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Credit risk for Russian banks skyrockets in the face of unabating sanctions

by Amrita Parab

- **NUS-CRI Agg (mean) 1-year PD of Russian banks shows the disproportionate increase in credit risk for sanctioned and non-sanctioned banks on the back of exclusion from SWIFT, asset freezes, transaction bans etc.**
- **According to NUS-CRI CriSIB, large sanctioned banks are largely interconnected to the remainder of the financial sector, making threat of further sanctions a systemic risk for the whole industry**

The Russian economy has been hit with crippling sanctions since it began its military campaign against Ukraine. With an aim to impede the financial support offered to Russia's military campaign, as well as to penalize Russia for their military escalation against Ukraine, the stringent sanctions imposed on the nation have been largely aimed at Russian banks and the Central Bank of Russia (BOR). The NUS-CRI Aggregate (mean) 1-year Probability of Default (Agg PD) of Russian Banks in Figure 1a showcases a steep increase in Agg PD towards the end of Feb-2022, with the increase in credit risk disproportionately affecting sanctioned banks compared to their non-sanctioned counterparts (See Figure 1a). These sanctions have the form of asset freezes, transaction bans, removal of access to capital, and exclusion from the SWIFT[1] messaging system which is instrumental in connecting the Russian economy to the global financial system. As demonstrated by the heightened level of the NUS-CRI Forward 1-year PD[2] (See Figure 1b) in Feb-2022, the sanctions imposed on the Russian banking sector bring considerable uncertainty regarding the liquidity and solvency of banking institutions as sanctions heighten the possibility of an increase in defaults and a bank run. However, the declining trend of the forward PD suggests that the Russian banking sector may benefit from the BOR's prompt policy actions in the form of lowering reserve requirements, rate hikes, and setting up capital controls.

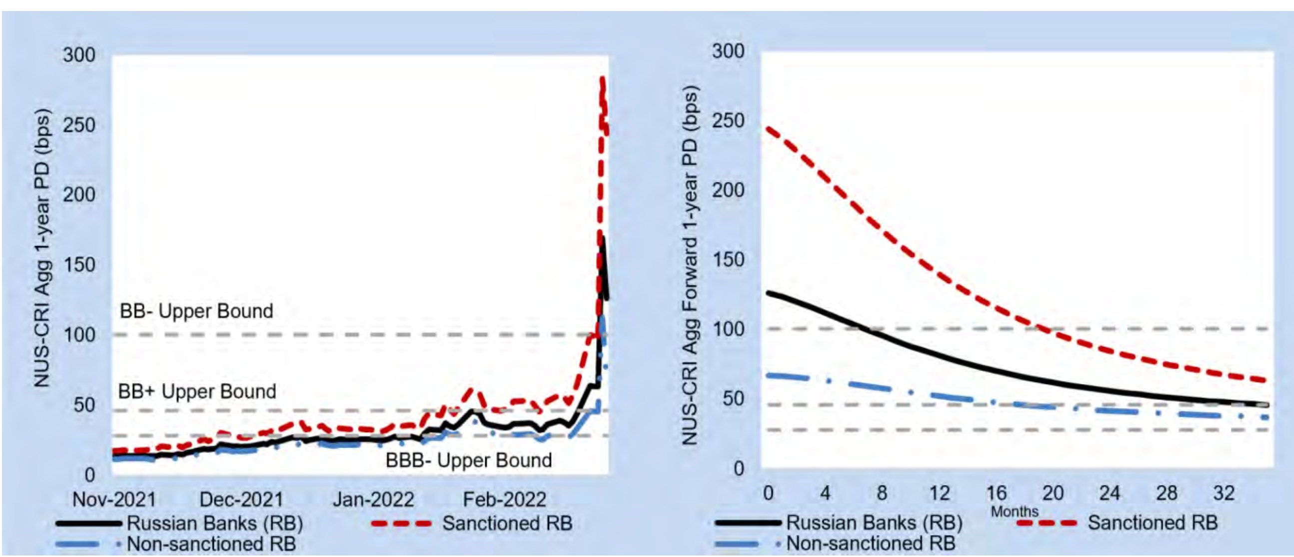

Figure 1a (LHS): NUS-CRI 1-year PD for Russian Banks, Sanctioned Russian banks[3] and Non-sanctioned Russian banks from Nov-2021 to Feb-2022 with reference to PDiR2.0[4] bounds. Figure 1b (RHS): NUS-CRI Agg Forward 1-year PD for Russian Banks, Sanctioned Russian banks and Non-Sanctioned Russian banks as of Feb-2022. *Source: NUS-CRI*

[1] Society for Worldwide Interbank Financial Telecommunication or SWIFT is a messaging system used by financial institutions which aids in the execution of transactions and payments between banks.
[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 – this is conditional on the firm's survival in the next 6 months.
[3] Sanctioned entities in sample are identified using the total list of sanctioned Russian institutions available on Bloomberg
[4] 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.

Since the beginning of military aggression, Russian banks have been subject to a multitude of sanctions imposed mainly by the US, UK, the European Union, and other developed nations. On 2nd Mar 2022, the European Union imposed their most severe sanctions yet on 7 Russian banks in the form of exclusion from the SWIFT payment system, effectively attempting to cut off their access to the global financial system. This move follows a slew of sanctions in the form of asset freezes, a ban on raising capital through equity or debt offerings, etc. These sanctions in totality are aimed at crippling the financial infrastructure of the Russian economy. The sanctions have curtailed the BOR's ability to rescue distressed institutions and prop up the deteriorating ruble by limiting its access to a major part of Russia's USD 630bn foreign reserves. Additionally, the BOR's ability to monetize available assets is also restricted by transaction bans and the reluctance of foreign entities to transact with it. Thus, the BOR's inability to access and monetize available reserves has increasingly limited the number of options available to support the banking sector.

The sanctions directly or indirectly affect nearly 80% of banking assets in Russia and may have a prolonged adverse effect on the credit health of the banking sector. In the short term, the banking sector may potentially face a severe liquidity crunch as fears of further sanctions spark the possibility of bank runs. Initial signs of a bank run have already started appearing after the imposition of the SWIFT ban on major retail banking institutions as people rushed to withdraw money from banks due to fears of imposition of limits on cash withdrawals. The BOR announced that the liquidity gap for Russian banks has reached USD 68bn as of 2nd Mar 2022, increasing by 27% within a day. The increase in the liquidity gap signifies that Russian banks face rising concerns in meeting short-term obligations, especially as their access to short-term liquidity takes a hit due to large-scale cash withdrawals and financing-related sanctions. A bank run could prove devastating for the banking sector as illustrated by Sberbank's Europe arm which faces liquidation as a result of a bank run. In response, the BOR had to step in with a string of measures to prevent widespread contagion by doubling its key rate from 9.5% to 20%, lowering reserve requirements, and introducing capital controls preventing foreign investors from selling securities.

The immediate and necessary steps taken by the BOR to protect its domestic banking sector from short-term liquidity concerns may aggravate the adverse impact sanctions have on the banks' credit growth and asset quality. The increased cost of borrowing will likely deter businesses and households from undertaking new loans hampering credit growth, while simultaneously squeezing interest margins and negatively impacting banks' profitability. Sanctions ensure that Russian companies' access to debt and equity capital is severely restricted which also may imply a lower fee-based income for banks. The exclusion from SWIFT limits the ability of impacted banks to process payments. The ban cuts off sanctioned banks' access to the global financial system and restricts cross-border transactions such as payment receipts for exports, etc. With exclusion from SWIFT and payment networks such as Visa and Mastercard suspending operations in Russia, banks have to rely on alternative costlier and limited networks for cross-border transactions which negatively impacts their profitability. In addition to the restricted access to capital and increased interest burden, the sharply deteriorating ruble, and operational impact of sanctions may make it difficult for borrowers to service their debt, leading to worsening asset quality of banks.

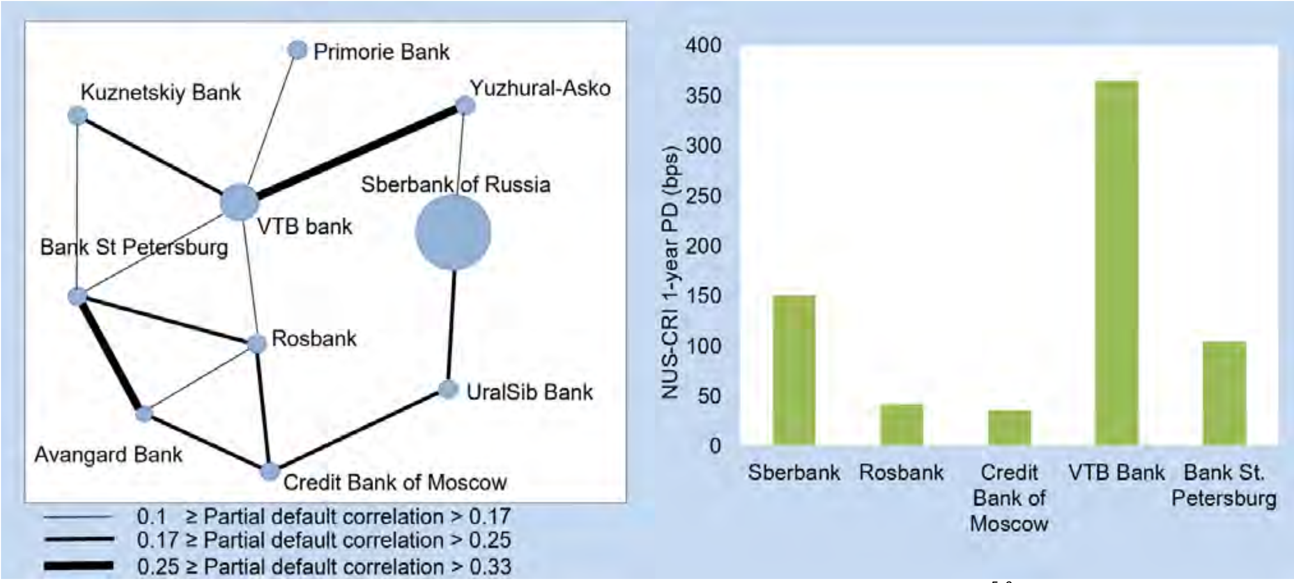

Figure 2a (LHS): Visualisation of the 'connectedness' and size of the top 5 systemically important banks[5] [6] in Russia with a partial default correlation of greater than 0.1 when referenced to CriSIB as of Jan-2022. Figure 2b: Change in PD of Top 5 NUS-CRI Systemically Important Banks in Russia on Feb 24, 2022 capturing the increase in credit risk of these banks due to the fallout of the war. *Source: NUS-CRI*

According to NUS-CRI Systemically Important Banks (CriSIB), the top 5 systemically important banks in Russia demonstrate a high level of interconnectedness (See Figure 2a), implying a negative fallout from the sanctions on individual banks is likely to affect the majority of the sector. Sberbank and VTB bank, which together account for more than 50% of assets in Russia's banking sector, show a high level of connectedness with other major domestic banks, implying that an increase in PD driven by sanction-related financing and operational issues (as seen in Figure 2b) for these two banks may trigger similar increases in PD of other banks, possibly due to the contagion impact of sanctions on depositor confidence in the whole sector. More specifically, VTB bank, which is a state-owned bank, has, rather unsurprisingly, been the target of a majority of sanctions imposed on the sector, including the SWIFT ban which has resulted in a steep rise in its PD[7]. As such, should the imposed sanctions on VTB escalate, large partial default correlations with other systemically important banks would put the country's financial network at high risk of a financial crisis. Furthermore, as the west continues to deliberate over imposing sanctions on Russia's oil and gas (O&G) industry, it won't be surprising if there is an uptick in PD for Sberbank of Russia as well, given that Sberbank has a large exposure to the O&G sector. An uptick in potential NPLs, specifically from Sberbank and VTB in the face of continued sanctions impacting their asset quality, is going to have a ripple effect on the whole banking sector due to their high interconnectedness.

Apart from their immediate impact, the long-term implications of these sanctions may impose a severe strain on the economy and the financial system. Currently, the tools deployed by the BOR have been sufficient to limit the effect of the sanctions on banks domestically. Additionally, the current exclusion of Sberbank from the SWIFT ban and the incumbent exclusion of the O&G industry from direct sanctions have served as mitigants and helped lessen the burden on the BOR. However, with the Russia-Ukraine crisis intensifying, major economies are now mulling a blanket SWIFT ban on the entire Russian banking sector and imposing sanctions on Russian O&G. If these sanctions materialize, the BOR might not be able to counter the additional strain on the liquidity or the further deterioration of overall credit health of the banking sector.

[5] The top 5 systemically important banks in Russia as of Jan-2022 as per CriSIB, in order of systemic importance (highest to lowest), are Sberbank of Russia, Rosbank, Credit Bank of Moscow, VTB Bank, Bank St Petersburg. The PD of Russia's top 5 systemically important banks soared on 24 Feb 2022 when Russia invaded Ukraine and also when initial sanctions were imposed as shown in Figure 2b.
[6] The size of the bubble is indicative of the asset size of the banks. Sberbank of Russia = USD 523458mn, Rosbank = USD 19645mn, Credit Bank of Moscow = USD 43782mn, VTB Bank = USD 274144mn, Bank St Petersburg = USD 10472mn, Kuznetskiy Bank = USD 89mn, Primorie Bank = USD 538mn, Yuzhural-Asko =USD 121mn, Avangard Bank = USD 1827mn, UralSib Bank = USD 7494mn.
[7] For example, weighed down by sanctions, VTB bank is already in the process of being forced to wind up its European operations.

Credit News

Investors fret over default protection for Russian bonds

Mar 6. While prices on Russia's USD 39bn of dollar-denominated government bonds have collapsed over the past week, prices on credit default swaps have surged. Russia's five-year CDS currently trades at around 45 percentage points upfront, implying that investors can expect to receive over 50 cents on the dollar in a restructuring of Russia's foreign debt. However, the price of the bonds themselves, at around 20 cents on the dollar, indicates a less favorable outcome for holders. There are growing concerns that the sanctions on Russia will interfere with the settlement mechanism for CDS contracts, affecting investors who use them to protect against defaulted bonds. Six of Russia's 15 dollar bonds allow Moscow to repay in rubles, while three others have effectively become untradeable since offshore settlement at Euroclear was blocked by Russian authorities. (FT)

Russian debt default may test limits of credit default swap market

Mar 4. International sanctions make it more complicated for creditors to be compensated for around USD 6bn of credit derivatives contracts. Usually, the investment banks need to participate in an auction in the secondary market to determine the value of the debt. However, investors are unable to utilize price discovery in the markets to accurately price risk in these bonds due to domestic sanctions. As such, a 30-day grace period will be given before a credit default swap event is triggered if Russia fails to pay for its debts. If the grace period is not lifted, the nation is expected to default soon on the back of capital controls and restrictions on its access to foreign-exchange reserves from the Russian government. (WSJ)

Investors start buying Ukraine, Russia bonds

Mar 6. Following the barrage of sanctions imposed on Russia for its invasion of Ukraine, bond prices for both countries have plummeted to an all-time low. Particularly for Ukraine, even with its renewed pledge to honor its debt, the uncertainties on the outcome of the ongoing conflict continue to push prices down. While some investors are taking it as a signal to "buy the dip" in anticipation of gains when the economies rebound, others are reluctant because of reputational, social, and moral costs. However, the averseness does not only affect the fund managers. Even for Russian dollar-denominated bonds whose value already declined over 82.0 percent, bondholders opt to keep holding as the threat of harsher sanctions looms. (WSJ)

Banks sit on billions of LBO financings as demand for debt falls

Mar 4. Activity in the US and Europe debt markets have slowed down, with an increasing number of offerings being delayed or withdrawn altogether. With rising concerns of war risks and rate hikes, the sale of junk bonds in the European debt markets has been frozen in the last few weeks, while the era of easy money for US companies is coming to an end. On the other hand, acquisitions and buyouts are still taking place, as banks have committed to lend tens of billions for these activities and must now find buyers for the debt, though demand is relatively weak. There are over USD 37bn of pending debt deals in Europe, and USD 38bn of coming leveraged loans in the US. (Bloomberg)

Russia says sanctions determine if foreign bondholders get paid

Mar 7. Russia and Russian companies are allowed to pay foreign investors in rubles to avoid default, according to a decree signed by President Vladimir Putin. For sovereign bonds, all debt will be repaid in full and on time. Residents will receive their Russian state debt repayment in rubles regardless of the original currency denomination. However, whether international investors can receive debt payments on sovereign bonds denominated in foreign currencies will depend on sanctions imposed on Russia. (Bloomberg)

Stock trading halt on Russian firms risks USD 2.4bn in bond defaults (Bloomberg)

Honda joins Ford by selling green debt in electric cars push (Bloomberg)

Oil surge turns India's bonds into most risky in emerging Asia (Bloomberg)

Regulatory Updates

Russia's central bank blocks coupon payments to foreign bondholders

Mar 2. The Bank of Russia has been putting its foot down and intervening with the financial markets in an attempt to break the further devaluation of the ruble. After its actions of shutting down the securities market before investors could dump their holdings and hiking the rates up to 20% proved inadequate, the central bank decided to stop payments of coupons on its local-currency bonds altogether, effectively defaulting on its obligations. Of the total sovereign debt, 19.0 percent, with an equivalent value of USD 26 billion, is owned by non-residents of Russia. This decision could severely invert the yield curve, especially when recovery is also indefinite. The exclusion of several Russian banks from SWIFT has prompted the central bank to operate in crisis mode and exhaust the tools available to it to protect its currency. At the rate it is going, Russia's activation of its reserves might not be too far off. (WSJ)

Russia holds off again on reopening stock market

Mar 4. The Moscow Exchange will remain largely closed for the fifth straight day, as Russian authorities seek to protect domestic shares from potentially severe selling pressure. On Thursday, over-the-counter trading in several US-listed Russian stocks was halted, while trading in over 50 Russian securities on the London Stock Exchange was suspended. (WSJ)

China needs rate cuts, not just lower taxes, top official says (Bloomberg)

Ukraine war won't deter Fed and Co. from March rate hikes (Reuters)

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Contributing Editors: Yao Xuan, Raghav Mathur, Wang Anyi