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Sanctions Turns Russian Bonds into No-Man's Land for Banks

By The Moscow Times

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LONDON — Banks fearful of wide-ranging Iran-style U.S. sanctions in retaliation for Moscow's actions in Ukraine are slashing their inventories of Russian assets to the minimum, effectively freezing up the trade in its bonds.

In the short-term, that is an inconvenience for the funds that may be seeking to dip back into Russian bonds after a huge sell-off in March and April. But if the drought persists it could threaten the ability of Russian borrowers to raise money by issuing new securities in primary markets.

What institutions fear above all is to be left holding Russian debt in the event of more sanctions. The result? Many investment banks, the so-called market makers that usually provide liquidity and hold stocks of securities to trade, have wound down their holdings of Russian bonds.

The situation has continued even as the market improved in May, investors say, and that has made it tough to buy debt. So the sell-off as well as the subsequent market rebound in May both happened in ultra-thin market volumes, market players say.

"We have seen a real drying up of liquidity when it comes to trading Russia. It has been difficult to adjust positioning because of the lack of depth in the market," said Aaron Grehan, senior portfolio manager at Aviva Investors.

"We are aware that some banks have applied fairly restrictive caps on Russian risk ... as a result there is a lower ability to facilitate trading," he added.

The world's biggest asset manager, Blackrock, last month told The Financial Times it had dumped all its Russian bonds because the secondary market was "freezing up" on fear of sanctions.

True, the Kremlin appears to have averted the immediate threat of crippling Western sanctions. But the fear is that Russian assets — like in the case of Iran some years ago — may suddenly become toxic, meaning banks may not immediately change their stance.

Aside from the reputational risks attached to Russia, banks also fear Eurobond coupon payments may be jeopardized if sanctions are imposed on paying agents — entities that take cash from bond issuers and disburse them to bondholders.

Reports of a $10 billion fine on BNP Paribas for breaking Iran sanctions will have done little to soothe fears.

One trader in Moscow, speaking on condition of anonymity, said he had been ordered by U.S. bank clients to close all Russian bond positions soon after the first sanctions round hit.

Another bond trader, based in London, said the cost of access to the Russian market had increased "because of wider bid/offer spreads caused by scarce liquidity." This was inevitable, he added, given the political volatility.

Structural

The Russian liquidity collapse highlights a longer-term structural issue: thinning volumes across emerging bond markets.

That is partly down to post-crisis regulatory changes which forced many banks to cut back or shut down proprietary trading — the practice of trading securities with their own money. They are also now required to hold higher capital buffers against the asset inventories they hold on their books.

Many see this as having crimped banks' risk-taking ability, especially in junk-rated or lower-quality assets.

"The way things work is that when someone sells, banks would build inventory and when demand appeared they would sell the inventory. That was the normal liquidity provision," said Okan Akin, emerging markets debt analyst at asset manager AllianceBernstein.

But he said very few banks were now buying or selling Russian inventory, with institutional investors and private banks the main foreign players left in the market.

"So if you want to sell $50 million worth of Gazprom [bonds] there might be no one to buy, and if you want to buy, there might be no one to sell it to you," Akin added.

Volumes

The shift is reflected in wider bid/offer spreads on Russian dollar-denominated bonds, which industry body EMTA says are among the sector's most traded instruments. The bid/offer spread is a simple measure of market liquidity.

Data from Tradeweb, an electronic trading platform, shows for instance that the spread between bids and offers on the 2022 bond of state oil firm Rosneft have blown out to about 450 basis points, doubling from early-January levels.

While Rosneft itself is not under sanction, its CEO Igor Sechin is on a U.S. list of sanctioned individuals.

Similarly, bid/offer spreads Russia's sovereign 2030 dollar issue have more than doubled from year-ago levels, Tradeweb says while Gazprom debt displays a similar pattern.

On Russian domestic bonds, among investors' favorite assets in 2012 and 2013, stock exchange data shows bond turnover halved from year-ago levels in April to 759 billion rubles ($22 billion) while daily turnover also halved.

Of late, Moscow's more conciliatory tone has helped Russian stocks, bonds and currency recover from recent lows. Rosneft's 2022 dollar bond for instance is up 9 cents on the dollar since mid-April while the 2030 sovereign issue has risen 6 cents.

But that has not translated into a reopening of the primary market for Russian firms, which remain locked out of the new issuance market. Josef Dayan, managing director of brokerage BCS Financial Group, says the prices do not imply surging volumes.

"[Lack of liquidity] is part of the reason why we have seen the rally being so large, both on the fixed income side and in the equity market," Dayan said.

He blamed Western banks' slow reaction, noting they had cut Russia inventories just as sentiment started to improve, leaving prospective buyers unable to find anything to buy.

"The Russian banks were very quick to pull the bids — they were the first to know the situation was dire," Dayan said. "[Western] banks have to go to credit committees and they step back when the situation is already past."

In fact, gains may be met with further selling from banks seeking to purge portfolios of any remaining Russian risk, predicts Luis Costa, Citi's head of CEEMEA debt and FX strategy.

"The headline action of recent weeks has not really changed the dynamics," Costa said. "Most banks are still looking to reduce the inventory of Russian securities in their portfolios."

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