The Russian Default: Considerations, Issues and Questions

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Introduction

The 2022 Russian default will challenge typical recovery norms and introduce novel issues that may need to be resolved by the English courts or through international arbitration. In this paper, I will briefly discuss the form of the June default[1] and Russia's payment history. I will also discuss current investor perceptions as well as introduce some issues and questions ahead of a likely atypical workout path. I conclude by highlighting a few considerations and questions related to Russian Credit Default Swaps (CDS).

Background

Russia's recent default on its foreign debt is notable because the issuer was, and based upon post-default actions and statements remains, willing and able to pay its non-ruble denominated debt but was, and continues to be, prevented from doing so by financial intermediaries enforcing sanction measures. While Russia found creative methods to pay its non-ruble obligations for several months following the imposition of increasingly restrictive economic and financial sanctions, these penalties eventually led banks and clearing firms tasked with facilitating bond payments to block funds deposited by Russia from being distributed to investors. In the specific situation which led to the 27 June default, the Finance Ministry[2] deposited approximately $100 million equivalent to make dollar- and euro-denominated interest payments due 27 May associated with two English law bonds.[3] When bondholders did not receive payment before the end of the 27 June grace period,[4] Russia defaulted; one that investors largely view as *technical* in nature.

[1] During the May – June time period, Russia defaulted on three non-ruble-denominated bonds. This paper does not discuss the default associated with approximately $1.9mm of unpaid post-maturity interest on the dollar bonds that matured 4 April 2022.

[2] Formal name is The Ministry of Finance of the Russian Federation.

[3] A 2026 U.S. dollar bond and a 2036 euro-denominated one.

[4] A grace period, typically 30 days, is a common convention contained within bond offering documents providing the issuer extra time to make a scheduled payment before being considered in default.

Technical vs. Actual Defaults

I emphasize the word *technical* above because a technical default typically results from circumstances other than the issuer's inability or unwillingness to pay. Defaults of this nature are often associated with covenant violations, especially those related to maintenance covenants contained in loan agreements. As an example, if a corporate issuer is required to maintain certain financial ratios for specified periods, such as total debt divided by trailing twelve-month EBITDA[5] below a certain level, and does not, this failure is considered technical. These situations are typically cured by either a waiver from debtholders forgiving the violation for a certain period and/or actions of the issuer to rectify the violation that led to it. Importantly, technical defaults are rarely cured through processes associated with non-technical defaults such as consensual bond exchanges[6] or debt restructuring as part of a bankruptcy reorganization. While Russia's foreign currency default has broader implications than a garden-variety, non-cured covenant violation (including triggering CDS) most investors at this point view Russia's default as technical given Russia's pre-default efforts and on-going willingness to pay.

The Finance Ministry continues to expend great effort to pay Russia's non-ruble obligations. Notwithstanding the country's weakened financial condition due to sanctions and the expense of war, Russia remains in good financial condition with still relatively low debt to GDP and low international debt to foreign reserves.[7] The government also continues to benefit from recurring dollar receipts from exporting crude oil and natural gas at elevated prices. A protracted, expensive war and/or a crash in hydrocarbon prices could result in Russia subsequently defaulting for reasons other than sanction-related payment prohibitions, but at this time, Russia's June 2022 default is widely considered technical in nature.

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[5] EBITDA, Earnings Before Interest Taxes, Depreciation and Amortization is a standard measure of a leveraged corporate issuer's cash flow available for debt service.

[6] A standard market practice whereby a specified percentage of bondholders vote to create newly issued bonds, often with more favorable terms for the issuer, that are then exchanged for the old, defaulted bonds should the issuer agree to the terms and conditions.

[7] Some of Russia's foreign currency reserves and gold are held outside the Russian payment system and therefore are presently inaccessible due to sanctions.

Russia's Debt Payment and Default History

When discussing the recent default, the financial press often mentions that it represents Russia's first since the 1917 Bolshevik Revolution. This is true when solely considering the timely payment of government-issued Eurobonds,[8] and ignoring non-payment by state-owned entities[9] (SOEs), with a few additional caveats that are important to consider when examining the payment history of a country that has issued debt in currencies other than its own and/or where some bonds are subject to the laws of different countries. There are instances with emerging market sovereign debtors when a country has defaulted on one class of sovereign debt, but not another. Such was the case in Russia in 1998 when President Boris Yeltsin's government chose not to repay some $40 billion equivalent of ruble-denominated debt, yet continued to service Eurobonds, and thus was considered to have defaulted on local currency obligations, but not its foreign currency ones.[10] While rare, bonds do exist that are issued in hard currency[11] though still governed by the issuing country's laws. This distinction is important when examining Russia's payment history as it defaulted in 1999 on a class of legacy Soviet dollar bonds that, when restructured, became known as MinFin IIIs. These restructured notes were governed by Russian law and therefore not considered Eurobonds, notwithstanding their dollar denomination.

The Search for Yield and Reduction of the Default Hangover

Of the many reasons Western nations, which typically have open financial and capital markets, financially sanction a sovereign nation is to penalize bad-actor debtors. These resultant penalties include restricted bond market access and/or higher borrowing costs due to either negative investor perception or perhaps due to a preceding debt default, technical in nature or not. Academic studies and economists examining decades of default data have found that defaulting countries generally have experienced reduced-market access and higher borrowing costs for a few years after a default. In my experience, these residual default penalties have diminished substantially since the adoption of ultra-low interest rates by developed-country central banks following the 2008-9 Great Financial Crisis. Until very recently, these central bank policies have prompted investors to embark on a global search for yield that often involved assuming increased default risk. One of the distortive impacts of these policies is that they have tended to have shorten the memory of investors with respect to borrower non-payment.

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[8] Eurobonds are those issued by governments typically denominated in a so-called hard currency that are also governed by developed-market laws, typically U.S. or English.

[9] Private companies controlled through majority or complete state ownership are considered by market participants as a separate class of corporate bond issuers referred to as quasi-sovereigns.

[10] Vnesheconombank, a Russian SOE, also missed dollar payments in 1998.

[11] Generally considered to be the British pound sterling, euro, Swiss franc, and U.S. dollar.

Look no further than Argentina, which, after defaulting in 2014 for the eighth time in its tumultuous financial history, issued $3B of a 100-year note (a.k.a. The Argy Century Bonds) in 2017 with a yield at issuance marginally over 7%.

Given Russia's payment track record and its recent efforts to attempt to pay coupled with its relatively strong, albeit recently diminished, financial condition, the country's debt hangover should be short-lived one. My position would only be strengthened in the unlikely event Russia was to repay completely its defaulted obligations once sanctions are relaxed.

Expect an Atypical Workout and Recovery Process

The early steps taken in a typical sovereign workout (forming ad hoc bondholder group(s), negotiating exchange offer terms with the issuer on various bond series, modeling sustainable debt levels and service, etc.) may not be undertaken in the case of the current Russian situation. While jurisdictional, legal and procedural issues will arise, practical ones exist as well. For instance, how do investors go about orchestrating an exchange offer when sanctions would likely prevent its execution? Perhaps novel solutions will arrive at something akin to Russian Federation Post Sanction Euro Recovery Notes due 2033 which could be locally cleared until such time sanctions are lifted, 1:1 par exchanged with past-due and accrued interest paid. Afterall, Russia is no stranger to bond modifications having restructured in the late 1990s Soviet era debt of both the U.S.S.R. and that of some SOEs.

Stepping back, do investors even need to take steps to recover past due interest (and perhaps principal should a principal default occur) when the issuer has stated repeatedly that it is willing and able to pay its debt obligations (and do so when allowed)? Additionally, is it even necessary to negotiate workout conditions or new exchange bond terms when the issuer has been taking all reasonable steps to pay, all while some investors believe that Russia will make good on at least some past due payments once sanctions are lifted? From the issuer's perspective, Russian officials maintain that the country did not default and remains willing and able to pay but is being prevented from doing so by Western sanctions.

Failure to Pay and the Implications for CDS

A lot has changed with the administration of related bond defaults associated with CDS since I began trading them in the late 1990s at PIMCO. At a high level, perhaps when ISDA[12] Credit Derivatives Definitions are once again updated,[13] officials will revise the standard Failure to *Pay* language to Failure to *Receive* Full Payment. In the case of the 27 June 2022 Russian Credit Event, the Finance Minister and other Russian government officials have emphasized that they did or attempted to pay the requisite financial intermediaries, and therefore should not be considered to have defaulted. Some CDS credit protection buyers could take a different view. After all, the buyer of CDS protection is doing so in order to protect against or speculate on related bondholders not receiving timely payment principal or interest, regardless of the reason. It is perfectly reasonable to assume some protection buyers were hedging the circumstance where Western sanctions would result in non-receipt of related bond payments, and at trade execution could have been agnostic whether Russia could or would make one or more future payments. Such is the issue with the 2022 Russian default, where atypically the issuer by most accounts was making a good faith effort to pay while also having the wherewithal to do so. In my decades of credit experience, especially when it comes to emerging markets, the opposite is typically the case. Either the issuer can, and refuses to pay investors, or simply lacks the means to do so. At this point, the 2022 Russian technical default is being viewed less harshly by many investors than most other emerging sovereign defaults, several of which occurred after the issuer refused to pay even with the ability to do so.

[12] International Swaps Dealers Association which governs CDS.

[13] The rules governing what constitutes a Credit Event and prescriptive settlement methods are revised and updated periodically. The last comprehensive update occurred in 2014.

The nature of and circumstances surrounding the prohibition of non-ruble debt has prompted ISDA to make certain changes and adopt some new provisions. For example, months before any missed Russian payments, the ISDA EMEA Determinations Committee[14] (EMEA DC) published in March 2022: "Additional Provisions for Certain Russian Entities: Excluded Obligations and Excluded Deliverable Obligations" intended to clarify which debt instruments could trigger a Credit Event or be delivered into a CDS auction, if applicable. Despite this and other related clarifications, many questions and outstanding issues remain:

- Eurobond trades typically settle and clear through Euroclear and/or Clearstream, both domiciled in Western Europe. Russia clears many of its local bonds through its own clearing network, the National Settlement Depository (NSD), which in theory could *send* Eurobond hard currency payments to investors. Even if Russian was able to transfer clearing and settlement of some Eurobonds to the NSD, many investors and/or their agent banks would likely not be able *receive* these NSD-originated payments. Furthermore, bond trustees might refuse to process payments that originate from sources other than those specified in the relevant bond indentures.

- The 2014 ISDA definitions state generally that a Deliverable Obligation needs to be transferable, calling into question how a party is to settle physically a Credit Event with a debt instrument that due to sanctions cannot transferred or traded by many market participants.

- Of the three Credit Event Settlement Methods, the Auction Settlement Method requires trading of deliverable bonds as not only a means to determine the Auction Final Price, but also to prevent the submission of cash bond bids/offers without the requirement to stand prepared to trade upon submitted levels in order to prevent gaming the auction process. Given that Russian Eurobond trading is currently prohibited in most major markets, when, under what circumstances and in what manner will a CDS auction take place, if at all?

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[14] Per ISDA's website: *The ISDA Credit Derivatives Determinations Committees (DCs) each comprise 10 sell-side and five buy-side voting firms, alongside up to three consultative firms and central counterparty observer members. Their role is to apply the terms of market-standard credit derivatives contracts to specific cases, and make factual determinations on Credit Events, Successor Reference Entities and other issues, based on information provided to the DCs by credit default swap (CDS) market participants. The DCs are also responsible for determining whether a CDS Auction should be held following a Credit Event.*

- When will the present auction proscription by the EEMA DC be lifted? If a decision is made to proceed with settling a Credit Event before the Russian Eurobond trading ban is lifted, which likely prevents utilizing the physical and auction methods, what will be the replacement settlement mechanism? Will this new or remodified replacement settlement mechanism apply only to a certain Credit Event or all current, and perhaps future, events?

- The 2014 ISDA definitions appear to address the use of indicative price quotations to determine the settlement price for the Cash Settlement Method only for situations when physical transfer is not possible. The definitions do not appear to contemplate situations when physical settlement is not possible *and* when no auction is or will be held. If there remains an inability to physically settle or execute trades as required for an auction to held, will investors accept dealer quotations of several illiquid bonds as a type of "forced-quotation" modified version of Cash Settlement?

- If the EMEA DC does not set an auction date and requires solely using quoted prices for settlement, would investors then be offered some type of opt out provision that would enable them later to elect to use Physical or Auction Settlement Method?

Final Thoughts

The short list of CDS issues and questions above is by no means exhaustive, and most market participants anticipate more hurdles and challenges to arise in the months ahead. While investors and the EMEA DC will likely be able to resolve some of these issues themselves, given their complex and cross-border nature, several of them are likely to be resolved in the years ahead by the English courts or through international arbitration.

Mr. Hinman has worked on numerous corporate and sovereign defaults and restructurings during his asset management career. He presently consults with debtors and investors on bond restructuring and trading matters. He is also an expert witness on security litigation matters in the areas of bond and CDS management and trading practices; offering document representations and risk disclosures; and investor materiality and reliance considerations.