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Russian Bond Default and CDS Credit Event: How Did We Get Here and Where Are We Going?

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On June 27, 2022, the Russian Federation reportedly missed two bond coupon payments totaling approximately $100 million, defaulting on its non-ruble-denominated sovereign debt for the first time in over a century. The default is the latest consequence of the wrangling that has taken place between Russia and the United States and its allies since Russia invaded Ukraine on February 24.

The Eurobonds

At the time of the invasion, 15 separate series of non-ruble-denominated bonds (eurobonds) issued by the Russian Federation were outstanding. According to data from the Central Bank of Russia, approximately half of this roughly $40 billion of debt was held by foreign investors. Each of these eurobonds is generally payable in either U.S. dollars (USD) or euros. However, if for reasons beyond its control, the Russian Federation is unable to make payments of principal or interest on the bonds in USD or euros, the documents governing the eurobonds may permit the Russian Federation to make payments in pound sterling or Swiss francs. The documents for six of the 15 series of eurobonds (the "RUB fallback bonds") also apparently provide that "if for reasons beyond its control the Russian Federation is unable to make payments of principal or interest (in whole or in part) in respect of the New Bonds in any of these currencies," the Russian Federation can make such payments in Russian rubles.

Russian CDS

In addition to the eurobond positions, investors also reportedly held about $3.5 billion (net notional) of credit default swap (CDS) positions referencing Russian sovereign debt. Sovereign CDS transactions generally operate like insurance policies on the debt issued by one or more countries. In a typical transaction, the credit protection buyer pays a premium to the credit protection seller for the duration of the transaction (most commonly five years). If the reference country defaults on its debt (i.e., a "credit event" occurs) during the life of the CDS transaction, the seller owes a settlement payment to the buyer. The amount of that payment is typically set by an industry-wide auction process and should theoretically represent the loss (from a hypothetical par investment) that a creditor would have suffered on a bond position as a result of the credit event. Unlike insurance, a party buying protection on a bond through a CDS is not required to own any underlying bonds, meaning that a party can take a short position in sovereign (or corporate) debt using a CDS. Similarly, a party can take a long position in a credit by selling CDS, rather than buying underlying bonds. CDS trades under standardized documentation, and important determinations like whether a credit event has occurred, whether an auction should take place, and what the particular rules for that auction will be, are made on a market-wide basis by a determinations committee composed of up to 10 leading dealers and five buy-side CDS market participants.

According to estimates, approximately $2.5 billion of the $3.5 billion of Russian CDS positions outstanding were held in the form of single-name transactions directly referencing Russian debt, while the other $1 billion of CDS positions stemmed from index trades, as the Russian Federation had been a constituent of each series of the CDX.EM (emerging market sovereign) index published over the prior decade. On March 11, the relevant determinations committee (EMEA) clarified that the RUB fallback bonds do not constitute obligations or deliverable obligations for Russian CDS trades because they fail to satisfy certain requirements. Russian CDS only applies to the other nine series of eurobonds. A default on an RUB fallback bond alone would not trigger a credit event; and if a credit event indeed occurred, the RUB fallback bonds would not be deliverable into the related CDS auction.

Sanctions

Promptly following the Ukraine invasion, the United States and its allies began implementing sanctions against the Russian Federation, as well as certain of its institutions and individuals.[1] The initial rounds of sanctions targeted Russia's ability to access the international capital markets and issue new debt, but they did not impede Russia's ability to service its existing debt and appeared to allow trading of that existing debt in the secondary market. Pursuant to President Biden's Executive Order 14024, Directive 4 of the U.S. Department of the Treasury prohibited U.S. persons from entering into transactions with the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, or the Ministry of Finance of the Russian Federation "except to the extent provided by law, or unless licensed or otherwise authorized by the Office of Foreign Assets Control" (OFAC).

OFAC, however, initially permitted U.S. banks to continue clearing USD interest and principal payments on existing Russian debt by issuing General License 9C, which allowed U.S. persons to engage in transactions "ordinarily incident and necessary to the receipt of interest, dividend, or maturity payments in connection with debt" of the Central Bank, the National Wealth Fund, or the Ministry of Finance issued before March 1, 2022. Secondary market transactions involving that debt, which generally would not involve transacting with Russia itself, were also generally viewed to be permissible.

On May 25, however, OFAC let General License 9C lapse, making it illegal for U.S. financial institutions to clear Russian debt payments and effectively eliminating Russia's ability to service its USD debt. Subsequently, OFAC revised FAQ 1005 and issued FAQ 1054 addressing the topic of trading in debt or equity of certain Russian entities. The distinction between what continues to be permitted and what is prohibited for U.S. persons in dealing with debt or equity of Russian entities in the wake of these two FAQs is a fact-specific analysis that has left lingering questions for the impacted private sectors of the U.S. economy.

Russia's Response

In response to the sanctions, President Vladimir Putin signed a decree on March 5 (and another on June 22) instructing Russia's Central Bank, National Settlement Depository, and Ministry of Finance to establish a procedure for servicing the eurobonds. The proposed mechanism involved the creation of ruble-denominated accounts at Russian banks for the benefit of Russia's foreign creditors so that Russia could make payments to these creditors in rubles (based on a foreign exchange rate set by the Russian Central Bank). As noted above, however, the documents for nine of Russia's 15 series of eurobonds do not permit payments to be made in rubles. Additionally, receiving payments in rubles is

[1] For comprehensive coverage and analysis of the Russian sanctions, follow our series of advisories here.

particularly problematic for foreign creditors because the same sanctions that prohibit Russia from making payments in USD or euros would also prevent those creditors from expatriating the rubles they received.

The Defaults

Russia's first reported missed payments occurred on April 4, when the Ministry of Finance reportedly attempted to transfer rubles to the National Settlement Depository in order to satisfy USD principal and interest payments owed on eurobonds maturing that day. On April 21, the EMEA determinations committee determined that Russia's ruble transfer was not sufficient to discharge Russia's payment obligations and that a potential failure to pay had occurred in connection with Russian CDS. This potential failure to pay would ripen into a failure to pay credit event (triggering settlement payments on Russian CDS) if Russia failed to deliver USD payments by the end of the 30-day grace period set forth in the relevant eurobond documents.

On or around April 29, Russia did indeed arrange for USD payments in the amounts owed on April 4 to be made to its creditors. However, Russia apparently neglected to pay the additional $1.9 million of accrued interest it was contractually required to pay on account of the delay, and on May 11 Euroclear reportedly received a default notice from certain holders of the bonds. Based on this failure to pay the additional accrued interest, on June 1 the determinations committee declared that a failure to pay credit event had occurred on Russian CDS as of May 19, which was the date upon which the unpaid accrued interest amount first exceeded the CDS market's $1 million payment requirement threshold.

Russia's June 27 default stems from two missed coupon payments totaling approximately $100 million that were due on May 27. Although Russia again reportedly transferred rubles to the National Settlement Depository, it appears to have been unable to cure its default within the 30-day grace period prescribed in the relevant bond documents by delivering the USD coupon payments because the U.S. financial system refused to clear such payments due to the lapse of General License 9C. Russian officials claim that Russia satisfied its obligations by delivering rubles and that any technical breach of the governing documents should be excused based on force majeure.

Current Bond Status

As Russia remains blocked from the U.S. financial system, additional payment defaults are likely to follow. When a nonpayment occurs and the grace period lapses for any series of eurobonds, an event of default will occur and the holders of at least 25% of that series will have the right to collectively accelerate the due date of those eurobonds by declaring them immediately due and payable. The eurobond documents also include cross-acceleration provisions with thresholds of $75 million, meaning that an event of default would occur for a series of eurobonds if at least $75 million of accelerations occur on other series of eurobonds, even if that particular series of eurobonds (e.g., one of the RUB fallback bonds) has not suffered a payment default.

A creditor looking to obtain a judgment against Russia for its defaults will need to consider the most desirable forum in which to bring the claim. In general, Russian eurobonds are governed by English law but do not contain a contractual jurisdiction clause. As a result, any court in which a claim is issued will need to decide upon its jurisdiction. In the case of an English court, permission would be required before proceedings could be served on Russia outside the UK. However, challenges to jurisdiction may take the form of arguments that the English court is not the most appropriate forum to resolve the dispute and should therefore refuse jurisdiction ("forum conveniens") or that Russia enjoys state immunity from suit (which may leave bondholders having to rely on any permitted exceptions to sovereign immunity). The eurobond documents expressly state that the "Russian Federation has not waived any of its sovereign immunity, and has not submitted to the jurisdiction of any court, in respect of its obligations under the Bonds."

If creditors can obtain judgments against Russia based on its defaults and the subsequent accelerations of the eurobonds, and subject to considerations of sovereign immunity, they may be able to begin enforcing those judgments by seizing Russian assets. The ease of enforcement will depend on the location of those assets and whether there are any treaties providing for enforcement of judgments between jurisdictions. Russia-based assets can expect significant enforcement difficulties. It remains to be seen whether alternative routes to enforcement, such as arbitral claims via an applicable bilateral investment treaty, will also be considered.

For the time being, investors appear to be taking a wait-and-see approach.

Current CDS Status

Despite significant efforts undertaken by the credit derivatives industry, the status of Russian CDS remains in limbo. Following the initial rounds of sanctions, the CDS market worked feverishly to address two potential problems. The first was the possibility that new Russian CDS trades would become illegal, and the second was the potential that existing CDS trades would be unable to settle following a credit event.

The initial step the industry took to address these issues was the removal of Russia from the CDX.EM index. Russia was removed from the new version of the index published in March, and market participants were provided with a streamlined way to trade older (off-the-run) versions of the index sans Russia.

The next step was the publication by the International Swaps and Derivatives Association (ISDA) of the 2022 Russian Sanctions Additional Provisions. These additional provisions, which are automatically incorporated into any standard Russian CDS executed after May 2, expressly exclude from consideration any debt issued by Russia after the February 24 invasion date. The provisions were also adopted into the rules of the primary CDS clearinghouses, meaning they also apply to all cleared legacy CDS referencing Russia, and they were incorporated into the uncleared legacy CDS transactions entered into among the 122 institutions that adhered to the ISDA 2022 Russia Additional Provisions Protocol.

Despite all these efforts, the CDS market still finds itself in a quandary over Russian CDS due to the confusion caused by the recent OFAC guidance. Although the determinations committee concluded that a credit event occurred more than a month ago, market participants have been unable to settle their Russian CDS transactions. CDS transactions on heavily traded credits like Russia are typically settled based on the price set by an auction involving firm bids and offers and actual sales and purchases of underlying bonds. If a material portion of the market is unwilling or unable to participate in such transactions on account of the sanctions, an auction is likely not a workable solution for setting the CDS settlement amounts. The fallback settlement methodology of physical settlement is similarly untenable because industry participants may be concerned that they are prohibited by sanctions from engaging in the necessary purchase of debt instruments to settle their CDS trades. The determinations committee is reportedly discussing potential solutions with OFAC that would allow an auction to be conducted.

In conclusion, the questions of if, how, and when eurobond holders will be repaid and Russian CDS trades will settle remain very much up in the air.

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