FT Alphaville European companies

Breaking down financial sanction 'fatbergs'

Lets get some plumbers on the scene

Unblocking a non-financial, very real fatberg under Regent Street © AFP/Getty Images

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America's sanctions superpower flows from its control of the US dollar and rests on a multitude of institutions — from the US Treasury to clearing houses on both sides of the Atlantic.

Together these enable what the scholars Henry Farrell and Abe Newman have termed "weaponised interdependence". As they put it in their original paper:

> Asymmetric network structures create the potential for "weaponized interdependence," in which some states are able to leverage interdependent relations to coerce others. Specifically, states with political authority over the central nodes in the international networked structures through which money, goods, and information travel are uniquely positioned to impose costs on others. If they have appropriate domestic institutions, they can weaponize networks to gather information or choke off economic and information flows, discover and exploit vulnerabilities, compel policy change, and deter unwanted actions.

The plumbing of these financial networks is therefore central to the ability to implement, oversee, and, enforce sanctions. But it's a complicated system, with pipes consisting of both public and private actors. Oversight and co-ordination are therefore necessary to maximise sanctions effectiveness, as well as ensuring that they don't impact financial markets more widely.

Functioning as intended, these networks would have been rerouted in a way that prevented the Russian state, its "partner-in-crime" Belarus, and Kremlin-connected actors from receiving new *inflows* of funds, while keeping the pipes clear for the *outflows* of foreign currency reserves. Coupled with an effective policy aimed at reducing oil and gas revenues, this might, eventually, deplete the funding of the Russian war machine.

However. despite the increasing importance of sanctions to Western policymakers, no plumber appears to be on site. Blockages are building up in the system, in all the wrong places. Without an effort to clear these financial fatbergs, cash reserves that ought to be flowing westwards are staying within Russia's reach. Eventually the plumbing might fail altogether.

Euro-murk

Nowhere is the divergence between the aspirations and reality of policy starker than with regards to Euroclear.

The Belgium-based clearing house has attracted significant attention in sanctions discussions because of the profits that frozen Russian assets are earning it, which the EU on 12 February approved setting aside going forward to help pay for Ukraine’s reconstruction.

In the Council’s words (their emphasis below):

> The Council decided in particular that [**Central Securities Depositories] holding more than €1 million** of CBR’s assets **must account extraordinary cash balances** accumulating due to EU restrictive measures **separately** and must also keep corresponding revenues separate. In addition, CSDs shall be **prohibited** from disposing of the **ensuing net profits**.
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> This decision paves the way for the Council to decide on a **possible establishment** of a financial contribution to the EU budget raised on these net profits to support **Ukraine** and its **recovery and reconstruction** at a later stage. This financial contribution may be channeled through the EU budget to the Ukraine Facility on which the Council and the European Parliament reached a provisional agreement on 6 February 2024.

Ukrainian officials hope that the manoeuvre will help deliver $4bn annually to its coffers (though it won’t be retroactive). Although Belgium has approved a windfall tax, it will target only roughly half of Euroclear’s 2023 windfall of €4.4bn, 80 per cent of its net interest earnings for the year.

Financial overview

Euroclear holding

(€ m)	FY 2022	Russian sanctions impacts	FY 2022 Underlying	FY 2023	Russian sanctions impacts	FY 2023 Underlying	Underlying vs 2022	
Operating income	2,769	814	1,955	7,171	4,400	2,771	816	42%
- Business income	1,600	-7	1,607	1,634	-24	1,658	51	3%
- Interest, banking & other income	1,170	821	348	5,537	4,424	1,113	765	219%
Operating expenses	-1,152	-20	-1,133	-1,351	-62	-1,290	-157	-14%
Operating profit before Impairment	1,617	795	823	5,820	4,339	1,481	658	80%
Impairment	-12	-1	-12	-125	0	-125	-113	
Pre tax profit	1,605	794	811	5,695	4,339	1,356	545	67%
Tax	-405	-197	-208	-1,459	-1,085	-374	-166	-80%
Net profit	1,200	597	603	4,236	3,254	982	380	63%
EPS	381.3		191.5	1346.0		312.1		
Business income operating margin	28.0%		29.5%	17.3%		22.2%		
EBITDA margin (EBITDA/oper.income)	62.3%		47.7%	82.7%		57.4%		

Even if and when a new multilateral effort to further tap the assets comes into force, the European Commission's proposed legislation includes allowing Euroclear to retain three percent of profits for Euroclear's operational expenses and 10 per cent to cover litigation from Russia.

However, Euroclear and EU policymakers' management of sanctions issues have in reality been pretty feeble.

Euroclear and its rival Clearstream were ordered on 28 February 2022 not to serve Russian customers or Russia's previously-linked National Settlements Depository (NSD), which meant that some Western holders of sanctions-afflicted bonds would continue to be paid while those in Russia could not. Or that was the plan at least.

Russian attempts to find workarounds are under-appreciated and under-reported. Not content to follow the prescribed playbook — and faced with the blockage of plumbing at EU clearing houses that would prevent their own domestic creditors from receiving cash — Russian regulators stepped up their efforts to develop domestic payment systems and, through counter-sanctions, tightened controls on hard currency outflows from Russia.

As a result, fewer dollars and euros reach Euroclear and Clearstream, and consequently, Western creditors. Meanwhile, in virtually all cases, the Russian companies that had previously accessed international capital markets (as well the state itself) have found ways to offer replacement "mirror" bonds to their domestic creditors, utilising these domestic payment systems to keep Russia's own credit market functioning, liquid, and none the worse for wear.

In contrast, Western creditors are often stuck in a limbo — unable to get paid on the bonds, unable to find meaningful recourse, and often unable to sell their holdings (including to market players in neutral countries who would be able to extract payment from Russia or Belarus).

When is a default a default?

For market participants, the effects of regulatory blockages have been further compounded by Euroclear's handling of other sanctions-affected Russia-linked debt obligations, whose owners rely on the clearing house to receive payments due to them and to trade the bonds among themselves in the secondary market.

These blockages built up unnoticed and without any particular thought or design by policymakers, and are almost always a creature of compliance departments. As a result, where blocking sanctions and asset freezes were meant to deprive sanctioned entities and individuals of their *assets,* blunt-force implementation has instead unburdened them of their *liabilities*. And even where no blocking sanctions are in place, the same blunt tools appear to help the debtors on the wrong side of the geopolitical divide.

Take for example the case of Russian Railways, the state-owned transportation company that plays a key role in Russia's war effort. The International Swaps and Derivatives Association (ISDA) — another under-appreciated but crucial valve in the plumbing of sanctions — ruled in April 2022 that Russian Railways was in default after it missed a payment to foreign bondholders due to the post-invasion sanctions.

That move was an important step in setting the stage for Russia's own sovereign default in June 2022 and the payout of credit default swaps to investors on both Russia's sovereign debt and that of affected entities like Russian Railways. Sanctions guidance also removed such protections as a tool for post-February 2022 Russian debt issuances and ISDA updated its rules accordingly.

But Euroclear's own treatment of affected debts has been less straightforward. A Russian Railways bond that came due in October 2023 has not been listed as in default, but instead is labelled as "matured" despite the fact that Western holders are unable to receive their principal and interest payments due to both Western sanctions and the Kremlin's own counter-sanctions. A matured bond that is not "In default" cannot be settled by Euroclear — ie it cannot be freely traded.

The only parties affected by Euroclear's position are Western creditors, who are unable to either extract cash from the sanctioned entity, or to sell their claims to parties that could do so. And so, the sanctioned company — an arm of the Russian state — gets to keep cash it should not have.

A similar issue also arises in the case for a Evraz Steel bond due last March (also labelled "matured"). In this case, US and EU sanctions are not even in play, given that Evraz is only under UK sanctions. Yet, as Euroclear's compliance team raced to find the lowest common denominator among all plausibly relevant sanctions regimes, US, EU and all Western creditors alike are left facing the costs of the Kremlin's countersanctions. These block Evraz's Russian subsidiaries from making payments abroad. Creditors have no means to mitigate things as the bond is not tradeable due to roadblocks erected by the European clearing houses.

The Minsk Discord

The issue is taken to its extreme in the case of Belarus' 2022 sovereign default, after president Alexander Lukashenko's regime copied Moscow's decision to limit foreign currency payments to Western creditors.

Belarusian sovereign bonds that were due to be repaid in early 2023 but never were — in this case entirely as a result of a decision by the Belarus government to suspend debt service — are also labelled "matured" rather than "in default" by Euroclear. This is despite the fact that sanctions don't prohibit Belarus from repaying the bonds, and that the sanctions that apply to the Belarusian Central Bank — which are not as restrictive as those that apply to the Central Bank of Russia — do not prevent payments to bondholders.

As with Russian Railways and Evraz, Russian creditors of Belarus have begun to receive payments through Russia's NSD, bypassing Euroclear entirely. Western creditors, in the meantime, have neither the option to get such payments, nor the ability to sell the bonds to mitigate the damage done. Euroclear's labelling system — based on a premise that it should never mark the bond as "defaulted" unless the *issuer* of the debt allows this action to be taken — means Belarus gets to keep more of its borrowed dollar reserves out of reach of creditors, at least for the time being.

Euroclear's logic for this position is odd. In a letter to holders of Belarus' 2023 Eurobonds who have been unable to sell on their claims due to the clearing house's actions it claims that Belarus's default should be seen as different from those of Lebanon, Sri Lanka, Venezuela and Zambia.

> These sovereign nations have admitted an inability to make payments and therefore acknowledged a 'default' even if they did not use that term. Belarus has admitted no such inability but has offered alternative payment options.
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> . . . [Euroclear] is not a party to the contractual documentation nor a court of competent jurisdiction which has any authority to decide on whether there is an Event of Default in relation to the 2023 Notes or not.

But it has never been up to sovereigns to determine whether they are in default, however — that is for its creditors to decide. And even the World Bank (one of the most important official sector creditors) thinks Belarus is in default. So do the rating agencies S&P, Moody's, and Fitch. Euroclear is in effect taking a position that only Belarus and Russia consider valid.

EUROCLEAR'S AWKWARD POSITION

Another plumbing issue may be shaping Euroclear's response — it faces a number of lawsuits in Russia over its actions. As the clearing house highlighted in its annual report:

> 2023 also saw various parties contest the consequences of the application of sanctions, with a significant number of legal proceedings ongoing, almost exclusively in Russian courts. Claimants have initiated legal proceeding aiming mainly to access the assets blocked in Euroclear's books. Despite all legal actions taken by Euroclear and the considerable resources mobilised, the probability of unfavourable rulings in Russian courts is high since Russia does not recognise the international sanctions. Euroclear will continue to defend itself against all legal claims.

While these lawsuits are overwhelmingly being filed in Russia, they could result in judgments against it that Russian litigants then seek to have enforced in the West.

Despite Russia's invasion of Ukraine and the conjoined economic war with the West, there has been little discussion of whether bilateral investment treaties and other international economic agreements remain fit for purpose — many of those with Russia are in fact holdovers from the late-Soviet era. The Kremlin is ahead of the game in this sphere of lawfare, having adopted legislation in 2022 to consider questions of "actions by unfriendly countries" (ie sanctions) and Russian countersanction in judging claims.

All this has led to a situation where Western holders of Russian bonds are materially worse off than their Russian counterparts, while the borrowers had their debts in the hands of Western investors, in effect, postponed. In the long run, this dysfunction could undermine Euroclear's position as a core part of the global financial plumbing.

As it glumly noted in its annual report:

> Euroclear is faced with a high level of complexity in managing both the wide-ranging package of sanctions and a set of countermeasures, which Russia has implemented to try to mitigate the impact of the sanctions. Euroclear allocates considerable time, resources and capital to manage market issues, potential risks and implications of these countermeasures, while maintaining regular dialogue with clients and other stakeholders.

Western policymakers cannot be happy with this outcome. But while Euroclear's outsized profits have been targeted, pressure to break through the wider blockages in the sanctions plumbing has been lacking. And while tweaks to sanctions are rightfully focused on hindering the Russian war machine and limiting the Kremlin's bounty from oil sales, maintaining the plumbing of the financial system that underpins sanctions' efficacy is equally important, if not as headline-grabbing.

A competent team of plumbers is sorely missing. In the modern Russian language, with its Bolshevism-induced love of portmanteaus, the word for plumbers — Santekhniki — nicely doubles as one for sanctions technicians as well as sanitation technicians.

And so, to adapt a phrase: *Santekhniki vseh stran, soyedinyaites!* — Sanctions Technicians of the World, Unite!