



Rising geopolitical tensions between Russia and Ukraine drive up credit risk for Russian companies

by [Wang Anyi](#)

- **Russian companies' credit risk increased since Nov-2021 due to intensifying Russia-Ukraine tensions, higher rates, and depreciating Ruble, as suggested by NUS-CRI Agg 1-year PD**
- **NUS-CRI BuDA toolkit shows that economic slowdown and Ruble depreciation will cloud Russian companies credit outlook**

Since Russia increased its [military presence](#) around Ukraine's border in Nov-2021, fears of geopolitical and macroeconomic instability in the region have gripped the attention of global markets. Resultantly, Russia's fixed-income and equity markets, as well as the relative strength of the Russian Ruble, have [slumped](#) as uncertainty pertaining to potential sanctions by the US and EU grip the markets. The NUS-CRI Aggregate (median) 1-year Probability of Default (PD) (Agg PD) in Figure 1a shows that the credit risk of Russia-domiciled companies¹ (Russian companies) has increased, in tandem, since Nov-2021. Accompanying this, the credit risk outlook for Russian companies has also worsened as the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD²) in Jan-2022 increased in the short-term, compared to the Forward PD prior to the rising geopolitical tensions in Nov-2021. The deteriorating credit quality of Russian companies may be driven by a combination of an increase in Russian companies' cost of debt, primarily due to a weakening Ruble, and their ability to refinance due to potential sanctions as a result of heightened geopolitical risks.

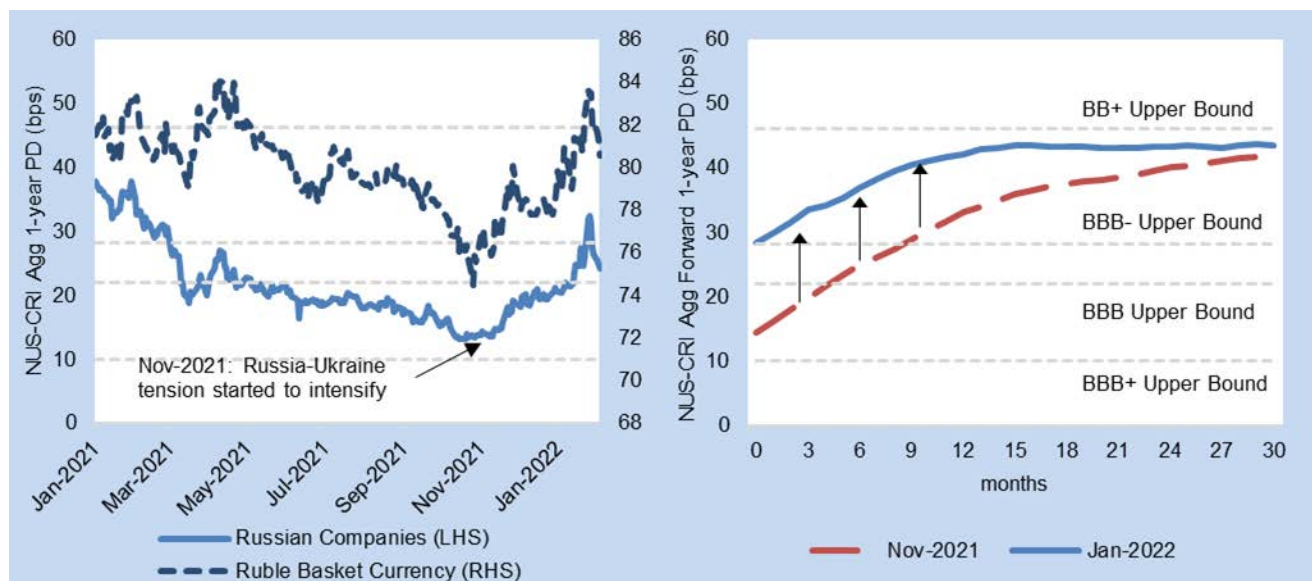


Figure 1a (LHS): NUS-CRI Agg 1-year PD for Russian companies with reference to PDiR2.0 bounds³ and Ruble Basket Currency (0.55*USD/RUB + 0.45*EUR/RUB) from Jan-2021 to Feb-2022. Figure 1b (RHS): NUS-CRI Forward PD for Russian companies as of Nov-2021 and Jan-2022 with reference to PDiR2.0 bounds. Source: NUS-CRI, Bloomberg

Benefiting from [recovering consumer demand and high oil prices](#), growth in the Russian economy (as well as improvement in Russian companies' Agg PD) rebounded to [pre-pandemic levels](#) in 2021, accompanied by a steady appreciation of the Ruble (Figure 1a). However, headline inflation also rose sharply reaching a [six-year](#)

¹ The Agg PD for Ukrainian companies has had similar trends since Nov-2021. However, the focus of this week's issue is only on Russian companies. Please refer to the [NUS-CRI website](#) to view the Agg PD of Ukrainian companies.

² The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

³ The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

high of 8.4% in Nov-2021. To combat rising prices, the Bank of Russia (BOR) increased policy interest rates 7 times from a low of 4.25% in Mar-2021 to [8.5%](#), significantly increasing the borrowing cost for Russian companies. To add to their woes, another hefty rate hike of 100bps to [9.5%](#) is expected in Feb-2022. Yields on Russian corporate bonds have also been trending up (See Figure 2a), reflecting the tightening monetary environment and investors' fears of conflict escalation potentially resulting in the imposition of sanctions on Russian companies. These sanctions may include [restrictions](#) on exports and [secondary trading](#) of Russia-domiciled bonds in foreign markets, hurting Russian companies' revenue generation and financing capabilities.

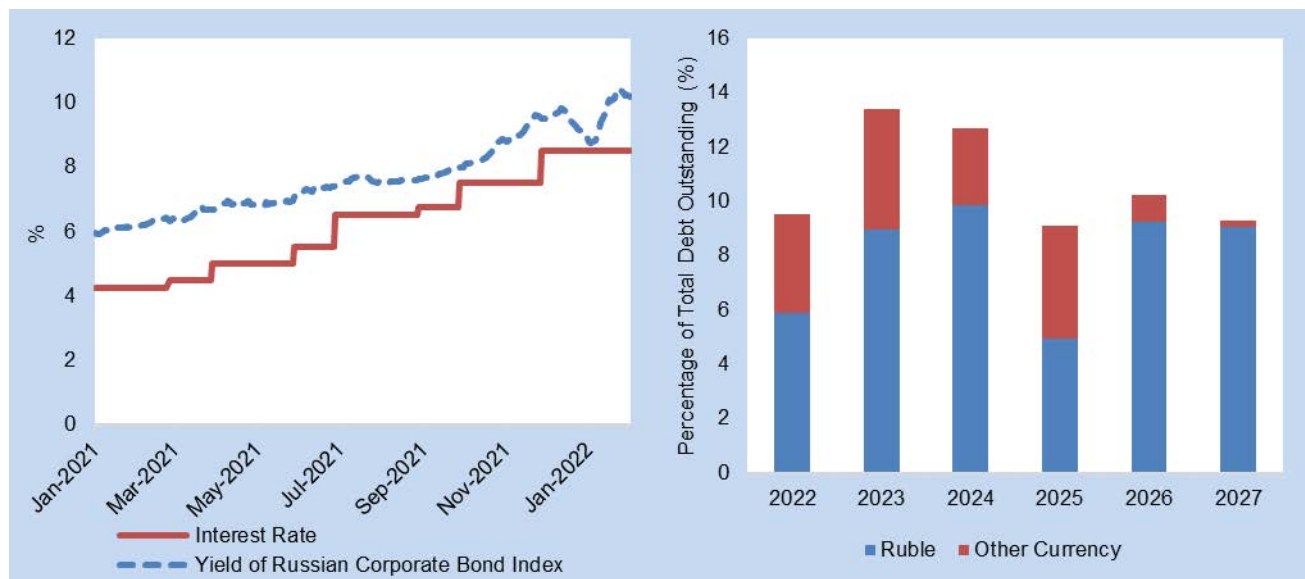


Figure 2a (LHS): Policy interest rate of Russia and yield of MOEX Corporate Bond Index from Jan-2021 to Feb-2022. Figure 2b (RHS): Percentage of total debt (corporate bonds and loans) outstanding of Russian companies from 2022 to 2027, broken down by denominated currency, as of Feb-2022. Source: BOR, [Moscow Exchange](#), Bloomberg

The Russian Ruble has also depreciated on the back of investors' fear regarding the impact of the current geopolitical crisis on Russian companies' operations and financing capabilities (Figure 1a). To contextualize the debt burden for Russian companies over the next few years, Figure 2b shows the distribution of debt outstanding broken down by currency. Around 40% of total debt maturing over the next two years is denominated in foreign currencies, leaving Russian companies vulnerable to further depreciation of their currency as it hinders their ability to service foreign debt. The threat of new sanctions may trigger further capital flight, bringing about further foreign exchange risk for Russian companies. Furthermore, the ECB has already warned [European banks](#) to manage their current loan portfolio of Russian borrowers should further sanctions take effect. Other foreign investors may also be more cautious in lending to, or investing in, Russian companies given the uncertainty on how this geopolitical crisis plays out. Such fears are already taking the markets by storm, as demonstrated by the recent [failure of Ukraine to raise new debt](#).

Should tensions escalate, any new sanctions restricting Russia's access to the global financial market or export controls from the US or EU might lead to a resultant slowdown of Russia's export-driven economy. To simulate the effect of such a slowdown on the credit quality of Russian companies, BuDA⁴ is utilized to stress test the impact on Russian companies PD due to changes in GDP growth and Ruble exchange rate (Figure 3 demonstrates the simulated Agg PD and interquartile range under the base⁵ and adverse⁶ scenarios). As witnessed by the projected change in Agg PD, Russian companies with strong credit profiles (those below the 25th percentile) remain relatively unaffected by the economic growth slowdown under both scenarios. Furthermore, under the adverse scenario, the credit risk for Russian companies worsens quickly compared to that in the base scenario, especially the medium-term uptick in credit risk for those companies in the 75th percentile, possibly due to their relatively lower buffer for absorbing sanction-specific losses and related financing challenges.

⁴ The Bottom-up Default Analysis (BuDA v3.3.0) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF).

⁵ Under the base scenario, GDP annual growth rates of 2022 and 2023 are 2.4% and 1.8% respectively, according to the median [forecasts](#) of the BOR as of Feb-2022. The exchange rate is assumed to remain stable.

⁶ The adverse scenario assumes that GDP growth rate will be 1.5% in 2022 and 1.0% in 2023, based on the lower range of [BOR forecasts](#), in combination with a 5% quarterly decrease in exchange rate over the same time horizon.

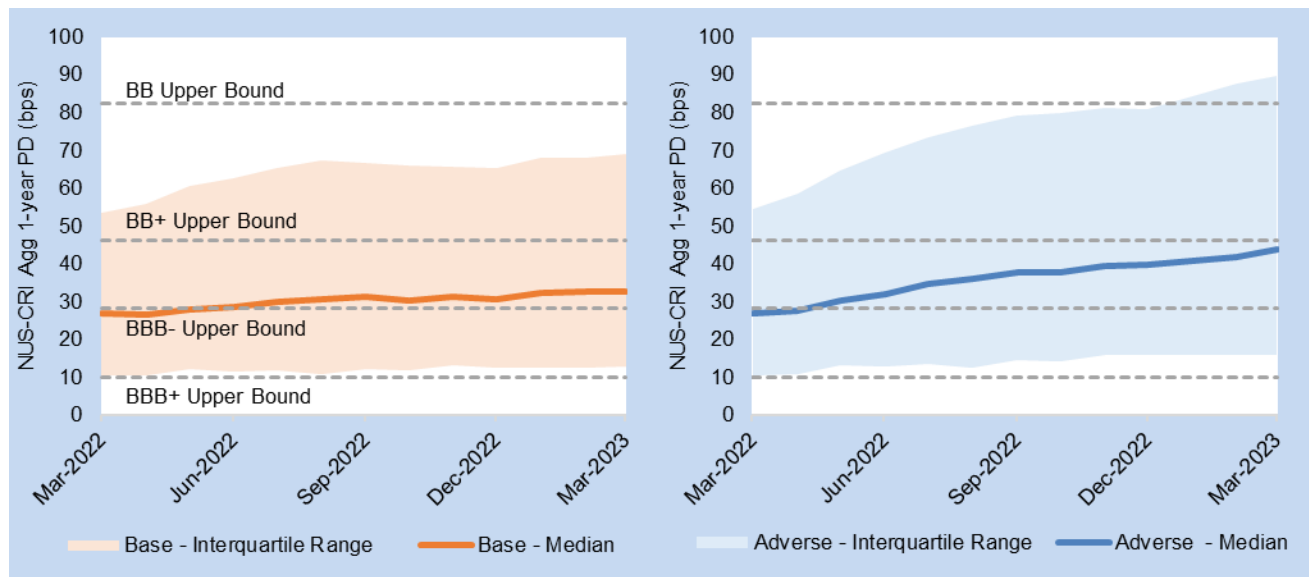


Figure 3: NUS-CRI Agg 1-year PD (Median and interquartile range) of Russian companies under base (LHS) and adverse (RHS) scenarios with reference to PDiR2.0 bounds. *Source: NUS-CRI, BuDA v3.3.0*

Aside from uncertainties brought by geopolitical tensions, Russian companies face a plethora of challenges. The Russian economy is expected to [slow down](#) in 2022, hampered by stricter [COVID-19 measures and tighter monetary policy](#). As such, Russian companies may see weaker operating environments and consumer demand compared to last year, which may put a strain on their revenue and operational outlook. Such suppressed earnings, in tandem with more expensive and less accessible debt, could deteriorate the credit outlook for Russian companies in the short term, shown by the heightened Forward PD in Figure 1b. Meanwhile, [underinvestment in human capital](#), as well as the reliance on energy exports against the broader green transition trend around the globe, pose medium-to-long term structural risks to Russian companies' credit profiles.

Credit News**Investors brace for turbulence in US corporate bond market**

Feb 6. Investors have rushed into the derivatives market to protect corporate bond portfolios from a possible sell-off, as they grapple with the growing risk that the recent equity sell-off will spill into fixed income. Trades on a widely used index of low-rated credit default swaps soared to USD 197bn in Jan-2022, up from USD 123bn in Dec-2021 and the most since Mar-2020. Despite worries of higher interest rates that would hit the valuation of riskier stocks and bonds, corporate bond markets have remained comparatively calm so far. However, investors are still taking steps to reduce their risk by turning to credit options and CDS indices. Some of the largest exchange-traded funds that track corporate bonds have also seen elevated short activity. In another sign of bearishness, funds that buy US high-yield bonds have suffered outflows for four consecutive weeks, taking YTD withdrawals close to USD 11bn. ([FT](#))

Rising rates squeeze bond funds

Feb 3. The majority of US-based bond funds, which typically invest in relatively safe assets such as investment-grade corporate bonds and Treasuries, posted losses between minus 0.1% to minus 3.6% in January. So far this year, investors have pulled over USD 1.6bn from these bond funds due to the anticipation that the Fed will raise short-term interest rates to combat inflation. This withdrawal sent bond yields to their highest levels since the beginning of the pandemic and triggered turbulent swings in the stock market. Two funds that have managed to perform well amid the market shift succeeded as their portfolios have shorter durations compared to their peers, which helped them reduce the fund's sensitivity to interest rate volatility. ([WSJ](#))

Green bonds still have long way to go to dent climate crisis

Feb 2. Global sales of green bonds achieved a record USD 513bn in 2021, and are expected to hit a new high of nearly USD 1tn and USD 5tn by the end of 2022 and 2025 respectively. However, global borrowers need more funds to fight climate change, as more and more countries commit to net-zero carbon targets. For example, Saudi Arabia is preparing to issue its first green bond, and Qatar's government is also eyeing this market. While the US government has not yet entered the market, they might join sooner rather than later, given the strong demand experienced by other countries. Compared with their untagged counterparts, green bonds are in great demand and perform better on average in the secondary market. ([Bloomberg](#))

Bond market signals room for Fed to raise rates without stalling economy

Feb 7. The US bond market is indicating that the Federal Reserve may be able to tighten monetary policy without hampering the growth prospects of the economy. Treasury yields registered an increase last week driven by an improvement in US jobs data, as investors priced in the possibility of tighter monetary policy. The jump in yields, along with stable expectations of inflation, have managed to increase the return expectations for investors. The increase in real yield indicates that traders expect stable economic growth despite tightening measures taken by the Fed. ([FT](#))

Rate hikes are coming too slowly in Asia for some bond funds

Feb 7. Bond managers are turning lukewarm on Asian debt on speculation the region will be the last in emerging markets to start raising rates. Meanwhile, central banks in several countries in Latin America are ahead of the curve, creating scope for a rally in the region's debt. Fidelity International Ltd. and Abrdn Plc are among the firms avoiding Asian local debt and favoring bonds elsewhere in the developing world. Most Asian local bonds have fallen so far this year, while South Africa, Brazil, Chile, and Turkey recorded the biggest gains among developing nations, even as the Fed prepares to raise rates. While policymakers in Latin America and Europe spearheaded the tightening cycle in emerging markets, rates have been kept on hold in most of Asia – with China even easing its policy in January. ([Bloomberg](#))

Europe's era of negative-yielding debt is coming to an end ([Bloomberg](#))

U.S. high yield bond ETFs see record outflows in January ([Reuters](#))

Catastrophe-Bond market hits a record USD 12.8bn as extreme weather worsens ([Bloomberg](#))

Regulatory Updates

Europe's hawkish pivot could be more bark than bite

Feb 4. European central banks signaled tighter monetary policy last week. With the Bank of England raising rates to 0.5% and the ECB President Christine Lagarde subsequently indicating that tighter monetary policy is on the horizon driven by record-high Jan inflation numbers. While the policy increase by BOE was expected, the change in ECB's stance on monetary policy tightening took the market by surprise. However, the ECB's hawkish pivot may not amount to a rate hike. The ECB President has stated that the ECB will not raise rates until the bond-buying stops, which could take a few months after its announcement. Until then, inflation may eventually decline to favorable levels, making a rate hike unnecessary. ([WSJ](#))

Goodbye easy money as hawkish central banks speed up rate hikes

Feb 6. Central banks around the world are preparing to raise interest rates as global inflation levels pose a larger concern than slowing economic growth. Currently, major economies are facing record inflation levels driven by surging demand and supply shortages, with the US reporting a 7.3% inflation for January. The Bank of England has just announced back-to-back rate hikes, while the Fed, the Bank of Canada, and the European Central Bank are expected to follow suit later this year. Consequently, bond prices have plunged and sent yields higher. While analysts are split on the speed at which a rate hike would occur, they agree that rate hikes are necessary to cool the market. However, China is expected to make credit cheaper due to slowdowns in the property sector, while Japan is expected to keep its policy unchanged. ([Bloomberg](#))

Derivatives market stalking Libor turns heads with volume surge ([Bloomberg](#))

Fed could hike at all seven remaining meetings this year ([Bloomberg](#))

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