OliverWyman

WAR IN UKRAINE

10 Watchpoints for Financial Services

4 March 2022

INTRODUCTION AND CONTEXT

The invasion of Ukraine has triggered a coordinated policy response that will have ramifications across the globe. The first priority has rightly been a human one: concern for, and outreach to, those directly affected by the unfolding humanitarian crisis.

This note focuses on the implications for the global financial system and the firms, policymakers, and regulators within it. We are seeing a crisis unfold that has far reaching implications for all participants in financial services. The financial system is at the heart of the response: as a transmission mechanism for sanctions being imposed; as a locus of the economic impact of the crisis; as a dynamic ecosystem that will evolve in response to structural change.

That said, it is also worth keeping in perspective the reduced — and at this point relatively limited — significance of the Russian economy on the global financial system. Russia represents under 2% of global banking assets. Foreign banking exposure to Russian borrowers is also modest at a little over $100 billion in assets and has halved since the annexation of Crimea in 2014. The first-order impacts on the global financial system are, therefore, likely to be contained, although the risk of contagion cannot be ruled out. The greater impact may be from broader second order geopolitical, macroeconomic, and systemic shifts that could emerge from the crisis.

We highlight 10 impacts that financial services leaders should be prepared for:

First-order impacts

1. Risks from managing a fast-moving and complex sanctions environment
2. Tough decisions on onshore Russian footprint
3. Challenges in liquidating or managing existing holdings of Russian securities
4. Credit exposure to the Russian economy, and broader contagion
5. Heightened cyber threats, requiring elevated defenses

Second- and third-order impacts

6. Disruption and divergence in macroeconomic outlook
7. Energy security at the fore, driving an uncertain path to net zero
8. Fragmentation in global market infrastructure
9. Development pathway of crypto, stablecoin, and central bank digital currencies (CBDCs)
10. Geopolitical reset with potential to reshape the policy environment

FIRST-ORDER IMPACTS

IMPACT #1
RISKS FROM MANAGING A FAST-MOVING AND COMPLEX SANCTIONS ENVIRONMENT

Never before have we seen such a significant economy be subject to such a comprehensive set of sanctions.

One of the most immediate impacts for financial institutions is the need to comply simultaneously with new sanctions regimes being drafted by each of the United States, United Kingdom, European Union, and other nations. These sanctions, while directionally the same, have some operational differences in terms of the speed and manner with which they're implemented. For multinational organizations these conflict-of-law challenges may ultimately force businesses to determine that effective risk management is too difficult, meaning they must consider exit options (see below).

It will be critical for firms to have a comprehensive understanding of any Russia-related nexus that exists across their operations and clients. Those who have not done so already will invest in a task force to track new sanctions, by country, in "real time." Firms will shortlist possible additional sanctions that are being mooted to improve preparedness and look at other regions where sanctions could be possible in the future to ensure agility in implementing them rapidly. Updating processes to feed new sanctions through from compliance teams to first, second, and third lines of defense will be necessary.

The precedent from this conflict sets entirely different boundaries than in any prior situation and could also lead to a future proliferation of similar sanctions in other conflicts, necessitating an ever-more-disciplined approach to sanctions implementation and monitoring.

IMPACT #2
TOUGH DECISIONS ON ONSHORE RUSSIAN FOOTPRINT

Financial institutions with a presence in Russia will face tough choices in the weeks ahead. Sanctions, exclusion from global market infrastructure, and shareholder and reputational pressure will make it increasingly difficult to maintain business operations onshore in Russia.

In particular for Western firms with operating subsidiaries in the country — including at least six large Western banks — the right path may be to exit, ideally in the context of a wind-down license to support loss mitigation. Some have already attempted such an exit. For some institutions, however, the scale of business with Russia will make a full exit difficult and a more nuanced approach will be required. Other financial institutions have local joint ventures that will need to be evaluated not just on their direct financial risks but also on their reputational risks. Remaining in Russia will be challenging — reputationally, legally, and economically — so for most the question will be what is the most expeditious exit route that preserves shareholder value and limits write-downs. In this regard, rapid action may be best.

IMPACT #3
CHALLENGES IN LIQUIDATING OR MANAGING EXISTING HOLDINGS OF RUSSIAN SECURITIES

Foreign investors are holding at least $150 billion in Russian securities. Sanctions, the termination of trading on the Moscow Stock Exchange, and the prohibition on the sale of securities on behalf of foreign holders, have effectively frozen Russian assets. Liquidity has plummeted and holders of these assets are unable to sell. Repatriation of proceeds is constrained due to the exclusion of a number of Russian banks from SWIFT. Furthermore, a number of international central securities depositories (ICSDs) have suspended trading in Russian securities, closing off an exit route for international investors.

A number of investors — including sovereign wealth funds — have announced that they will exit their Russian positions. MSCI has announced that it will exclude Russian securities from its indices, driving greater sell-offs from passive funds. But for now, there is no clear exit route. This will likely require write-downs on net asset values until exit routes become clear. For now, a number of funds have suspended redemptions of Russian-related funds.

The pressures are also affecting derivative markets. The lack of a liquid securities market limits the ability of market makers to price and risk manage derivative positions, further restricting the functioning of the financial system. While the impacts should be manageable (Russian equities represent less than 1% of European long fund investments), the risk of contagion remains.

IMPACT #4
CREDIT EXPOSURE TO THE RUSSIAN ECONOMY, AND BROADER CONTAGION

The tail risk event that is this war will test the systemic preparedness of the financial system, as well as the robustness of stress tests and resolution preparedness frameworks set up to deal with such events. The resolution of Sberbank Europe, a bank with almost 4,000 employees but only 13.6 billion euros in assets, likely foreshadows additional credit events.

Financial institutions have several credit exposures that they will need to evaluate rapidly:

- Direct exposures to the Russian financial and economic system via subsidiaries
- Exposure to Russian banks and financial institutions indirectly via the interbank market; or to other banks with exposure to the region

- Exposure to Russian sovereign debt via direct government bond holdings or derivative instruments. It is widely expected that there will be a future default on Russian government bonds. Missed coupon payments on 2nd March 2022 mean that some asset managers are treating the Russian government as in default in internal ratings.
- Exposure to Russian corporations and individuals, such as loans, credit lines, and insurance products. International funds have at least $150 billion of direct exposure to Russian assets
- Exposure to corporations who are themselves exposed to suppliers or raw materials from Russia and Ukraine or other affected regions
- Exposure to corporations who could be impacted by additional inflationary pressures and supply chain constraints

The interconnectedness of the global financial system means that one domino falling can lead to multiple unanticipated impacts. Some banks have, for several years, been running scenarios based on a Russian invasion of a neighboring county as part of a broader geopolitical scenario suite. The use of these scenarios, and consideration of second-order effects beyond direct counterparty exposures, is not widespread, however. Recent events should spur financial institutions to reconsider their approach to internal stress testing and scenario planning, and supervisors are likely to probe further on these impacts in the weeks to come.

The beginnings of the Covid-19 pandemic reminded leaders of the potential systemic impact of global events. Many set up dynamic “situation rooms” to update the inputs to credit models as the situation evolved — these should become standard features of credit risk practices in financial institutions, including mechanisms to work with policymakers to provide early warnings on potential contagion to help safeguard the financial system should events escalate further than expected.

IMPACT #5
HEIGHTENED CYBER THREATS, REQUIRING ELEVATED DEFENSES

Western intelligence agencies see a high risk of Russian state-sponsored cyber-attacks on Western critical infrastructure, including the financial system. Furthermore, opportunistic bad actors are already using the smokescreen of the conflict to launch cyber-attacks, and this is expected to continue.

In response, many banks have increased cyber drills, monitoring activities, and training and awareness initiatives — as well as increasing resource capacity to counteract potential successful attacks. Covid-19 has inadvertently helped prepare organizations, as these have improved cyber risk security strategies in the last couple of years. This is particularly true in financial services, where one-third of employees are now working remotely and hence require cyber security that was not as widespread prior to the pandemic. Improvements have also been made to third-party cyber security arrangements at financial institutions — accelerated especially by the 2020 SolarWinds hack.

Nonetheless, risks remain. Organizations will need to be well-practiced for potential incidents and vigilant in their surveillance and threat preparedness. Collaboration and information sharing across peers and with authorities is most important in times of heightened cyber security risks, and leaders will need to encourage their teams to work not just inward-facing but also with a view to what is happening across the broader ecosystem. For most large financial institutions, the risks of consequences from cyber-attack to the market infrastructure they use, or to their counterparties or suppliers is likely to be higher than the risk of a successful attack on themselves.

SECOND- AND THIRD-ORDER IMPACTS

IMPACT #6
DISRUPTION AND DIVERGENCE IN MACROECONOMIC OUTLOOK

Before the invasion, there was an increasing consensus that monetary policy had to tighten significantly to combat inflation. This consensus is likely to become stronger in the medium-term, due to inflationary pressures from higher energy prices and worsened supply chain conditions. Growth and inflation could also be boosted by increased defense spending and aid. Pushing in the other direction, broader credit impacts (as discussed in Impact #4) could put pressure on growth and necessitate a re-consideration of the trade-off with inflation in the near-term. Banks have positioned themselves for a consensus rise in rates but will need to remain alert to potential changes to this path given these unanticipated developments. The US and Europe are likely to diverge more than was expected previously.

It is likely that asset prices and liquidity in certain asset classes will be affected. This is of course true for FX markets and those directly linked to sovereigns and companies in the region, as discussed in Impact #3. It is also likely true of global commodity markets for wheat, oil, gas, aluminum, palladium, and nickel — which have substantial dependence on the affected region, despite current sanctions not targeting commodities directly. Furthermore, there could be secondary effects on assets related to countries and companies exposed to the above debt or commodities.

On the other hand, we believe it is unlikely that the direct effects of the conflict alone would change the underlying value of global equities materially, given the modest size of the Russian and Ukrainian economies. One must recognize, however, that markets are moved by sentiment as well and that this could precipitate sharper declines in the short run. Higher volatility has already been seen and could persist.

IMPACT #7
THE PRIMACY OF ENERGY SECURITY, AND AN UNCERTAIN PATH TO NET ZERO

European reliance on Russian oil and gas has proven to be a major strategic vulnerability. Europe depends on Russia for over one-third of its gas supplies and about one-third of these supplies transit through Ukrainian pipelines. The near-term cost is reflected in elevated energy prices, and urgent demand for non-Russian energy sources. Germany has paused the approval of the NordStream 2 gas pipeline that would bring Russian gas directly to Germany. National energy security — and reducing reliance on sourcing energy from non-allied states — will become a top priority for governments.

This development will have mixed effects on global commitments to reach net zero emissions by 2050. The reduced reliance on Russian oil and gas could spur faster development of renewable energy sources. Adoption of renewables will also elevate the importance of natural gas as part of the energy mix given challenges in storage and reliability of renewable sources; this may revive debates on domestic shale gas extraction, the build-out of liquid natural gas infrastructure, and a renewed interest in nuclear despite the unpopularity in some countries. Near-term, urgent need for replacement energy sources is likely to see spikes in coal consumption. Elevated oil prices may incentivize increased extraction of hydrocarbons in the near-term, such as US shale gas.

For financial institutions, this creates a complex path in delivering on net-zero commitments. In the near-term transition pathways may be impacted. In the medium term we could see an acceleration in demand for investment in renewables to achieve energy security. Equally, Western governments will require more investment in liquid natural gas infrastructure and gas storage to provide greater energy security. Europe will require financing at scale to support this transition, especially if required on an accelerated timeframe.

IMPACT #8
FRAGMENTATION IN GLOBAL MARKET INFRASTRUCTURE

Restrictions on access to the SWIFT network may trigger longer-term fragmentation of global cross-border payments networks. Russia has been developing an independent alternative (SPFS) since 2014, though it has limited adoption outside of Russia. More significantly, China has launched an alternative, the Cross-Border Interbank Payment System (CIPS). While it remains unclear whether China will permit Russian banks to use CIPS to circumvent sanctions (themselves risking breaching US sanctions), it is likely that the use of SWIFT as a political tool will accelerate the adoption of CIPS and alternative networks. The weight of US sanctions reflects the continuing dominance of the US dollar in global finance, but the rise of the renminbi could erode US leverage over time.

IMPACT #9
DEVELOPMENT PATHWAY OF CRYPTO, STABLECOIN, AND CBDC

There has been conjecture in recent days as to how cryptocurrencies are used in times of crisis, especially whether such cryptocurrencies might be used as an alternative settlement method to avoid sanctions. While crypto has grown quickly over the last few years, the reality is that when it comes to moving money at the scale that would impact this situation, cryptocurrency markets are small. There is also an argument that cryptocurrency transactions, even in decentralized public blockchains, are traceable and transparent, and it's likely that this crisis will provide a test arena on this point. With this extremely expanded use of sanctions as a geo-political force however, we can extrapolate more public attention to and potentially increased support for the broader regulation of cryptocurrencies.

Central bank digital currencies (CBDC) are already under launch, design, or consideration in many jurisdictions as a means to achieve several objectives, including trackability of the financial system, reserve currency status, control of the cross-border payments, and other features of finance. Policymakers might be leaning towards more centralized controls in their CBDC design choices, and public attention may create momentum for an accelerated CBDC implementation process.

IMPACT #10
GEOPOLITICAL RESET WITH POTENTIAL TO RESHAPE THE POLICY ENVIRONMENT

Within a few days, geopolitical dynamics have been turned upside down: Germany and Sweden, historically cautious in post-World War II European conflicts, have delivered weaponry into an active conflict zone; Switzerland has applied strong sanctions, despite a long-standing policy of neutrality; and European leaders speak in ever greater unison about strengthening collective security arrangements. Liberal institutions, it is fair to hope, may come out of this crisis with renewed resolve.

The importance of this "reawakening of Europe" — and the parallel realignment of Europe and the United States for the world's economic and financial structure — could yet become more material than anticipated today. "Europe," in the form of the Brussels-based institutions, may gain further powers and moral authority, with a spillover from defense and foreign policy to a new momentum for economic integration policies such as a European banking union.

There will almost certainly be strong implications for national politics, including the fate of current UK and US governments in upcoming domestic political battles. However, these implications are difficult to predict and will depend on the outcome of the war, the security and economic ramifications, and how those will translate into the popularity of politicians and parties.

What does all this mean for leaders in financial services? Participation choices financial institutions make, their geographic footprint, and their entity and booking structures will need to be reactive to potential geopolitical events. Firms that have begun pivoting away from Europe towards the faster-growing Asian and American markets may find that a more united European market would also present new opportunities for growth. Regulatory cooperation may also improve again, opening an opportunity for financial institutions to drive policymakers to increase regulatory consistency across allied countries.

WHERE NEXT: PIVOTING FROM FIRST ORDER TO SECOND ORDER ISSUE MANAGEMENT

It is unlikely, though not impossible, that the war in Ukraine will directly precipitate contagion and a financial crisis. However, we cannot be complacent and need to further strengthen monitoring and management of the situation across the system. And the focus has to start to move from first order to second order impacts which could be more consequential. Across the impacts we highlighted, there are some common themes that will necessitate actions from financial institutions and policymakers.

First, all players must ensure they have a highly coordinated "control tower" to manage the many threads of crisis response and handle the complex first- and second-order impacts detailed above. This includes coordinating with specific domains such as cyber risk mitigation, sanctions compliance, and credit risk management. What was fit as a control tower for weeks one and two will not be right for weeks three to six and beyond.

Second, it's clear we face a much wider range of potential macroeconomic and geopolitical outcomes over the next few years. Firms and policymakers need to immediately re-think their scenario planning. In the case of banks, that includes a wider set of stress scenarios feeding into planning and balance sheet management.

Finally, this is a time to collaborate more on broad policy issues, especially those that are national security-related, such as sanctions and cyber risk. Collaboration should be encouraged across peers, with regulators, and with policymakers, with a view to strengthening collective action. This war is also a good reminder that leaders of financial institutions will need to be active in shaping future market-structure changes as a result of the geopolitical shifts we discussed and strengthen their emphasis on government relations.

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