Russian Sanctions: How Will They Impact Credit Default Swaps?

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Economic sanctions against Russia as a result of the invasion of Ukraine have had a broad impact on the global economy and have raised the question of whether Russia will be able to meet its obligations on foreign denominated bonds. If Russia defaults on its bonds, credit default swaps meant to protect investors from a Russian default may not work as planned because of these sanctions.

At the end of last year, Russia had $40 billion in foreign currency sovereign debt, half of which is owed to foreign investors. While U.S. sanctions allow for Russia to continue to make debt payments at least through the end of May 2022, Russian restrictions on allowing foreign exchange transactions could force a default on bonds that do not allow for payment in Rubles. On Monday, April 4, 2022, the U.S. Treasury restricted U.S. banks from processing payments on Russian bonds, increasing the risk of a default.

Credit default swaps are meant to help investors receive near full recovery in the event of a default on the underlying debt. Payments under credit default swaps are owed to the purchaser of the credit default swap when a “Credit Event” has occurred. Credit Events include: a failure to make a payment under the debt (following any applicable grace period), insolvency of the issuer, debt restructuring and repudiation of the debt. There are approximately $4.5 billion in credit default swaps tied to Russian government debt and another $1.5 billion in derivative indices, according to JPMorgan.

Escalating western sanctions against Russia have raised questions about whether Russia will be able to meet its obligations under its sovereign debt, whether credit default swaps will be triggered if Russia does not meet the terms of its obligations and whether sanctions will interfere with the settlement of credit default swaps if a Credit Event is triggered.

Will credit default swaps be triggered if Russia does not meet the terms of its obligations?

Russia’s decision in March to pay some of its foreign debtors in Rubles could have triggered a Credit Event. ISDA’s Credit Derivatives Determinations Committee (the “DC”) applies the terms of market-standard credit derivatives to specific cases, and makes a factual determination as to whether a Credit Event or other events under a credit default swap have occurred and other issues. The DC determined that payment of obligations in Rubles, when not the original currency of denomination of the debt, would not constitute a Credit Event where the underlying debt allows for payment in Rubles. However, certain of Russia’s bonds do not provide for payment in Rubles. A failure by Russia to make a payment under the terms of the bonds (whether by failing to make a payment entirely, or by making a payment in Rubles when not permitted under the terms of the debt) would most likely constitute a Credit Event, triggering credit default swaps referencing Russian debt.

For the time being, Russia has avoided defaulting on its foreign currency debt, making $732 million in coupon payments on US Dollar denominated bonds in the month of March 2022. Russia owed approximately $2 billion on a bond that came due on Monday, April 4, 2022 (the “2022 Bonds”), and owes another $84 million in interest payments on a second bond. The recent U.S. Treasury restrictions on U.S. banks processing Russian government debt effectively blocked the payment on both bonds. A failure by the Russian government to find another way to make the payments within the thirty day grace period provided for in the bonds would likely constitute a default under the bonds and trigger a Credit Event under credit default swaps referencing Russian sovereign debt.

On May 2, 2022, Russia paid the approximately $2 billion owed on the 2022 Bonds but failed to include $1.9 million in interest that accrued on the 2022 Bond following the bond maturity date on April 4, 2022. On June 1, 2022, the DC determined that the failure of Russia to pay $1.9 million in post April 4 interest when it paid the principal amount of the 2022 Bonds constituted a failure to pay Credit Event.

What debt will be “deliverable” under credit default swaps?

The settlement of a credit default swap requires the delivery (for physical settlement) or pricing (for cash settlement) of debt that meets certain characteristics, including Not Domestic Currency (i.e., payable in a currency other than the Ruble), Not Domestic Law (i.e., governed by non-Russian law) and Not Domestic Issuance (i.e., not issued primarily in the Russian market). Additionally, the obligation must be payable in a G-7 currency and transferable to institutional investors without contractual or regulatory restrictions. The DC has determined that non-Ruble denominated debt that allows for payment in Rubles will not meet the Not Domestic Currency test and therefore will not be "deliverable" for settlement under credit default swaps. Similarly, if the Russian government decides to make a payment in Rubles under G-7 denominated debt, such debt may no longer be considered "deliverable". Additionally, on March 25, 2022, ISDA published "*Additional Provisions for Certain Russian Entities: Excluded Obligations and Excluded Deliverable Obligations*" (the "Protocol") which contains new terms that can be added to existing or new credit derivatives transactions. The new terms in the Protocol provide that a default under certain Russian sovereign debt ("Restricted Debt") will not trigger a Credit Event under credit default swap transactions and exclude such debt from the definition of "deliverable" obligations. In an FAQ released in conjunction with the publication of the Protocol, ISDA noted that it would be impractical to hold a settlement auction referencing Restricted Debt.

Will sanctions interfere with the settlement of credit default swaps?

Sanctions could prevent certain bonds from being delivered in the event a credit default swap is triggered and/or misalign the pricing mechanism for settlement of credit default swaps. The expected recovery under credit default swaps is usually determined using an auction process based on bonds that are “deliverable” under the terms of the credit default swaps. The auction process relies on the existence of a secondary trading market for the debt. Russia has blocked offshore settlement of bonds through Euroclear which would make certain bonds, which by their terms are to settle in Russia, untradeable. Further sanctions could also impact whether other Russian bonds are tradeable and eligible to be delivered under credit default swap contracts. If fewer bonds are deemed “deliverable” under the terms of the credit default swap, the auction price is likely to be higher (as more parties bid on fewer bonds), leading to a lower recovery for credit default swap buyers and a possible loss on the bonds that the purchase of the credit default swaps was meant to avert. One solution would be to circumvent the auction process entirely, leaving parties to the credit default swaps to agree to a cash price to close out the swap. This could potentially result in different recoveries for different market participants.

On Friday, July 22, 2022, the U.S. Treasury Office of Foreign Asset Control issued General License 46 (“GL 46”) authorizing certain transactions in connection with a DC auction process that would otherwise be prohibited by the sanctions against Russia. Specifically, GL 46 authorizes the submission of bids and offers to the auction, delivery of Russian debt obligations, and settlement of payment. GL 46 also permits financial institutions to help facilitate, clear and settle transactions arising from the auction process. U.S. persons may purchase or receive Russian debt beginning two business days prior to the announced date of the auction until eight business days after conclusion of the auction.

Credit default swap buyers should carefully review the terms of their contracts to determine whether they will be required to physically deliver the underlying debt to receive the expected payout under the terms of their credit default swap contracts and determine whether they will be able to deliver the debt.

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