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Sanctions Push Russia to First Foreign Default Since Bolshevik Revolution

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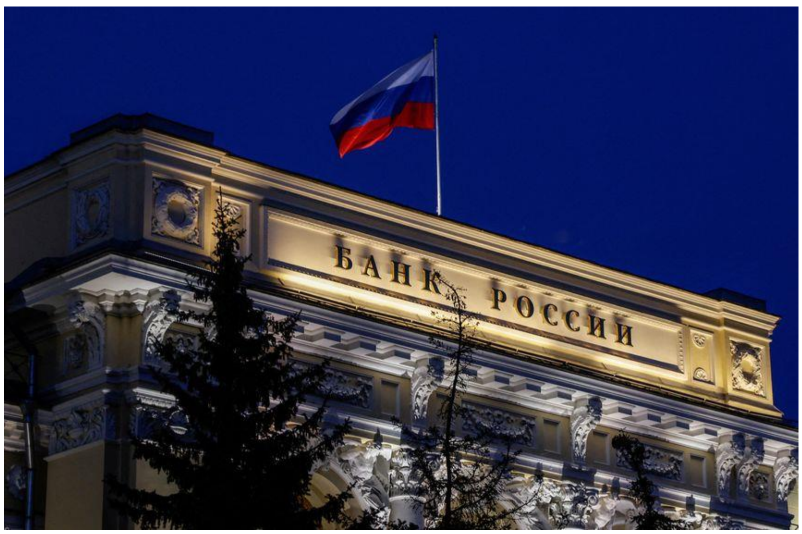

By Caitlin Ostroff and Chelsey Dulaney

Russia defaulted on its foreign debt for the first time since 1918, pushed into delinquency not for lack of money but because of punishing Western sanctions over its invasion of Ukraine.

Russia missed payments on two foreign-currency bonds as of late Sunday, according to holders of the bonds. The day marks the expiration of a 30-day grace period since the country was due to pay the equivalent of $100 million in dollars and euros to bondholders.

The default has been long in coming since the West all but unplugged Russia from the global financial system, creating payment obstacles Moscow couldn't overcome. It wasn't expected to cause any immediate ripple effects in markets or Russia's economy. Russian bonds have traded for pennies on the dollar since days after the invasion, a sign that investors believed default was probable.

Russia last failed to pay its foreign borrowing during the Bolshevik Revolution when Vladimir Lenin, the newly installed communist leader, repudiated the debt of the Russian

Empire. Russia defaulted on its ruble-denominated bonds during a financial crisis in 1998, but it was able to stay current with its overseas debt at the time.

Litigation over the lack of payment could span years. Russia has accused the West of manufacturing an artificial default, and has gone to great lengths in recent months to route money in roundabout ways to get the required payments into the hands of bondholders.

Finance Minister Anton Siluanov on Thursday said Western nations created barriers in order to "hang the label 'default'" on Russia and called the situation a farce.

Russia has plenty of money from oil and gas sales to pay its foreign debts, which are relatively small compared with the size of its economy. But allied Western governments have blocked the Kremlin's ability to tap foreign bank accounts or use cross-border payment networks to move money.

The Treasury Department last month let a prior sanctions exemption expire that had allowed U.S. banks and investors to process and receive payments on existing Russian bonds.

Because Russia has the money and intent to pay, its default is expected to pose unique legal challenges. Once the grace period is breached, bond investors can declare a default. Russia will claim its obligations were fulfilled. Unusual for most sovereign bonds, Russia's don't specify a jurisdiction to decide disputes. Lawyers say English or U.S. courts are likely venues to decide who is right.

The first step is for holders of 25% of the bonds to agree to invoke the so-called acceleration clause, which allows them to demand immediate repayment on the bonds' outstanding amount. Bondholders have three years to bring claims against Russia to court.

"This is the messiest and most legally uncertain case of sovereign default that I can think of," said Mark Weidemaier, a sovereign-debt specialist and law professor at the University of North Carolina at Chapel Hill. "That's got to be one of many things that makes investors nervous when they think about the prospect of suing the Russian government."

One investor said clearinghouse Euroclear received funds for the May interest payments just before the Treasury's exemption expiration. But the funds were frozen there because of sanctions, unable to be forwarded to his account. Lawyers say the bond documents are unclear over whether payments that reached the clearinghouse, but not the bondholder account, would constitute a formal default.

A Euroclear spokesperson didn't immediately respond to a request for comment.

Russia last week codified plans to pay bondholders in rubles under a decree signed by President Vladimir Putin. Russia will send ruble payments to accounts for foreign bondholders at unsanctioned Russian banks. Foreign investors could then convert the rubles into foreign currencies.

The Russian Finance Ministry said it made roughly $400 million in payments on Thursday and Friday to bondholders under the new mechanism.

Bondholders will struggle to move the money out of Russia without breaching Western sanctions. The payments pass through Russia's National Settlement Depository, which has been sanctioned by the European Union. And the U.S. has barred American banks from processing Russian debt payments since late May, meaning many investors won't be able to easily repatriate the funds.

In theory, creditors could try to seize Russian assets abroad, though it is unclear what they might go after. Some investors have suggested they might claim frozen central-bank reserves or oligarchs' assets. Bondholders of Venezuelan debt sought assets of a state-owned oil refiner after the country's default. In 2013, Argentina hired a private jet for the then-president's trip to Asia and the Middle East because of the risk of creditors seizing the official aircraft.

"I suspect, remembering what happened with Argentina, that the Americans would be keen to have creditors chasing Russian assets all over the world," said Paul McNamara, an emerging-market fund manager at GAM. "It's basically contracting out the job of going after Russian assets."

The default isn't expected to have a widespread impact on Russia's economy. Russia reduced foreign borrowing in recent years, making itself less reliant on foreign capital. In the longer term, the default will make it harder for Russia to re-enter international financial markets.

"Hydrocarbon prices are sky high, so at the moment they don't need to borrow," said Tatiana Orlova, lead emerging markets economist at Oxford Economics. But Russia's energy-focused economy is vulnerable. Russia "would need to have an ability to borrow if oil prices were to come down," said Ms. Orlova.

Investors who hold the bonds say they are planning to take a more patient approach, expecting that Russia will eventually resume payments if sanctions ease.

"The market approach will be laying low. You might have creditors' committees just to discuss and know who holds what," said Kaan Nazli, a bond portfolio manager at Neuberger Berman Group.

Moscow missed $1.9 million in interest payments on a bond in April, triggering a credit-default swap insurance payout connected to those bonds. But the payment miss was too small to allow creditors to declare a wider default on most of Russia's outstanding foreign currency debt.