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Sanctions Forcing Banks to Re-Assess Russian Relationships

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With the U.S. and Europe implementing new economic sanctions against Russia in response to its government's intervention in Ukraine, Russian interests may become the new epicenter of the global flight from risk.

Global financial institutions are under unprecedented scrutiny from governments and regulators for their financial crimes compliance. Faced with massive fines and challenging regulations, many institutions are simply exiting markets where these risks are the highest rather than trying to manage them.

There are many examples of this trend. Over the last two years some of the largest global banks have cut entire lines of business and significant foreign correspondent relationships deemed too costly or difficult to manage especially in high-risk jurisdictions.

With the ink still wet on the first round of Russia sanctions, the conflict is drawing increased attention in Western capitals and financial centers over corruption and cronyism in Russia. As the U.S. and Europe continue to calibrate their sanctions response, one likely outcome will be increased regulatory scrutiny on Russia-related financial crimes risk in particular.

Over the last decade, Russia's financial interconnectedness with the west has expanded significantly. Most global banks have significant exposure to Russia across various lines of business including investment banking, corporate lending and wealth management, both directly and indirectly. For instance, British Petroleum owns a 20% stake of OAO Rosneft, Russia's largest oil firm. Rosneft trades on both the Russian and London stock exchanges, obtains financing from US, European and Asian financial institutions, and works closely with energy majors such as

ExxonMobil.

The rising political risk and threat of additional sanctions, however, is creating significant new uncertainty for financial institutions and industry. While reports of stirred up civil unrest, potential military conflict and sanctions dominate headlines, western financial institutions and investors have in many cases paused on Russian exposure. Reuters reports that billions of dollars of syndicated loans and several IPOs in the pipeline for primary Russia deals are on hold.

Questions over the propriety of business with Russian interests are not new. Many in the U.S. policy making and enforcement communities have been concerned about Russia-related financial crime and corruption risks for some time, but the political will to expose and deter this behavior in a strategic way never took hold as a national security priority.

The Kremlin's controversial intervention in Ukraine has changed this.

As a result, we can expect much greater attention from policymakers and regulators. Not only will actors with questionable legitimacy be scrutinized more closely, but legitimate businesses will feel the impact too with increasing relevance, due to the heightened level of Russian integration with the global economy today.

From a political perspective, the Kremlin may be right to question U.S. and European resolve to adopt an Iran-style sanctions regime against Russia. However, from a purely economic perspective, President Putin and his associates would be wise to consider the new dynamics of the western financial regulatory environment and understand that the individuals and entities named on the sanctions lists reflect only one dimension of the financial battle space. Many more individuals and businesses than those named under sanctions will inevitably be swept up in their wake. JPMorgan Chase's temporary hold on a Russian Embassy payment and the disruption of VISA services for SMP Bank — majority owed by the blacklisted Rotenberg brothers — are likely just the tip of the iceberg.

These broader impacts are not entirely unintended. The sanctions regime provides wide-ranging authority and will be communicated with purposeful ambiguity — spurring asymmetric ripples through the private sector. Fear and uncertainty over how the financial sanctions will be implemented will be just as important as the tools themselves.

As the campaign unfolds, financial institutions will undoubtedly follow orders and freeze the assets of designated entities. However, this is only one component of the heightened sensitivity and risk control expectations that may dampen business with Russia. As a result, all institutions can be expected to scrutinize their existing Russia-related customers which may include for example, determining whether information on ownership and management is up to date, refreshing and retooling Russia-related risk assessments and ensuring capabilities are in place to monitor currency clearing and payments.

The scale of these risks can be hard to quantify. With the conduct of president Putin's inner circle of business associates increasingly dominating the headlines, lines of business active in Russia may face new demands from risk managers, auditors and examiners to account for a variety of exposures including corruption, organized crime, reputation laundering, weapons trafficking, politically-exposed persons and opaque organizational structures.

With Russian oligarchs and global banks already out of favor, and scrutiny of Russia-related interests likely to grow in response to international sanctions, it would not be surprising if many financial institutions decide they lack the capabilities to assess and manage these risks and move to rein in exposure.

No matter which Russian officials, oligarchs or banks end up explicitly named on a black list, Russian interests in general should be concerned about the potential intersection of these trends. Russian banks and businesses need only glance at Iran to observe the potential consequences of sanctions and increased regulatory scrutiny applied with broad brushstrokes and a growing aversion to risk.

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