Research Briefing | Russia

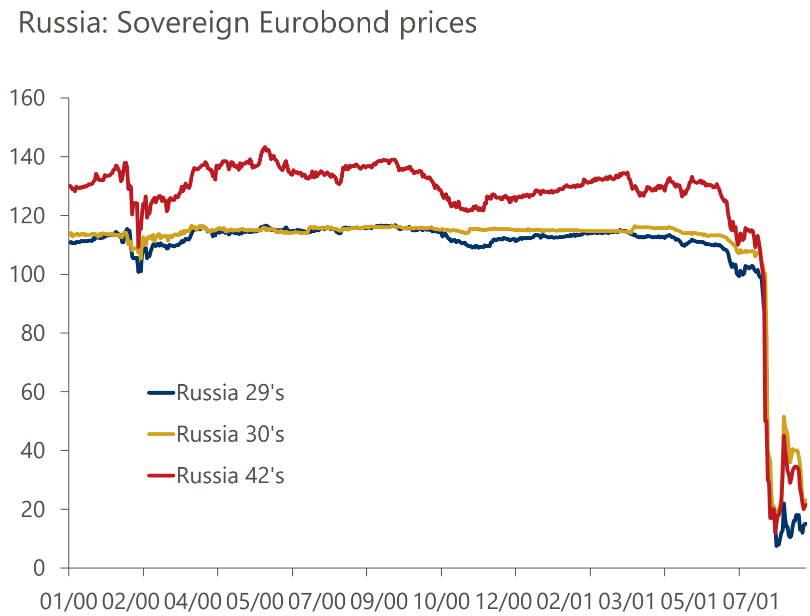
Sovereign default won't be Russia's only headache

- **The Russian government is no longer able to make payments on its US-denominated external debt as the US Treasury has stopped providing permissions for such transactions to correspondent banks. Russia will be declared to be in default once the one-month grace period on missed Eurobond payments due on April 4 has expired.**
- **Russia's debt crisis will be among the most difficult in history to resolve, since the default has its roots in politics rather than finance, and restructuring appears highly unlikely until a major change in the political relationship between Russia and the West occurs.**
- **Absent a deal with Russia, we think the legal path for bondholders to seek recompense from Russia's frozen assets will be very long and difficult. Even if Western courts were inclined to redistribute these assets, bondholders would need to compete with a Ukrainian government seeking to lay claims on Russian assets to finance its post-war reconstruction.**
- **An avalanche of Russian corporate defaults is also about to begin. Russian corporate borrowers linked to sanctioned oligarchs and officials are unable to make payments to foreign bondholders, for the same reason as the sovereign.**
- **Despite Russia's default and the loss of access to borrowing markets, we estimate that Russia can still afford anti-crisis support and contain the federal budget deficit within 2% of GDP.**

Up to April 5, the Russian government was still using the central bank's frozen FX reserves to make debt repayments. However, on April 5 the US treasury banned such payments.

On April 6, Russia's Finance Ministry reported that US banks rejected its payment for a Eurobond maturing on April 4 this year, amounting to $552.4mn, and a coupon on bonds maturing in 2042 amounting to $84mn. According to Bloomberg, JP Morgan Chase & Co, the correspondent bank for the transaction, did not receive approval from the US Treasury and therefore did not execute the payment.

Chart 1: The market has priced in the looming default



Source: Oxford Economics/Haver Analytics

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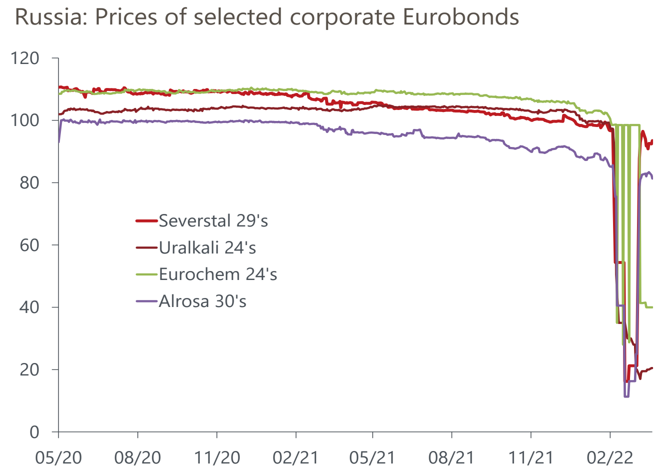
Following the invasion of Ukraine, the US imposed sanctions on Russia's central bank, finance ministry, and sovereign wealth fund, and froze CBR assets denominated in US dollars (later in March the US widened the freeze to also include gold, which is part of the CBR's reserves).

However, at that time, the Office of Foreign Assets Control of the US Treasury (OFAC) allowed investors to accept payments from Russia until May 25, provided that money for such payments was not coming from accounts held by the CBR, Finance Ministry, or the Welfare Fund in US banks. To make a payment from the frozen CBR's FX reserves, a correspondent bank had to be granted permission by the US Treasury. The Russian Finance ministry's correspondent bank, JP Morgan and Chase, and its payment agents, Citibank or BNY Mellon, must have obtained this permission ahead of the several repayments successfully made on behalf of Russia's Finance Ministry in March.

In Russia, external debt repayments are now regulated by the Presidential decree of March 5, 2022, which allows borrowers to make external debt payments in roubles irrespective of the currency in which the funds were initially borrowed. In a statement issued on April 6, the Russian Finance Ministry said the measures were forcing it to pay bondholders in roubles. The payments are be made to special Type C accounts in Russia and the proceeds can be converted into FX after Russia regains access to its foreign assets frozen abroad. Neither the 2022 nor the 2042 bonds allow repayment in roubles, and both have a 30-day grace period. Importantly, S&P and Fitch had earlier said that they will treat debt repayments made in currencies different from the original borrowing currency as defaults. Indeed on April 8, S&P cut Russia's rating to SD (selective default).

Meanwhile, Russian companies are increasingly caught in a position where they are unable to ensure that their debt repayments reach bondholders. Due to the US, EU, or UK sanctions, payment agents have blocked debt repayments on several occasions. On March 23, Severstal announced that it could not pay coupons of the amount of $12.6mn due on its 2024 bond because its main payment agent, Citibank, had rejected the payment. Other companies that have encountered this problem are fertiliser producers Uralkali and Eurochem (**Chart 2**). Russian Railways had already announced that it was unable to repay principal and interest on its $605mn Eurobond that matured on 5 April because of the UK sanctions. Referring to the Decree of March 5, the state-owned railway monopoly said that it would repay bondholders in roubles. On April 11, a panel in charge of determining pay-outs on derivative contracts ruled that Russian Railways was already in default.

Chart 2: Corporate bond prices gyrate as borrowers encounter problems with payment transfers



Source: Oxford Economics/Haver Analytics

Russia has sought to pay sovereign and corporate debt from frozen FX reserves

The last time Russia defaulted on its FX-denominated sovereign debt was more than a hundred years ago – in 1918, after the Bolsheviks came to power. In 1998, Russia defaulted on its local sovereign debt but continued servicing its external debt. From February 24, the onset of the invasion of Ukraine, up to April 4 the Finance Ministry had made all external and local debt repayments promptly.

According to the Vedomosti business newspaper, the authorities are considering a plan to make the CBR a sole payment agent with respect to settling the external debts of both the sovereign and corporate borrowers. As the sole agent of all Russian borrowers, the CBR will send instructions to payment agents (most of whom are major American or European banks) to make debt repayments to bondholders from the CBR's FX reserves. Thus, foreign creditors from "unfriendly" countries will receive debt repayments owed by the Russian state and entities only if the frozen CBR FX reserves are unblocked.

According to Vedomosti, the new debt repayment procedure may be announced in the coming days. But it appears that making the CBR the sole payment agent won't resolve the problem as the US has already stopped providing permissions to use the frozen CBR FX reserves. As this situation has arisen because of the US sanctions imposed on Russia for invading Ukraine, bondholders are likely to comply with the US sanctions and not attempt to circumvent them.

Bondholders won't find getting their money back easy

As of early May, Russia will be officially in default. Many Eurobonds have so-called aggregation clauses, which allow bondholders to demand immediate repayment if a set percentage of holders of a particular bond vote in favour. But investors will have to weigh their chance to enforce their claims on Russian assets carefully given that these assets have been frozen under Western sanctions. What's more, Ukraine could also lay claims against frozen Russian assets. The Ukrainian government has already said that it is assembling a legal team to claim rebuilding costs from Russia in Western courts. The Ukrainian officials have provided estimates of the damage to Ukraine's civil and military infrastructure starting from $270bn and up.

Russian Eurobonds contain some unusual clauses. Those issued after 2014 allow the borrower to make repayments in roubles if events beyond its control prevent it from making payments in the original currency. Such clauses may complicate bondholders' efforts to achieve awards in their favour in courts. Jurisdiction may be another thorny issue – the terms of Russian bonds state that the borrower won't submit to the jurisdiction of a foreign court.

Given the unusual circumstances of Russia's default, it's unclear whether bondholders will be keen to immediately start litigation against the Russian government that could take many years.

An avalanche of corporate bond defaults is also around the corner

Given the difficulties in making payments to bondholders, an increasing number of Russian corporates and banks may find themselves in the same situation as the sovereign in the coming months. Russia's total external debt stood at $478bn as of the end of 2021, and just $63bn (13%) is owed by the government. Of the rest, $34bn is owed by the CBR, $80bn by banks, and $302bn by other sectors. Of the latter figure, $130bn were liabilities to FDI investors – the status of this kind of borrowing is currently unclear owing to capital controls imposed by Russia at the beginning of the war.

Net of liabilities to FDI investors, total external debt is lower than the value of the CBR's assets frozen by Western sanctions, which we think could be around $420bn, assuming that the currency composition of CBR's reserves was the same at the end of February 2022 as at the end of June 2021 (the latest date for which data on the currency composition is available).

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The US might eventually consider an Afghanistan-style solution

Instead of chasing relatively illiquid and hard-to-seize Russian assets abroad, such as oil tankers or property of state-owned Russian banks or corporates, bondholders could attempt to claim the amounts owed to them from the CBR assets frozen in foreign banks under the US and EU sanctions. As the calculation above shows, there could be enough in the pot to satisfy all bondholders' claims. And if the Russian side is itself considering a mechanism allowing it to re-direct bondholder claims towards the frozen FX reserves, perhaps this could be the easiest way to recover the funds.

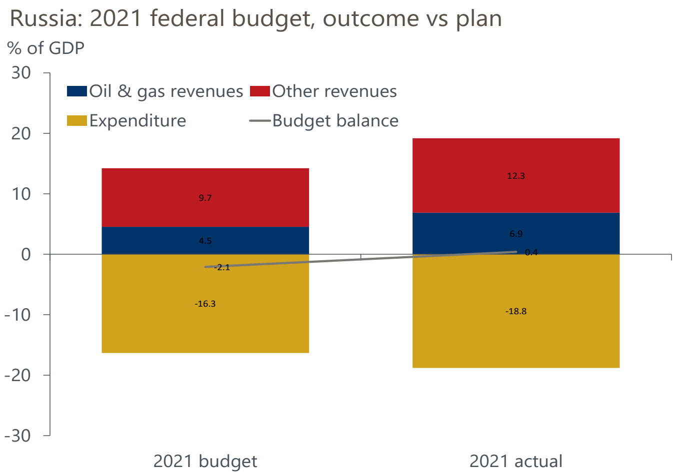
There are some indications that the US could eventually consider such a solution. In February, US President Joe Biden issued an executive order that split Afghanistan's central bank FX reserves in half, making one half of the $7bn reserves available for compensation to victims of the 9/11 disaster and the other half for humanitarian aid to Afghanistan. In the case of Russia's FX reserves, the US administration could possibly find a stronger moral cause for splitting the US-denominated portion of Russia's FX reserves between Ukraine and bondholders.

Appendix 1: Apart from the US sanctions, there are no reasons for Russia to default

Russia's default will be unusual as it is both willing and able to pay. Russia's budget planning has traditionally been very conservative. In 2021, the federal budget envisaged hydrocarbon revenues of RUB6tn, but the actual hydrocarbon tax take was RUB9.1tn (**Chart 3**). The commodity boom was the main driver: the average Urals was $69/pb vs $43.25/pb pencilled in the budget, and the average natural gas price was $280 per 1000m3 rather than $156.3 per 1000m3.

This year's budget is targeting a surplus of 0.2% of GDP, based on the average Urals price of $44.2pb. So Russia could pay its debts even though it's not fully benefitting from the very high global oil prices, with Brent hovering near $100/bp. Russia's Urals oil brand is trading with a deep discount owing to the "self-sanctioning" by Western buyers and logistical difficulties.

Chart 3: Windfall oil and gas revenues helped the budget to post a surplus in 2021



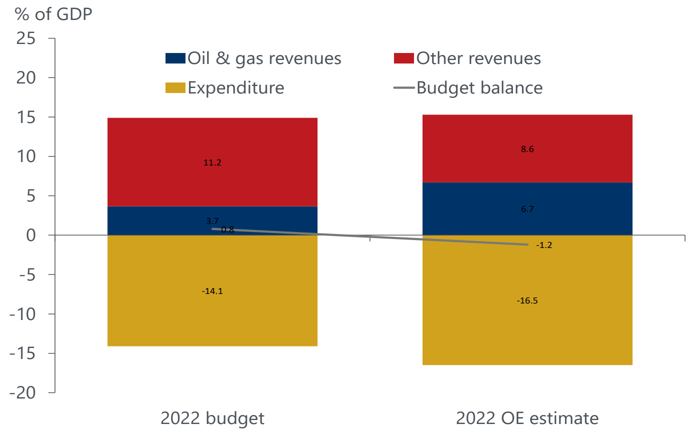
Source: Oxford Economics/Haver Analytics

Russia's hydrocarbon revenues are forecast to reach RUB6.145tn this year. But we estimate revenues could exceed RUB 10tn, even factoring in the expected drop in volumes of natural gas exports to Europe (**Chart 4**).

Conversely, non-hydrocarbon revenue will shrink owing to the deep recession the economy is falling into. Demand-based taxes (such as VAT), income and profit taxes, and especially import duties will be hit. We estimate that the non-hydrocarbon tax take in 2022 may be only 8.6% of GDP vs 11.2% of GDP pencilled in the budget. Meanwhile, although the Finance Ministry has yet to present amendments to this year's budget, preliminary estimates suggest that the government may consider increasing spending by RUB4tn to support the economy. Instead of 14.1% of GDP pencilled in the current budget, public spending in this case would amount to 16.5% of GDP, according to our calculations.

Chart 4: Despite a deep recession, the budget deficit is likely to be small if hydrocarbon prices stay high

Russia: Federal budget, 2022, planned vs OE forecast



Source: Oxford Economics/Haver Analytics

When all these factors are taken into account, we calculate that this year's budget will likely post a deficit of 1.2% of GDP instead of a surplus of 0.8% of GDP (all the above estimates are based on our amended GDP forecast which sees the economy shrinking 10.9% this year).