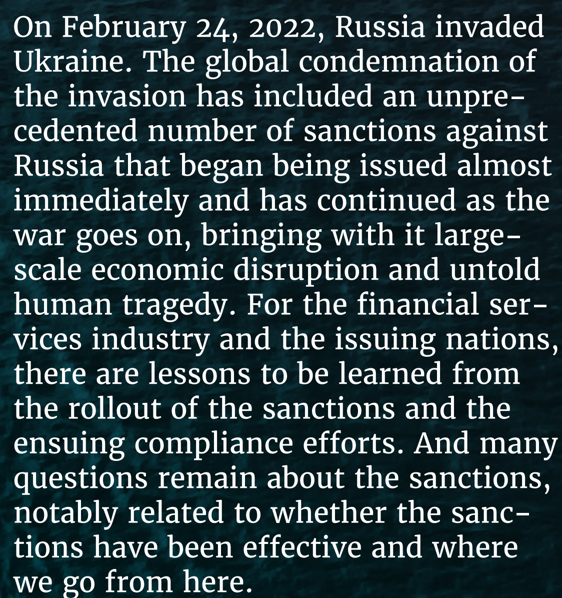
WHITE PAPER

SANCTIONS SERIES

ONE YEAR OF RUSSIAN SANCTIONS: FINANCIAL SERVICES INDUSTRY PERSPECTIVE



On February 24, 2022, Russia invaded Ukraine. The global condemnation of the invasion has included an unprecedented number of sanctions against Russia that began being issued almost immediately and has continued as the war goes on, bringing with it large-scale economic disruption and untold human tragedy. For the financial services industry and the issuing nations, there are lessons to be learned from the rollout of the sanctions and the ensuing compliance efforts. And many questions remain about the sanctions, notably related to whether the sanctions have been effective and where we go from here.

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LESSONS LEARNED TO DATE

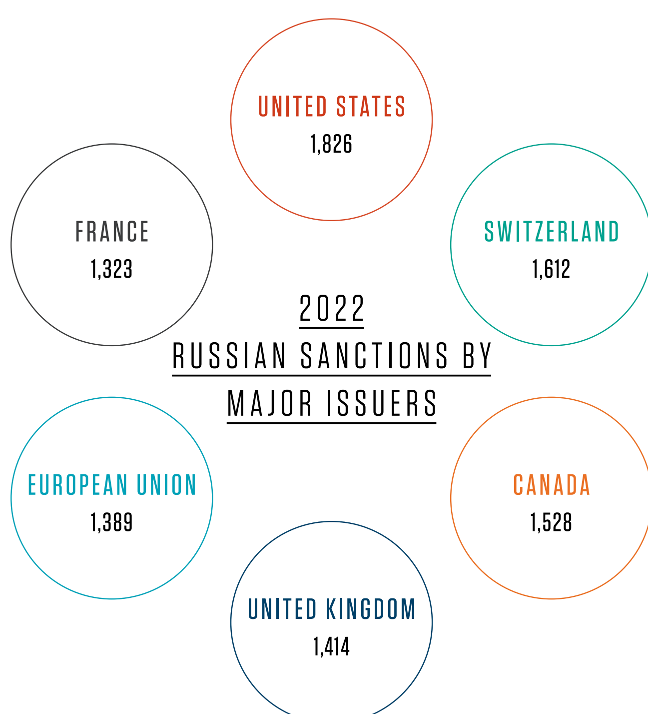
The number of sanctions issued against Russia (more than triple those issued against Iran, the country with the next-highest number)[1] and the speed at which the sanctions were issued in the days following the invasion are unmatched. There are many lessons to be learned from the compliance challenges that followed. The first two of these are very familiar to financial institutions because they have dealt with them in other contexts:

> »... the rollout of the sanctions quickly disclosed not just subtle nuances but also significant differences in how the sanctions were propagated.«

GLOBAL COORDINATION WORKS IN PRINCIPLE, BUT NOT IN PRACTICE.

As unified as the Western countries and their allies have been on the need to sanction Russia and who and what should be targeted by the sanctions, the rollout of the sanctions quickly disclosed not just subtle nuances but also significant differences in how the sanctions were propagated. Some of these differences were administrative (e.g., the extent to which an issuing country did or did not provide implementation guidance), but others were structural (e.g., one country sanctioned a named entity only, but another sanctioned a named entity and all its subsidiaries, or the European Union issued a new policy but gave its members latitude in implementing it).

These variations resulted in massive compliance challenges for global financial institutions that were required to reconcile national differences. Financial institutions should be adept at managing such inconsistencies since they are so often forced to do so — global anti-money laundering (AML) and privacy laws and regulations are two good examples. What is different with the Russian sanctions is how highly charged the environment is: A wrong decision might not only garner regulatory criticism but also result in a blow to a company's reputation. Decisions needed to be made instantaneously, and there are no precedents on which to fall back.



LACK OF ENFORCEMENT MAY UNDERMINE THE EFFECTIVENESS OF A NATIONAL SANCTIONS REGIME.

Though not an issue in the United States, which has levied fines in the billions of dollars for sanction violations, in other jurisdictions, including major markets like the United Kingdom, the Russian sanctions exposed weaknesses and led to changes in enforcement authorities. Financial institutions deal with disparate enforcement all the time and may even engage in regulatory arbitrage to take advantage of it. However, in the case of the Russian sanctions, where reputation management has been as important as technical compliance, the issue may be less about whether financial institutions would do the right thing than whether jurisdictions had the power and political will to go after offenders.

Other lessons learned relate to the operations of individual institutions' sanctions programs:

SOME RISK ASSESSMENTS ARE UNDERDEVELOPED.

Some institutions were clearly better prepared than others to know where to look for customers and transactions exposed to the risks of Russian sanctions. Those institutions had a clear advantage over

institutions that had failed to consider contagion risk in their risk assessment processes.

TUNING A SANCTION SCREENING SYSTEM IS NOT JUST SOMETHING DONE TO SATISFY THE REGULATORS.

Financial institutions that decided dealing with the noise of a poorly tuned sanction screening was easier than developing and maintaining an ongoing tuning program likely added significantly to their compliance burden.

NOT ALL SANCTION SCREENING VENDORS ARE EQUALLY DEPENDABLE.

Some financial institutions learned at the most inopportune time that the vendors they relied on to update sanctions lists were not prepared to deal with the pace of change witnessed with the Russian sanctions.

BEING ABLE TO ASSEMBLE ALL INVOLVED PARTIES QUICKLY AND FLEX THE SIZE OF THE SANCTIONS COMPLIANCE TEAM CAN BE CRITICAL TO THE SUCCESS OF THE COMPLIANCE EFFORT.

Those institutions that had a contingency plan for dealing with changes to the requirements and surges in sanction alerts, including engaging counsel and other subject-matter experts (SMEs) to build a dynamic library of sanctions, were able to put their Russian-sanction compliance plans into operation far more quickly and effectively than those that responded in an ad hoc manner and/or were forced first to locate and train additional resources.

THE RISKS OF THE SANCTIONS EXTEND BEYOND COMPLIANCE.

As of June 2022, global companies had experienced nearly $60 billion in losses from their Russian operations,[2] an amount that continues to grow. These losses affected the financial performance of companies in varying degrees, which in turn may have had implications for the banks that service them. The sanctions also led to increased counterparty risks for financial institutions to the extent they were doing business with Russian banks or other banks heavily exposed to Russia. Financial institutions need effective processes for identifying the broader impact of sanctions on their customers and business partners to manage their risks.

INNOVATION CAN ADD EFFICIENCY.

While innovation cannot — and probably never will — replace qualified sanctions SMEs, it can be used to improve the efficiency of the sanctions compliance function (e.g., by prioritising and triaging the most at-risk customers and transactions for review). Institutions that had already explored and implemented innovative techniques were better prepared to take a risk-based approach to dealing with the Russian sanctions. Now is the time for financial institutions to consider what changes should be made to their sanction compliance programs so they can be better prepared for future events.

DID THE SANCTIONS MAKE A DIFFERENCE?

Despite the multiple rounds of global sanctions, Russia's economy is still standing and the war against Ukraine continues. Does that mean the sanctions have not been effective? The short answer to that question is, "It depends," and the deciding factor is what your expectations were. If you believed that sanctions would cause Russia to retreat, that was never a realistic expectation; sanctions rarely, if ever, cause the reversal of the behaviour that prompted them.

If you thought that the Russian economy would collapse by now, that was not realistic either; sanctions take time to take their toll.

If you thought sanctions would brand Russia as an international pariah, you have a pragmatic understanding of how sanctions generally work. If you believe that, apart from their impact on Russia, the breadth of the global response will serve as a deterrent to other countries that might consider territorial grabs and/or inflicting massive human suffering, only time will tell whether you are correct. Below are some key themes and impacts of the sanctions that we saw play out in 2022 and what they may foretell:

FINANCIAL FLOWS:

Shortly after Russia's invasion of Ukraine in late February 2022, the U.S., Canada and several European countries released rounds of potent financial sanctions packages against Russia, including cutting off many Russian banks from the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the widely used global messaging system. By the end of February 2022, the U.S. Department of Treasury took measures to immobilise assets of the Central Bank of the Russian Federation (CBR) held in the U.S. or by any U.S. person.[3] Then, in April 2022, the G7, the EU and the U.S. released full blocking sanctions to further siphon off Russia's financial networks, including Russia's largest bank, Sberbank.[4]

In June 2022, Russia's government defaulted on external debt for the first time in decades, as the sanctions prevented payment to international creditors.

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The ruble tumbled, and many economists thought the Russian economy would implode; however, even to date, Russia's economy appears to have avoided catastrophe. How could that be? Is Fortress Russia sanction-proof, or at least sanction-resilient?

Russia's early life support success in part was due to the significant increase in revenue due to high oil and gas prices and to years of built-up foreign reserves that continue to be tapped. Although they took several months, sanctions have in fact achieved something of note as it relates to its financial sector: A significant amount of Russia's reserves remains frozen, Russia's economy has narrow access to global financing, international payments are limited to and from Russia, oil and gas revenues continue to decline, and Russia's financial deficit is expected to widen.

Further, many organisations and financial institutions have exited the country. It is this loss of foreign direct investment that may very well emerge as one of the most devastating consequences for the economy, and Russia will be challenged to locate new sources of foreign investment. Suffice it to say, the Russian market is still functioning, but it is weathered and weakened.

DIGITAL PAYMENTS AND CRYPTO:

The CBR presented a concept of its central bank digital currency (CBDC) in 2020; prototyped the platform in 2021; began piloting it in 2022; and, amid mounting sanctions on Russia, sped up the project's timeline with a full launch of the digital currency, expected to be released in 2024. This acceleration coincides with the impact sanctions have had on Russia's access to global markets and financing.

In conjunction with the accelerated launch plans, the CBR has relaxed its position on crypto payments for international trade, which would provide a bit of a work-around to having to rely solely on SWIFT for processing global transactions. If this practice of sidestepping SWIFT is adopted by not only Russia but also other jurisdictions, cross-border payments may become more fragmented, adding complexity and costs to the global payments environment, and may open doors to trade with sanctioned parties.

OIL, GAS AND ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG):

Russia's oil and gas industry has suffered less through yearend 2022 than its financial sector. Throughout 2022, to Russia's benefit, oil prices spiked, and Russia reoriented its export strategy to target new export markets, notably India and China.

The end of 2022, however, revealed a significant shift in power when the G7, the EU and Australia agreed on and instituted a $60 per barrel cap, resulting in an immediate squeeze on Russia's export income and a threat to its widening deficit.Restrictions on oil imposed by the EU took effect in December 2022. By the start of 2023, more than 90% of Russia's previous oil exports to the EU will be banned.[5]

With the embargo and the price cap, 2023 will serve up a different and less prosperous story for Russia's oil and gas revenues as sales to Europe, once its largest purchaser of oil, are expected to plunge. Even as Russia finds new regions to export to and continues to tap into its cookie-jar reserves, its efforts to fund the war will be strained as more countries join in on reducing reliance on Russian oil and gas, and Russia's overall economic health and resilience will be tested. Already this dynamic is playing out. Year over year in January, Russia's oil and gas revenues dropped by 46% and its monthly budget deficit swelled to $25 billion.[6]

TECHNOLOGY:

The Russian technology sector, from both import and export perspectives, has shown obvious signs of impact as a direct result of targeted technology-focused sanctions and export controls. Despite attempts to replace imports of Western technology with its own domestic production, Russia remains highly dependent on technology, and in particular on those goods and inputs aiding its war efforts. Exports and imports have fallen and are expected to continue to contract. We can anticipate this impact

to gradually intensify as the war rages, as Russian inventory of machinery and parts decreases, and as the country's need for goods and maintenance increases, with minimal global aid to the rescue.

AGRICULTURE:

With Russia blocking shipments of grain from Ukraine and restricting its own exports, including fertilizer, the war has led to inflationary pressures and increased global food insecurity, despite efforts by the U.S. and other governments to allow food and other humanitarian support to continue despite the sanctions.

OLIGARCHS:

To undermine a corrupt political system and shatter elite support protecting Putin, Western nations worked together to impose sanctions on those closest to him and his regime. The sanctions froze and seized assets of Russian oligarchs, and — even if in muffled tones — are thought to have spurred public dissent against Supervision and enforcement

For the most part, regulators seemed to appreciate the pressures financial institutions were under to deal with the Russian sanctions and remained somewhat on the sidelines to avoid adding to that pressure. But it is now likely Putin. Any deviation of support from Putin contributes toward destabilising his control and authority. The ripple effect of sanctioning the oligarchs spans luxury goods and real estate, where they are known to park and launder their money, as well as use of Western banking systems, and global policymaking.

BROADER POLITICAL AND SOCIAL DISCONTENT:

The possibility of broader political discontent looms. History suggests that public discontent with a significant downshift in the living standard of the Russian people will eventually translate into political activity, which Putin, distracted by the war, will have difficulty handling.[7] The above list is far from complete and will only continue to grow as the war continues.

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SUPERVISION AND ENFORCEMENT

For the most part, regulators seemed to appreciate the pressures financial institutions were under to deal with the Russian sanctions and remained somewhat on the sidelines to avoid adding to that pressure. But it is now likely that a year later, they will begin focusing on assessing how well individual institutions were able to respond and how effective they have been. This shift means, as noted above, that financial institutions should be reviewing what did and did not work in their response to the Russian sanctions and what improvements they made or need to make to mature their sanctions playbooks, so they are prepared to share this information with their regulators, if asked.

Financial institutions should also be able to explain to their management and their boards, as well as to the regulators, how they are assessing emerging global crises and planning for the next worst-case sanctions scenario. That strategic view will become a critical component of an institution's sanctions program.

While we are cautiously optimistic that most financial institutions did a reasonable job of supporting the sanctions decisions they made and that regulators will not engage in aggressive second-guessing, it seems inevitable that there were missteps and that for some financial institutions, the future will bring program criticisms and financial penalties for compliance failures, in particular to those supporting sanctions evasion.

WHERE DO WE GO FROM HERE?

The effectiveness of sanctions will continue to be scrutinised, and sanctions compliance will be a regulatory priority in 2023 and likely beyond. So long as the war persists (and it will persist), Western

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countries and their allies will continue to issue sanctions against Russia. New sanctions will include more of the same types of sanctions that have already been issued, potentially broader sectoral sanctions, and the continued threat of the U.S. branding Russia a state sponsor of terrorism, a step already taken by the EU. We can expect to see shortened timelines for implementations, an overall rise in designations and a heightened focus on sanctions evasion techniques as the evasion channels become clearer.

The U.S. Treasury's Financial Crimes Enforcement Network (FinCEN) set the tone for other Western enforcement regimes as it reinforced its commitment to combating the abuse of digital assets by, less than a month into 2023, labelling crypto exchange Bitzlato as a primary money-laundering concern and levying a $700 million fine. As Russia is an established haven for cybercriminal activity, we can also predict that the U.S. and its allies will home in on cybercriminals operating with Russia.[8]

As time passes, the sting of the sanctions will continue to intensify as Russia becomes increasingly isolated from the rest of the world and the global financial system. Russia, of course, will not be the only region impacted. The Russian sanctions broadly affect the global economy, which is still struggling to recover from COVID-19. The extent of the impact varies depending on a country's economic engagement with and reliance on Russia and Ukraine. Specifically, the toll on the EU will be significant because of its historical energy imports and certain member states' dependence on food imports from Russia or Ukraine. Other countries, such as the U.S., may be less affected, at least in the shorter term. However, to the extent that the Russian sanctions accelerate efforts by other countries, notably China, to reduce their reliance on the U.S. dollar, U.S. borrowing costs could increase. The issuing countries will need to continue to evaluate these broader implications as they evaluate the effectiveness of sanctions as a public policy tool.[9]

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ABOUT PROTIVITI'S FINANCIAL CRIME PRACTICE

Protiviti's Financial Crime practice specialises in helping financial institutions satisfy their regulatory obligations and reduce their financial crime exposure using a combination of AML/ combating the financing of terrorism and sanctions risk assessment, control enhancements, and change capability to deliver effective operational risk and compliance frameworks. Our team of specialists assists organisations with protecting their brand and reputation by proactively advising on their vulnerability to financial crime, fraud and corruption, professional misconduct, and other financial business risk issues.

SOURCES [1] Number of International Sanctions Imposed Worldwide as of January 12, 2023, by Target Country, Statista, www.statista.com [2] "Business Losses From Russia Top $59 Billion as Sanctions Hit," by Jean Eaglesham, Wall Street Journal, June 10, 2022, www.wsj.com [3] Treasury Prohibits Transactions With Central Bank of Russia and Imposes Sanctions on Key Sources of Russia's Wealth, U.S. Department of the Treasury, February 28, 2022, home.treasury.gov [4] Fact Sheet: United States, G7 and EU Impose Severe and Immediate Costs on Russia, The White House, April 6, 2022, www.whitehouse.gov [5] "Why Sanctions Against Russia Aren't Working — Yet," by Paddy Hirsch, Planet Money, NPR, December 6, 2022, www.npr.org [6] "The World This Week — Business," The Economist, February 9, 2023, www.economist.com [7] Beyond the Headlines: The Real Impact of Western Sanctions on Russia, by Vladimir Milov, Wilford Martens Centre for European Studies, November 16, 2022, www.martenscentre.eu [8] FinCEN Identifies Virtual Currency Exchange Bitzlato as a "Primary Money Laundering Concern" in Connection With Russian Illicit Finance, Financial Crimes Enforcement Network, January 18, 2023, www.fincen.gov [9] The Economic Impact of Russian Sanctions, Congressional Research Service, December 13, 2022, crsreports

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