The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

Russia Sanctions Throw Up Hurdles for Bond Investors

By The Moscow Times

May 11, 2014

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LONDON — Confusion over the legal implications of sanctions on Russia and worries about further, harsher restrictions from the West are making investors cautious about owning bonds issued by Russian companies.

Two rounds of U.S. sanctions on Russian individuals and companies, in March and April, have not directly affected any companies which issue publicly traded debt. EU sanctions are regarded as even lighter.

Sanctions imposed so far on individuals such as Igor Sechin, chief executive of Rosneft, do not directly target the company, because Sechin does not own a controlling stake in the firm.

But worries about how the sanctions might be implemented have triggered a selloff in the debt of Rosneft as well as that of Novatek and Russian Railways, where sanctioned individuals hold noncontrolling stakes.

The risks of sanctions-busting are at the front of investors' minds, with French bank BNP Paribas under investigation in the U.S. over sanctions violations.

And even while investors fret about how to treat existing sanctions, U.S. Republican lawmakers have called for tighter sanctions on Russian firms. These include frequent borrowers in global markets — Sberbank, VTB Bank, VEB Bank, Gazprom and Rosneft.

This measure is expected to go nowhere in the Democrat-controlled Senate. But the Obama administration too is working on new sanctions that would be imposed on Russia if it dramatically ramped up aggression against Ukraine, U.S. officials said this week.

And in the post-financial crisis world, as regulators sharpen their teeth, investors feel they cannot be too careful.

"There is caution among financial institutions — many want to be transparently compliant, with banks having been caught out for things like money laundering," said Andrew Carey, capital markets partner at law firm Hogan Lovells. "There may have been a time when they would have shrugged it off."

Analysts speculate that sanction worries were behind U.S. export credit agency Ex-Im Bank's decision to pull out of Russia's $27 billion Yamal liquefied natural gas project, headed by Novatek. Sanctioned billionaire Gennady Timchenko owns 23 percent of Novatek via his investment vehicle Volga Resources. Ex-Im has said it suspended consideration of the Yamal LNG application in March.

Lawyers warn that the U.S. Office of Foreign Asset Control, responsible for U.S. sanctions, is eager to avoid investors exploiting any loopholes.

"Even in situations where the sanctioned person has an ownership interest in the joint venture of less than 50 percent, but that interest is nonetheless considered to be significant, the U.S. Office of Foreign Asset Control advises counter-parties to exercise caution when dealing with such entities," lawyers from Eversheds said in a briefing note.

"The same is likely to be true in respect of EU sanctions."

Assets or Liabilities

Analysts and lawyers say the question is not only whether companies with outstanding debt will be hit in any future sanction rounds, but also the form the measures could take.

If sanctions only target a company's assets, existing bonds should be safe as they are classed as liabilities. Investors who trade the bonds are not doing so directly with the company concerned.

However, such sanctions would still stop the company from being able to sell new debt.

If both assets and liabilities of a company are targeted, trade in existing bonds would be frozen.

"Historically, sanctions have targeted both assets and liabilities, but more recently it has just been assets," said one analyst who declined to be named because he did not have authorization to speak to the media on this topic.

If assets alone are targeted, sanctions would be unlikely to trigger default, lawyers added.

There has also been confusion among investors about the possible impact of U.S. sanctions on a company, even where the European Commission does not impose sanctions.

Analysts and lawyers say that any financial firm with U.S. connections, or U.S. employees of that firm, would not be able to do business with the sanctioned company.

It is a similar situation to Cuba, which is subject to U.S. sanctions but not to European sanctions — many investors avoid Cuban debt to be on the safe side.

Cuban debt, however, only amounts to a few billion dollars, compared with $650 billion in Russian corporate debt.

There is also a worry that the payment agent on a Russian bond, usually a U.S. bank, would be prevented from paying out the coupons on the debt of a sanctioned Russian company.

The extent to which the ramifications of sanctions could run through the financial system is unclear.

"It is not unreasonable to expect the companies would have problems making payments," said Andrew Burge, partner with law firm Linklaters in Moscow.

"The financial system could freeze up on them — payment agents, clearing systems and correspondent banks."

However, others said payment agents would only be affected if this role was specifically named in sanctions.

Iran

U.S. sanctions also exist on North Korea, Syria and Sudan as well as Cuba, and there have been sanctions in the recent past on countries including Iran, Iraq, Libya and Ivory Coast.

But analysts say the case of Russia is different, as it is a far larger economy — one of the BRIC emerging market powerhouses — and is more closely linked to the world economy.

TD Securities puts the world's exposure to Russia at $1 trillion, including trade and financial links.

Sanctions have also generally focused on governments, rather than individual companies.

Analysts at Bank of America-Merrill Lynch, however, say that the situation with Iran, which has won limited relief from western sanctions after agreeing to curtail its nuclear activities, shows that sanctions can easily escalate.

"Sanctions have tended to be gradually imposed, becoming more severe and wide-ranging over time, as seen with the implementation of the Iranian sanctions," they wrote in a note.

But sanctions will not be as far-reaching as those on Iran, the analysts reckon, adding: "The likelihood of the extreme sanctions scenario is quite low, given the detrimentally high costs that all sides would incur."

Investors also see deeper sanctions as unlikely, due to Russia's role in the world economy, particularly via its energy companies.

Some think the risks are already priced in.

Steve Ellis, emerging market portfolio manager at Fidelity Worldwide Investments, finds Russian corporate debt attractive.

"We like bonds in Gazprom and Sberbank, we think those kind of companies carry a tremendous risk premium."