up seafront property, parking smaller yachts and settling on Cyprus, where the Russian community is estimated to reach 50,000. Now their bank accounts are frozen while real estate prices may tumble, putting their lifestyle in jeopardy. Russia's overall losses in the Cyprus meltdown are unclear, but could amount to many billions of euros (www.newscom.ru, March 21).

Apparently Cypriots believe that Moscow has so much to lose in the meltdown, the Kremlin will be ready to outbid the EU and the IMF in a bailout by offering kinder terms. On March 19, the newly elected Cypriot President Nicos Anastasiades phoned Putin and Finance Minister Michael Sarris was sent to Moscow to ask for support. Sarris met with Russian ministers but did not make any progress, while Putin—the only true decision-maker in town—avoided contact. Reportedly, Russia was offered to take over large, insolvent Cypriot banks for a nominal price of one euro and buy drilling rights to the recently discovered underwater natural gas deposits in the Mediterranean south of Cyprus. Sarris was apparently surprised that Russians, whom Cypriots have become used to seeing throw money around, did not pounce on the offer (Kommersant, March 21). Meanwhile, Putin's economic adviser, Sergei Glazyev, told journalists Russia could bail out Cyprus if the island joined the Eurasian Union together with Belarus, Russia and Kazakhstan (RIA Novosti, March 20).

According to Russian sources, the Cypriot offer of property in exchange for cash was too vague to discuss seriously (Kommersant, March 21). Medvedev acknowledged that "a list of things for sale was offered," but that Moscow wants to first see what bid the EU may offer. The true price of Cypriot offshore gas deposits is unclear, according to Medvedev, "and there are problems with Turkey." Ankara has threatened to use naval power to stop any gas drilling in the Cypriot exclusive economic zone, if the interests of Turkish Cypriots are not taken into account (Interfax, March 21). Russia may be interested in purchasing Cyprus on the cheap—thus buying a strategic foothold in the Mediterranean. But at present, an open-ended commitment that may cost tens of billions of dollars seems too risky. Also, if the ruble effectively replaces the euro in Cyprus as it transforms itself into a Mediterranean Belarus, its attractiveness as an offshore banking hub may be undercut.

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