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Impact of Russian Sanctions on CDS Markets

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This Article addresses the impact of Russian sanctions on credit default swap (CDS) transactions and market participants, the ISDA Russian sanctions protocol and its impact, issues relating to specific features of Russian sovereign debt, as well as other initiatives that may be adopted by the industry to address a possible expansion of Russian sanctions.

The decision by the US Treasury Department, in coordination with a number of governmental authorities in the European Union, the UK, and other jurisdictions, to sanction certain Russian entities and individuals connected to the Russian government (collectively, the sanctions) following the invasion of Ukraine has raised a number of issues for the trading of both corporate and sovereign credit default swaps (CDS). The derivatives industry dealt with many of these issues in 2014 following the invasion of Crimea, as well as in connection with the Venezuela sanctions imposed by the US in 2017.

On April 4, 2022, the International Swaps and Derivatives Association (ISDA®) launched a protocol (Russia sanctions protocol) enabling market participants to amend their CDS contracts in an effort to allow the proper functioning of covered Russian CDS trades impacted by the sanctions (see Legal Update, ISDA Publishes 2022 Russia Additional Provisions Protocol to Exclude Restricted Debt from CDS Contracts). This Article addresses the impact of Russian sanctions on CDS transactions and market participants, the Russia sanctions protocol and its impact, issues relating to specific features of Russian sovereign debt, as well as other initiatives that may be adopted by the industry to address a possible expansion of Russian sanctions.

Background: Summary of Russian Sanctions

Pursuant to Executive Order 14024, the US Department of the Treasury's Office of Foreign Assets Control (OFAC) has issued a number of directives prohibiting certain transactions and imposing restrictions on dealings with certain Russian persons or entities (collectively, OFAC sanctions), as well as general licenses granting exemptions for activities otherwise prohibited by the directives. Relevant directives and general licenses may be found on the US Treasury's dedicated webpage.

Directive 3 (Prohibitions Related to New Debt and Equity of Certain Russia-Related Entities) is the most impactful for the CDS markets. Directive 3 prohibits US persons from engaging in transactions on new debt or equity of greater than 14 days maturity issued by certain persons and entities. Sanctioned entities include a number of reference entities on which CDS contracts have been traded, such as Sberbank, Russian Railways, and Gazprom Public Joint Stock Company (Gazprom). The Russian Federation (including any of its government ministries, agencies, or instrumentalities) and a number of Russian government agencies are also covered by the OFAC sanctions. Similar sanctions have been implemented across a number of other jurisdictions.

Implications of Russian Sanctions for CDS Transactions

Legality of CDS Contracts on Reference Obligations Subject to Sanctions

Although a number of general licenses have been issued in connection with Russian sanctions, none explicitly exempt derivatives transactions on prohibited debt or equity issued by a sanctioned person. This is a departure from the Crimea sanctions, which allowed derivatives transactions to benefit from such an exemption pursuant to General License 1B.

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This raises the question of whether a specific general license would be needed in order for a US person to trade CDS on debt or equity covered by US sanctions. While OFAC FAQ 371 confirms that transactions on existing debt or equity are permissible, and the market continues to operate on the basis that CDS on existing debt can still be traded, the permissibility of CDS transactions in which prohibited new debt is the reference obligation is arguably still an open question.

Settlement Risk

Settlement Risk Relating to Current Sanctions

A CDS contract on a reference entity with debt that has become subject to sanctions (restricted debt) would be subject to settlement risk in the event ISDA's Credit Derivatives Determinations Committee (DC) were to determine that a credit event occurred with respect to the underlying reference entity, triggering settlement of related CDS trades. Following a credit event, the DC may elect to hold a CDS auction to determine the final price of the underlying debt of the reference entity for purposes of CDS settlement (see Practice Note, Credit Derivatives: Overview (US): Auction Settlement of Credit Derivatives).

However, in order for the CDS auction to be run and yield a final price reflecting the actual market value of the reference entity's debt obligations, the debt needs to be tradable by market participants participating in the CDS auction. If a majority of market participants are not legally permitted to trade some of the underlying debt, the CDS auction will not function as intended. The 2017 sanctions imposed by the US on Venezuela provide an instructive precedent. In that case, the Russia sanctions protocol enables market participants to amend the terms of their contracts and exclude the relevant restricted debt issued by Venezuela or by Petroleos de Venezuela, S.A.

ISDA has adopted a similar approach to CDS trades referencing the Russian Federation and Gazprom Public Joint Stock Company. For new single-name and index CDS trades referencing those entities entered into after April 25, 2022, new Russia-specific provisions (Russia CDS provisions) that essentially exclude restricted debt from being taken into account under the contract will be incorporated by reference, as described in more detail below (see Legal Update, ISDA Publishes 2022 Russian Sanctions Additional Provisions Booklet to Exclude Certain Obligations from Derivatives Contracts).

Additionally, for legacy transactions that would require the parties to agree to an amendment, the Russia sanctions protocol, similar to the one used in the context of the Venezuela sanctions, was launched by ISDA on April 4, 2022. The Russia sanctions protocol enables market participants to amend their existing CDS trades referencing the Russian Federation and Gazprom with a standard amendment incorporating the Russia CDS provisions.

The Russia CDS provisions specify that restricted debt issued by the Russian Federation and Gazprom is deemed to be an Excluded Obligation and an Excluded Deliverable Obligations for purposes of both the trigger and settlement of the CDS contract. In other words, any credit event affecting the restricted debt will no longer trigger settlement of the CDS contract because the restricted debt will no longer be a qualifying obligation under the contract. Likewise, the restricted debt would not be included in the CDS auction or otherwise taken into account for settlement purposes, for instance if settlement were to default to physical settlement (because the restricted debt will no longer be a qualifying deliverable obligation under the contract).

For those market participants that have adhered to the Russia sanctions protocol, this approach effectively permits both new and legacy transactions to be included in any CDS auction that might be held in the future, excluding such restricted debt.

Settlement Risk Relating to Expansion of Current Sanctions

In addition to settlement risk, there is also a risk that sanctions could be expanded to cover not only new but also existing debt obligations of sanctioned entities (which would likely also cover any existing debt that could get rolled into or exchanged for new debt). In that case, all CDS trades on these reference entities would be referencing restricted debt. In this case, the new Russia CDS provisions incorporated into the CDS contracts would be of no help because all debt would be restricted, thereby preventing CDS trades from settling via auction settlement or any physical settlement that would apply as a fallback if the DC elects not to run a CDS auction.

In the event physical settlement is not feasible because it is illegal or impossible for the parties to either deliver or take delivery of the restricted debt, the CDS contract falls back to cash settlement under Section 9 of the 2014 ISDA Credit Derivatives Definitions (CDS Definitions). In that context, in order to value and calculate the final price of the underlying debt for CDS cash settlement purposes, the calculation agent under each CDS trade must run a dealer poll to assess the value of the restricted debt obligation selected by the buyer of CDS protection under the contract. In doing so, each calculation agent

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(generally the swap dealer counterparty to the trade) solicits bids from a minimum of five dealers, with the quotes obtained subject to certain averaging and other rules specified in the CDS Definitions. Quotations sought by the calculation agent will be indicative, since the restricted debt may not be legally traded.

While this approach may work in theory, it creates a number of issues in practice. Because CDS contracts are held by a variety of market participants, multiple calculation agents will likely run contemporaneous dealer polls to value (potentially multiple) restricted debt obligations selected by the CDS protection buyer under the contract, with a relatively high potential for differing results. This lack of uniformity creates mismatch risk because trades intended to be offsetting may not settle at the same price, with a high potential for hedging mismatch for the dealers writing the contracts and also for end users holding offsetting trades with different swap dealer counterparties. In addition, it is questionable whether a dealer poll procedure is the best approach for valuing debt that can no longer be traded by the vast majority of market participants and is likely to be subject to trading disruptions for the foreseeable future.

An alternative, uniform valuation mechanism is needed to resolve these issues. Market participants actively trading CDS are currently discussing whether a more rigorous uniform valuation process is feasible, what form and shape it would take, and what impediments may need to be considered. Given the potential for regulatory scrutiny, approval from derivatives regulators (including the SEC and CFTC in the US) may be necessary. Also, antitrust issues may need to be considered and a uniform approach may be subject to oversight by antitrust authorities (including by the DOJ in the US).

From a timing perspective, any alternative settlement method will likely need to be put in place (and adhered to by market participants) within 60 business days of a credit event triggering settlement of the CDS contract, as the contract would otherwise automatically fall back to the dealer poll procedure described above. Finally, it is not entirely clear whether cash settlement would be permitted by applicable sanctions and further guidance from OFAC may be needed to confirm this point, especially if a uniform approach is adopted to amend existing CDS contracts.

Sovereign CDS

Domestic Currency Obligations

On March 5, 2022, Russia announced that, as a result of the sanctions, it would seek to make debt payments in Rubles, as permitted by the terms of some of its sovereign bonds. A CDS holder on Russian sovereign debt denominated in US dollars that had previously been paid in US dollars might reasonably expect a failure to pay credit event to occur as a result of a Rubles payment by Russia since Russia would have failed to make the relevant payment in the specified currency under the terms of the debt obligation (see Failure to Receive or Failure to Pay?). The market also identified a number of debt obligations under which Russia merely had an option to make the payment in Rubles. This raises the question as to whether the bonds containing this optionality qualified as Obligations under the CDS Definitions, capable of triggering a credit event under the CDS contract.

It was also questionable whether these bonds qualified as Deliverable Obligations, as the specified currency deliverable obligation characteristic specified in these contracts called for bonds to be paid in hard currency. Bonds that did not satisfy that characteristic would be disregarded for CDS settlement purposes and would not be taken into account in a CDS auction.

To clarify those questions, on an anticipatory basis, the ISDA Credit Steering Committee requested the DC to make a determination on this point. On March 11, 2022, the EMEA DC determined that Russian sovereign bonds with a Rubles payment optionality do not constitute an Obligation nor a Deliverable Obligation for CDS trigger and settlement purposes. In a statement, the DC declared that "[i]f the characteristics merely required that one currency in which a bond is payable is not the Domestic Currency … the protection that the characteristics were intended to provide would be significantly reduced." Further information on the DC's determination can be found here. The consequence of the DC determination is that the Russian sovereign bonds with a Rubles payment optionality will not be capable of triggering the CDS contract nor will they be taken into account in settling the contract.

Currency Indemnity

A related question on which the DC has not yet ruled is whether certain currency indemnity provisions included in the documentation for some Russian sovereign bonds amount to a payment-currency optionality, which could exclude these bonds from CDS trigger, auction, and settlement. While this depends on how the relevant provision is drafted, if the provision primarily addresses the calculation of damages following the occurrence of a default, which would merely take into account a payment in a currency other than the payment currency specified in the debt documentation, a strong argument can be made

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that the provision does not amount to a payment-currency optionality that would disqualify those bonds from CDS trigger and settlement.

Failure to Receive or Failure to Pay?

Another issue is whether a failure to pay credit event can occur when the reference entity is able and willing to make a payment under the terms of a debt obligation, but it is prevented from making such payment as a result of sanctions. Section 4.1 of the CDS Definitions make it clear that an illegality would not excuse a payment failure and does not prevent the occurrence of the failure to pay credit event under the CDS contract.

Corporate CDS

Loan Participation Notes

CDS trades on Russian corporate reference entities may reference so-called loan participation notes (LPNs), as it is not uncommon for Russian corporates to issue eurobonds via a special purpose vehicle (SPV) that in turn lends the issuance proceeds to the reference entity. In those structures, the obligations under the LPNs are guaranteed by the loan made to the reference entity, providing the LPN investors with an indirect claim against the reference entity in the event of a default under the LPNs. The CDS contracts on those instruments incorporate additional LPN-related provisions to account for these ubique features.

Qualifying LPNs are regularly reviewed by IHS Markit and published on an LPN list maintained by Markit for each underlying reference entity. Any LPN on this list automatically qualifies as a reference obligation under a CDS contract, and is taken into account for both CDS trigger and settlement purposes since the reference obligation is both an Obligation for purposes of triggering a credit event and a Deliverable Obligation for CDS settlement purposes under the CDS Definitions.

If an LPN does not appear on Markit's list, it may still qualify as an Additional LPN under the CDS Definitions, but further analysis is needed to ensure that both the LPN and the underlying loan made to the reference entity satisfy applicable characteristics. When entering into a basis trade for the purchase of both an LPN and CDS protection on the related reference entity, it is therefore important to make sure that the LPN is listed on the Markit's list, and if that is not the case, request Markit to update its list accordingly. As the Russian invasion took the market by surprise, certain LPNs had not been listed by the time certain market participants entered into CDS trades, creating some risk that LPNs being purchased as part of basis packages did not meet the applicable contract criteria.

Credit Deterioration Requirement

ISDA's 2019 Narrowly Tailored Credit Event Supplement to the 2014 Definitions (NTCE Supplement) introduced an additional credit deterioration requirement that applies to certain CDS trades (see Legal Update, ISDA Publishes 2019 Narrowly Tailored Credit Event (NTCE) Supplement to 2014 ISDA Credit Derivatives Definitions Governing CDS). If applicable, a credit event only occurs if the applicable failure to pay results from or in a deterioration of the reference entity's creditworthiness or financial condition. Where the Reference Entity has the ability to make a payment, but the payment cannot be processed as a result of sanctions, it is debatable whether the failure to pay results from a deterioration of the reference entity's creditworthiness or financial conditions.

However, the nonpayment is likely to result in a default or acceleration of the reference obligation, and other obligations of the reference entity may be similarly affected. This criteria was specifically listed in the guidance that ISDA provided as part of the NTCE Supplement as a factor indicative of a deterioration of the creditworthiness or financial condition of an affected reference entity. This issue has been considered by the DC in the context of the Russian Railways credit event determination request submitted in early April 2022.

In that case, the failure to make a coupon payment by Russian Railways on one of its debt obligations gave rise to a cross-default under a significant amount of other Russian Railways debt obligations. The affected debt obligations became capable of being accelerated as a result. The DC likely considered that this was sufficient to constitute a deterioration of the reference entity's financial condition, caused by the failure to pay, and thus determined that the credit deterioration requirement was satisfied. This will likely create a precedent for other Russian corporate CDS contracts with similar features, most notably Gazprom.

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