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# Russian Sanctions and the Banking Sector

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**Western allies have imposed restrictive measures on Russian banks and threatened harsher sanctions on the finance sector since the annexation of Crimea in 2014. However, this did not impede sanctioned banks reporting record profits, nor deter Russia from invading Ukraine on 24 February 2022. Although the sanctions' full effectiveness remains in question, the impact of Russia's invasion of Ukraine has not only caused a retreat of foreign banks from mainland Russia, but also ended the international ambitions of the largest Russian banks in Europe and beyond.**

## Introduction

Russia has been subject to sanctions from the Western nations for years, dating back at least to 2014, with the annexation of Crimea and the non-implementation of the Minsk agreements.[1] Governments impose sanctions for various reasons, but typically to change the behaviour of a target country's regimes, individuals or groups. However, there is no universal agreement in international legal doctrine in relation to the concept of sanctions, and there is longstanding controversy about the role, success and, particularly, risks associated with sanction policies. With reference to the Trump Presidency, for example, Hanania (2020) discusses the dangers associated with over-reliance on sanctions and other forms of economic coercion as instruments of foreign policy to achieve 'tactical aims' (i.e. political goals), even during the COVID-19 pandemic (see e.g. Timofeev, 2021).

The European Union (EU) played a crucial role, despite bearing higher risks due to its geographical proximity, its reliance on Russia for energy production and trade, and the considerable exposures of some of its banks (on this last point, see the section 'International banks and the direct and indirect effects of financial sanctions'). In 2020, Russia delivered 43% of the EU's gas imports – supplies that cannot easily be replaced from other sources. In addition, it is the largest investor in Russia in terms of foreign direct investments (FDIs). The EU was also Russia's first trade partner, accounting for 38% of its total exports.[2] The EU labels sanctions as 'restrictive measures' and an essential tool in its common foreign and security policy (CFSP), through which the bloc can intervene where necessary to prevent conflict or respond to emerging or current crises. The United Kingdom (UK) also refers to sanctions as 'restrictive measures that can be put in place to fulfil a range of purposes'.[3] Typically, sanctions are intended to be temporary and are classified based on the specific objectives (targets) they have, from targeting annexation of foreign territories to cyber-crimes, but they can also focus on specific areas such as diplomatic sanctions and implementing United Nations (UN) resolutions. Many sanctions' regimes are mandated by the UN Security Council or to comply with other international obligations, and they usually aim to promote international peace and security,

[1]Two Minsk peace agreements were signed in 2014 and 2015 in the Belarusian capital, between Kjiv and Moscow, and were intended to end the fighting in the Donbas region of Eastern Ukraine.

[2]See European Commission (2022) for an updated overview of EU trade relations with Russia.

[3]Prior to Brexit, UK sanctions were imposed in a coordinated move by the EU, which the UK was a Member State of at the time (Mills, 2022).

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supporting democracy, human rights and preventing terrorism.[4]

The literature on sanctions spans many disciplines, and has a long history and a broad agenda that includes the effectiveness, enforcement and costs of sanctions, not only for the target but also for the sanctioning countries. Centuries ago, in what became the most famous document on military strategies, Sun Tzu wrote: 'Begin by seizing something which your opponent holds dear; then he will be amenable to your will' (*The Art of War*, Chapter 11: 18). The problem is that economic sanctions and embargoes can have a massive impact and impose unintended suffering on everyday civilians, especially those at the margins of society, hence raising serious ethical concerns, as seen in the cases of North Korea, Iraq, Haiti, Venezuela, Cuba and, more recently, Syria.

In this note, after a brief overview of the most important Russian sanctions, I describe the main features of the Russian banking sector and offer some considerations of the direct and unintended impact of international sanctions on Russian banks operating abroad and on foreign banks operating in Russia.

## Smart sanctions as weapons of financial disruption against Russia

### *Variety of sanctions*

The existing literature does not refer to a universally accepted sanction typology. A recent attempt to classify sanctions can be found in the Global Sanctions Database,[5] which distinguishes them by type, by political objective and by perceived degree of success for each identified sanction. In broad terms, sanctions imposed by partner countries on Russia include a mixture of (i) individual sanctions (asset freezes and travel bans for top politicians, oligarchs, military personnel and 'propagandists'); (ii) economic sanctions (impacting trade with import and export bans); (iii) restrictions on media (such as the suspension of broadcasting activities); and (iv) diplomatic measures (e.g. the recall of diplomatic representatives). The exceptional economic sanctions imposed on Russia in a coordinated move by the EU, United States of America (USA), UK and other Western allies include harsh *financial* measures. Often these are called 'smart' or 'targeted' sanctions because they are thought to diminish human costs and to some extent to be more effective (Allen, 2022). Essentially, smart sanctions are selective penalties that use financial institutions and instruments to put pressure on specific groups, and directly impact governments, individual officials or elites (in the case of Russia, the oligarchs).

### *Russia as the world's most sanctioned country*

At the time of writing, Russia is the world's most sanctioned target country, with a total of 5581 sanctions, followed by Iran (3616), Syria (2608) and North Korea (2077).[6] Over half of Russia's sanctions have been imposed after Putin's invasion of Ukraine by partner countries (EU, USA, UK and other Western allies such as Canada, Japan and Switzerland). However, as well summarized by Russell (2022), sanctions on Russia started escalating after the 2014 annexation of Crimea, and particularly since 2017 when the USA decided to take many measures unilaterally (see also Åslund and Snegovaya, 2021). Currently, an international coordinated effort has also been initiated to ensure sanctions are implemented. The EU has so far adopted six packages of sanctions aimed at (i) weakening the Kremlin's ability to finance the war and (ii) imposing clear economic and political costs on Russia's political élite responsible for the invasion. It has also adopted sanctions against Belarus in response to its involvement in the invasion of Ukraine.

[4]The UN Security Council, that is the UN's principal crisis-management body, may decide what measures not involving the use of armed force should be employed to give effect to its decisions. Article 41 of the Charter of the UN specifies that these may include 'complete or partial interruption of economic relations and of rail, sea, air, postal, telegraphic, radio, and other means of communication, and the severance of diplomatic relations' (The Charter of the United Nations Chapter VII *Action with respect to Threats to the Peace, Breaches of the Peace, and Acts of Aggression*).

[5]In 2021, the Global Sanctions Database (GSDB) covered 1101 publicly traceable multilateral, plurilateral and purely bilateral sanction cases over 1950–2019. See Kirilakha *et al.* (2021) and https://www.globalsanctionsdatabase.com/ Another useful source is https://www.castellum.ai/russia-sanctions-dashboard

[6]Data from Statista accessed 11 June 2022.

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*Targeted 'smart' measures: Ban from Swift and Central Bank of Russia asset freeze*

Targeted measures have been taken against individuals and entities with the specific aim to: (1) remove Russia's access to capital markets, increase borrowing costs for the sanctioned Russian-owned financial institutions and progressively erode the country's industrial base; (2) block Russia's foreign exchange reserves and prevent key Russian banks from conducting fast and efficient financial transactions globally.[7] However, one of the most important and controversial financial measures relates to the decision to impose a selective ban on Russian financial institutions from Swift, that is a vast network used by over 11,000 institutions to send and receive information and instructions about financial transactions to each other.[8] A crucial service provided by Swift is global financial messaging to ensure safe and secure international payments between banks. By excluding key international banks in Russia and Belarus from Swift, their ability to obtain foreign currency or transfer assets abroad in a cheap, easy and secure manner is strongly reduced. A possible long-term risk of this sanction could be that Russia, together with partners that are more independent from Western countries – like China, could be encouraged to develop viable alternative messaging systems.

Further financial sanctions include the national Central Bank of Russia 'asset freeze', that seems to have taken Russian officials by surprise as they did not expect they would be targeted by Europe and Japan in addition to the USA. Such coordinated action against a central bank was, in fact, unprecedented and it prohibits the Central Bank of Russia from accessing its assets and reserves stored in central banks and private institutions in the EU, USA, UK and other Western allies which also store a share of foreign reserves. Figure 1 shows that the top three countries by value of assets of the Bank of Russia frozen due to sanctions relating to the war in Ukraine are France, Japan and Germany.

According to the European Council (2022), it is estimated that more than half of Russian reserves are frozen, hence potentially affecting: (i) the stability of the country's currency exchange rate and (ii) the ability to use foreign assets to provide funds to Russian banks in an attempt to limit the effect of other sanctions. In addition, G7 sanctions cover transactions to liquidate gold holdings, since around half of the remaining reserves are in physical gold in Russia. This was expected to constrain Russia's ability to support its domestic currency. In fact, the sanctions have also affected the ruble indirectly, as Russian authorities reacted by introducing strict capital controls. Within a few months after the shock of the invasion, the ruble became the best-performing currency in the world, in a bizarre situation explained only by the isolation of the country due to the international economic sanctions and the dramatic rise in fossil fuel prices. At the same time, for the first time since 1918, Russia has defaulted on its international debts.

## International banks and the direct and indirect effects of financial sanctions

*Russian banks: The end of the ambition to expand internationally*

Between 2013 and 2021, the number of banks operating in Russia decreased by 550. Bank closures were part of an effort of the Central Bank of Russia to tackle financial fraud and other crimes in the industry. As of January 2022, there were 370 credit institutions, compared to 1108 in 2009 (a reduction of nearly 200%), but market concentration of the top ten banks was around 92%. In addition, the combined market share in terms of total assets of the country's two biggest state-backed lenders, Sberbank and VTB, exceeded 50%, with the former controlling over a third of the market. VTB was Russia's largest capital market player, and like Sberbank, was also managing accounts for local governments and many businesses across the whole of Europe, and particularly in Germany and Austria.

Although Sberbank and VTB became 'too-critical-to-fail' for the Russian economy, internationally their operations were under attack on

[7]As noted by Mills (2022), the recent sanctions represented a coordinated response by Western allies and could not be backed by a UN Security Council resolution because Russia, as a permanent member of the Security Council, would have used its veto to block them.

[8]SWIFT (Society for Worldwide International Financial Telecommunications) is used by over 200 countries and territories; in April 2022 it recorded 46.2 million secure messages per day (https://www.swift.com/about-us). The reason for a selective or partial ban was due to the continued European reliance on Russian energy.

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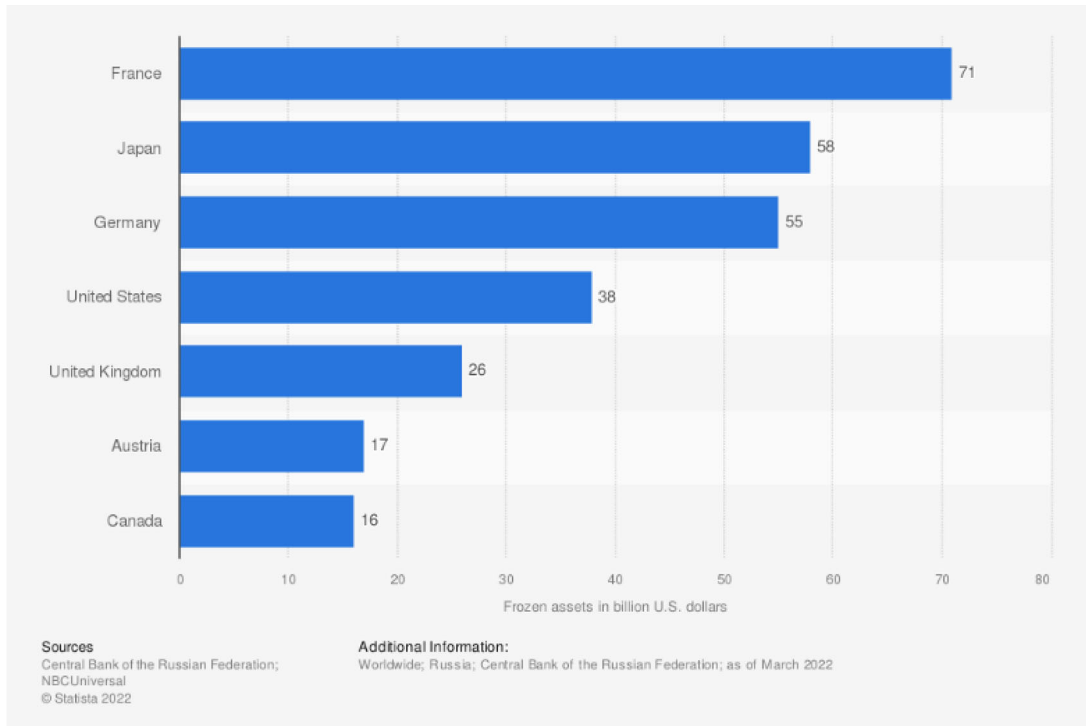


*Figure 1. Value of assets of the Bank of Russia frozen due to sanctions relating to the war in Ukraine as of March 2022, by country (in billion US$).*
Source*: Statista.*
*[Colour figure can be viewed at wileyonlinelibrary.com]*

multiple fronts. For example, Sberbank has been blocked from using the dollar, forced to pull out of Central and Eastern Europe, and was recently disconnected from Swift. VTB's assets were frozen and the group was also blocked from using the global Swift payment system. Like Sberbank, the group is making plans to wind down its European operations, as discussed in more detail below. Remarkably, both banks managed to quickly adapt and even 'prosper' in this new environment (Russell, 2022). For example, in December 2021, Sberbank was Europe's second most valuable bank by market capitalization (US$88.3bn) after HSBC (US$122bn), with record profits exceeding 1.2 trillion roubles (US$16.4bn), up 60% from the previous year.[9]

[9]With over 40 countries in operation worldwide, Sberbank was also the second biggest in terms of number of customers worldwide (101.6 m), after Santander (148 m) (data from Statista).

### *The retreat from Russia of international banks*

The Russian invasion of Ukraine has also prompted many international banks to urgently review their presence in Russia, with some starting to unwind their businesses and operations, including, for example, Credit Suisse (which has tens of billions of dollars in assets managed for wealthy Russian customers), Deutsche Bank, Goldman Sachs and JPMorgan. Particularly affected are French bank Société Générale's subsidiary Rosbank, Austria's Raiffeisen Bank, Italy's UniCredit Bank and the USA's Citibank. These four institutions are the biggest foreign players in the Russian banking sector, as ranked in the top 20 for market share of total assets at the end of 2021. As they are subsidiaries, they operate as separate entities with locally held capital and liquidity, however for them, exiting the market is very costly and complex and potentially a long process. These banks are supporting their large clients as they also unwind their operations in Russia, while complying with sanctions and numerous legal and regulatory requirements.

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*Domestic consolidation*

As a result, internally in Russia the consolidation process accelerated even more rapidly after February's invasion: at the end of April 2022, the Central Bank of Russia's governor backed a plan to merge VTB with top 10 lender Otkritie and its former subsidiary RNCB in an effort to raise capital adequacy and enhance efficiency (Financial Times, 2022). The move demonstrates how Russian banks' ambitions to expand in global markets were deeply affected by Western sanctions. In addition, to avoid a potential banking sector panic triggered by a run on bank deposits in Russia, the national central bank introduced several measures to stabilize financial markets including, among others, increasing its base rate, imposing capital controls, shutting down the Moscow exchange for nearly a month, providing extra liquidity to banks, as well as temporarily reducing supervisory measures for banks to support the banking sector (Bofit, 2022).

As mentioned above, foreign banks have been impacted in various ways – both directly and indirectly – by Russia's invasion of Ukraine and the subsequent sanctions.

*Direct effect on international banks' equity prices*

A recent IMF (2022) report on global financial stability shows that at the end of 2021, although the direct exposures to Russia, Ukraine and Central and Eastern European countries were modest in aggregate, they were sizeable for some banks, with euro area banks the most exposed. After 24 February, with greater uncertainty, the prospects of lower profitability and higher expected losses, equity prices dropped by over 20% for European banks (compared to 8% for US banks) and cost of equity increased from 11% to 16.5%. However, credit default swap spreads experienced a more modest decrease, suggesting investors' trust in banks' stability.

*Indirect effects: European deposit insurance scheme*

One of the major indirect effects with potential to burden the whole local banking sector is the impact on the deposit insurance scheme, both in terms of higher bank payments and payout to customers, in case of a collapse of Russian banks operating in Europe. As discussed above, Sberbank and VTB have over one million customers in Europe and are particularly concentrated in some countries, for example Sberbank Europe AG in Austria, with subsidiaries in Croatia and Slovenia, and VTB Bank Europe in Germany. The former collapsed after it was officially prohibited from continuing its business operations on 1 March 2022, a status that triggered the deposit insurance case. Regarding VTB's Frankfurt-based subsidiary, since April it was completely 'ringfenced' following new sanctions imposing that management is no longer allowed to take instructions from the parent bank, and that the parent company cannot access the financial assets or economic resources of its European unit.

*Other indirect effects*

As observed in the IMF (2022) report, banks' indirect exposures deriving, for example, from investment banking activities, wealth management and derivative markets are more difficult to quantify due to their significant interconnectedness, and the lack of consistent data by country or activity. Arguably, the effects of the economic isolation of Russia will survive the duration of the war and the sanctions for many years to come.

## Conclusions

The 1990s and 2000s have shown a rapid increase in worldwide globalization and international economic integration. In more recent years, the world has seen a rise in populism, social and political conflicts, and polarization, accompanied by greater use of sanctions of different types. This increase has been driven by both demand and supply factors: on the demand side, it is associated with the combination of a preference for strategic trade policy considerations rather than armed conflict resolutions; on the supply side, it is linked to greater efficiency (lower costs) and lower collateral damage, in other words, less adverse consequences for the target population. Sanctions have also come at an economic cost to the countries that impose them – mainly to EU Member States rather than the USA, given that the latter's trade and general interdependence with Russia is much smaller. For example, sanctions imposed after the Crimea annexation were followed by Russian counter-sanctions banning, for example, the

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import of various EU agrifood products, affecting in particular the Baltic countries.

The wave of sanctions that Europe, the USA and other Western countries have rolled out on Russia are significantly impacting banks, markets and businesses operating both in Russia and internationally. Nonetheless, they did not impede sanctioned banks from reporting record profits, nor deter Russia from invading Ukraine on 24 February 2022. In addition, the effect has been sizeable in Europe, given its trade and general interdependence with Russia. As oil and other commodity prices (including food) keep rising, and global supply chains weaken, the USA and the rest of the world too are starting to feel the strain of the ongoing economic uncertainties. Global financial conditions have tightened, downside risks increased and further disruption could originate from the increase in cyber risks, more fragmentation in capital markets and instability in the oil, gas and other energy markets.

The invasion of Ukraine in February 2022 has also marked the end of a 20-year strategy among Russian banks to expand internationally, although their withdrawal from Europe was already underway in the aftermath of the Crimea crisis. At the same time, it has halted the ambitions of international banks to operate in mainland Russia. After the COVID-19 pandemic, the world is now also suffering from a globalization crisis as geopolitical risks increase. There are crucial challenges ahead for bank regulators and policymakers. A structural issue is the effect that the war and associated international sanctions will have indirectly on climate transition efforts, as energy and food security concerns become increasingly more critical. The efforts to reduce energy dependency on Russia may help policymakers achieve net zero targets in the medium term. Another challenge is ensuring financial stability by addressing financial vulnerabilities and fostering the resilience of the banking sector through improving capital positions as well as assessing borrowers' ability to repay their debts as interest rates and inflation continue to rise.

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