(U) INTRODUCTION

(U//FOUO) In accordance with Section 242 of Public Law 115-44 (P.L. 115-44) ("Countering America's Adversaries Through Sanctions Act" (CAATSA)), the U.S. Department of the Treasury, in consultation with the Department of State and the Director of National Intelligence, was tasked with preparing a report addressing the potential effects of expanding sanctions under Directive 1 issued under Executive Order (E.O.) 13662 to include sovereign debt and the full range of derivative products.[1]

(U//FOUO) The following report provides analysis of the potential effects of expanding Directive 1 as outlined in Section 242 of CAATSA to include *new* sovereign debt and the full range of related derivatives. As such, the following analysis excludes the implications of prohibiting dealing in *existing* issuances of sovereign debt or existing derivatives. The report has three sections: 1) an overview of the current sanctions program, 2) a description of Russia's economy and existing sovereign debt and derivatives market, and 3) analysis of the potential effects of expanding Directive 1 to include new sovereign debt and derivative products on U.S. and international markets and the Russian government and economy.

(U//FOUO) This release of this report is not a sanctions action and does not constitute public guidance regarding the implementation of new sanctions. Additionally, this report does not represent a change in sanctions policy toward Russia.

(U) SECTION I

(U) Existing Debt and Derivative Restrictions

(U//FOUO) In response to Russia's invasion and occupation of Ukraine in 2014, President Obama declared a national emergency in E.O. 13660 and imposed sanctions on entities and individuals engaged in specified activities related to Ukraine. President Obama expanded the scope of the national emergency in subsequent Executive orders, including E.O.13662 of March 20, 2014 ("Blocking Property of Additional Persons Contributing to the Situation in Ukraine"), which blocked the property and interests in property of any person determined by the Secretary of the Treasury, in consultation with the Secretary of State, to operate in sectors of the Russian economy selected by the Secretary of the Treasury, in consultation with the Secretary of State.

(U//FOUO) Pursuant to the authority provided by E.O. 13662, and following the Secretary of the Treasury's determination under section 1(a)(i) of the Order with respect to the financial services sector of the Russian Federation economy, the U.S. Treasury Department issued Directive 1 on July 16, 2014, which prohibited U.S. persons from transacting in, providing financing for, or otherwise dealing in new debt of longer than 90 days maturity or new equity of persons determined to be subject to Directive 1, their property, or their interests in property. On two subsequent occasions, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) has issued amended versions of Directive 1, reducing the tenor of allowable new debt in

[1] (U//FOUO) This report is explanatory only, does not have the force of law, and is not a legally binding interpretation of the provisions of CAATSA.

each instance (the September 12, 2014 version reduced the tenor from 90 to 30 days, and the September 29, 2017 version reduced the tenor from 30 to 14 days).[2] The prohibition on dealing in proscribed new debt also applies to any transaction processed to or through the United States, by non-U.S. persons. Currently, these prohibitions do not apply to the sovereign debt of the Russian Federation.

(U//FOUO) In the Ukraine/Russia-related sanctions program, OFAC has considered dealing in derivatives linked to proscribed new debt to be equivalent to dealing in the underlying new debt. Directive 1 consequently prohibits U.S. persons from dealing in derivatives linked to new debt with maturity periods in excess of the applicable authorized tenor. To mitigate undue disruption to the derivatives markets, however, and to prevent unintended consequences, OFAC issued General License No. 1 – currently General License No. 1B, following two rounds of updates to maintain consistency with the updates to the authorized tenures under Directive 1 – authorizing all transactions by U.S. persons and transactions within the United States involving, among other instruments, derivative products whose value is linked to an underlying asset that constitutes debt of longer than the applicable authorized tenor issued by a person subject to Directive 1. Thus, while Directive 1 prohibits U.S. persons from dealing in specified new debt, General License 1B authorizes U.S. persons to deal in derivative products that are related to such new debt. The general license does not, however, authorize other transactions involving such debt, such as the holding, purchasing, or selling of such debt.

(U) **SECTION II**

(U) <u>Russian Macroeconomic Environment</u>

(U//FOUO) Following two years of recession, due in part to falling oil prices and Western sanctions, the Russian economy rebounded in 2017. Prudent Russian government monetary and fiscal policies have brought inflation down and reduced the fiscal deficit while also maintaining a low level of public debt. However, the medium-term outlook for the economy remains muted due to underlying structural weaknesses in Russia's domestic economy and continued sanctions pressure by the United States and EU.

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[2] (U) The modifications to Directive 1 made on September 29, 2017 were required by Section 223(b) of CAATSA, and as required by that section, took effect on September 29, 2017, the authorized tenor for new debt issued on or after November 28, 2017 is 14 days or less. U.S. persons are therefore prohibited from dealing in new debt issued by, on behalf of, or for the benefit of persons operating in Russia's financial sector named under Directive 1, their property, or their interests in property if the debt's maturity period exceeds 14 days. Other tenors apply to debt issued between July 16, 2014 and November 28, 2017. Directive 1 also includes a prohibition on dealing in new equity issued by, on behalf of, or for the benefit of persons operating in Russia's financial sector named under Directive 1, their property, or their interests in property. This report does not further address the equity prohibitions of Section 242 of CAATSA.

(The following graphic is classified U//FOUO)

Table 1: Russia Macroeconomic Indicators, 2013-2021	2013	2014	2015	2016	2017 (f)	2018 (f)	2019 (f)	2020 (f)	2021 (f)
Nominal GDP (Bil, RUB)	73,134	79,200	83,233	86,044	92,537	97,942	103,385	109,158	115,222
Nominal GDP (Bil, US$)	2,297	2,064	1,366	1,283	1,469	1,523	1,586	1,653	1,725
Real GDP Growth (y/y %)	1.8	0.7	-2.8	-0.2	1.8	1.6	1.5	1.5	1.5
Inflation (EOP, y/y %)	6.5	11.4	12.9	5.4	4.0	4.0	4.0	4.0	4.0
Fiscal Deficit (% GDP)	-1.2	-1.1	-3.4	-3.7	-2.1	-1.5	-1.0	-0.5	0.3
Gross Debt (% GDP)	12.7	15.6	15.9	15.6	17.4	17.7	18.2	18.2	18.0
Current Account (% GDP)	1.5	2.8	5.0	2.0	2.8	3.2	3.6	3.8	3.9
Reserves (EOP, Bil US$)[1]	510	385	368	378	425	N/A	N/A	N/A	N/A
Crude Oil (US$/Barrel)[2]	104	96	51	43	50	50	51	51	52

Source: International Monetary Fund, Central Bank of Russia

1. As of January 2018

2. International Monetary Fund forecasted average prices

(U) Russian Sovereign Debt and Derivatives Market

(U//FOUO) The Russian sovereign debt and derivatives market is one of the largest among emerging markets and continues to attract international investors. Russia's sovereign debt consists primarily of ruble denominated bonds (referred to as "domestic" throughout this report) and foreign currency denominated bonds (referred to as "external" or "Eurobonds"[3] throughout this report), many of which trade actively on international markets.[4] Derivatives related to sovereign debt consist of a variety of instruments, including currency derivatives, interest rate swaps, and credit default swaps (CDS), which Russian and international investors use to manage market risk and speculate on market movements. In addition to Russian CDS, which explicitly reference Russian sovereign debt, sovereign debt investors use currency and interest rate swaps to hedge against interest rate and currency risk inherent in bonds.

(U) *Russian Sovereign Bonds*

(U//FOUO) The total stock of sovereign bonds issued by the Russian Federation at the end of the third quarter of 2017 (3Q2017) was equivalent to $160 billion, of which domestic debt was $122 billion and Eurobonds were $38 billion (see Table 2 below).[5] Domestic bonds outstanding consist almost exclusively of Federal Loan Obligations (OFZs), which are medium to long-term bonds that primarily offer a fixed coupon. OFZs are the primary instrument used to finance Russia's budget deficits and manage banking sector liquidity. Russia issues Eurobonds primarily to raise foreign currency for the purpose of building currency reserves, servicing external debt and import obligations, and to maintain visibility with foreign investors, particularly in Europe, who have been a traditional source of foreign investment for Russia. Foreign investors are essential participants in both the domestic and external bond markets and hold approximately one-third of the outstanding bonds in each market. Publically available information obtained

[3] (U) Eurobonds, despite their name, can be denominated in any foreign currency. The term simply refers to bonds denominated in a currency that is not local to the issuer. Most Russian Eurobonds are denominated in U.S. dollars.

[4] (U//FOUO) In addition to bonds, Russia's public debt stock consists of bilateral and multilateral loans, and guarantees provided to state-owned enterprises. For the purposes of this report, with the exception of data tables, we exclude loans and state guarantees, as they are not generally tradable instruments.

[5] (U//FOUO) Data for this report is as of January 2018.

from Bloomberg as to which entities own this debt only accounts for 8 percent of the total share of all Russian Eurobonds and OFZs outstanding, leaving a large data gap as to the remaining holders.

(The following graphics are classified U//FOUO)

Table 2: Public Debt of the Russian Federation, 2013-2019 *(Bil. US$)*

Domestic	*2013*	*2014*	*2015*	*2016*	*2017 (f)*	*2018 (f)*	*2019 (f)*
Bonds	**135.4**	**97.3**	**76.5**	**100.6**	**121.8**	**140.5**	**158.9**
o/w OFZ [1]	*114.1*	*83.4*	*68.5*	*92.9*	*113.2*	--	--
% of Total Public Debt	*49.5%*	*45.6%*	*45.6%*	*50.7%*	*55.4%*	--	--
o/w Other [1,2]	*21.3*	*13.9*	*8.0*	*7.7*	*8.6*	--	--
State Guarantees	**39.4**	**31.4**	**23.8**	**31.4**	**31.2**	**36.0**	**37.5**
Total	**174.8**	**128.7**	**100.3**	**131.9**	**153.1**	**176.5**	**196.3**
External	*2013*	*2014*	*2015*	*2016*	*2017 (f)*	*2018 (f)*	*2019 (f)*
Eurobonds	**40.7**	**39.3**	**35.9**	**37.6**	**38.2**	**41.1**	**43.2**
% of Total Public Debt	*17.6%*	*21.5%*	*23.9%*	*20.5%*	*18.7%*	*17.6%*	*16.9%*
Loans & Other [3]	**3.7**	**3.0**	**2.2**	**1.9**	**1.3**	**1.5**	**1.3**
State Guarantees	**11.4**	**12.1**	**11.9**	**11.7**	**11.7**	**14.1**	**15.2**
Total	**55.8**	**54.4**	**50.0**	**51.2**	**51.2**	**56.7**	**59.8**
Total Public Debt	*2013*	*2014*	*2015*	*2016*	*2017 (f)*	*2018 (f)*	*2019 (f)*
Total	**230.6**	**183.1**	**150.3**	**183.2**	**204.3**	**233.2**	**256.1**
% of GDP	*10.6%*	*13.2%*	*13.5%*	*13.2%*	*14.6%*	*14.9%*	*15.3%*

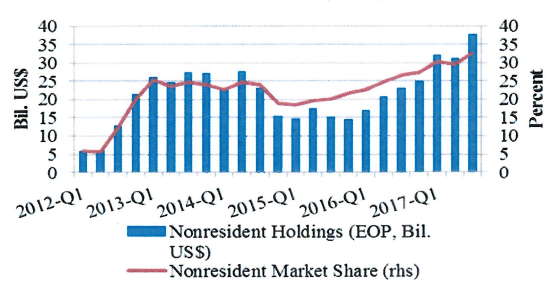
RUB 60.66/USD, 2015: RUB72.88/USD, 2014: RUB 56.26/USD, 2013: RUB 32.73/USD

[1.] As of third quarter 2017

[2.] Other sovereign domestic bonds issued by the Russian Federation

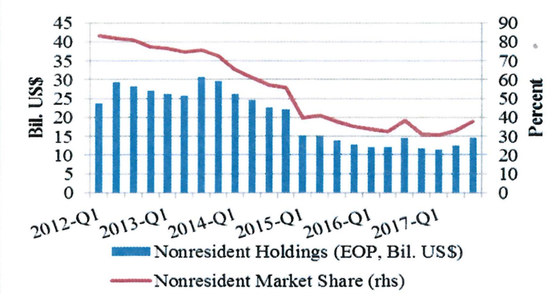
[3.] Includes loans due to foreign governments, multilateral banks, and other bonds

Graph 1: Nonresident Holdings of Federal Bonds (OFZ)



Source: Central Bank of Russia

Graph 2: Nonresident Holdings of Eurobonds



Source: Central Bank of Russia, Ministry of Finace

(U//FOUO) According to public information from the Russian Finance Ministry, Russia plans to issue roughly $17 billion annually in net new domestic bonds to finance its fiscal deficits over 2018-2019, but to taper issuance beyond 2019 as the Russian budget comes into balance.[6] On the external side, Russia's persistent current account surplus, supported by energy exports, its ample foreign exchange reserves, and its manageable schedule of dollar-denominated bond redemptions limit the need for Eurobond issuance in upcoming years. However, Russia plans to continue to maintain a presence in this market to support a benchmark yield curve and to reach new investors. Future external debt issuances will continue to be primarily denominated in U.S. dollars.

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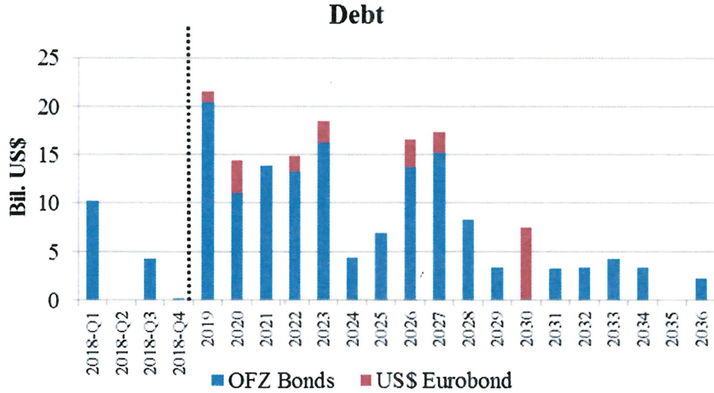
[6] (U//FOUO) The Ministry of Finance of the Russian Federation, *Public Debt Management Policy of the Russian Federation for 2017-2019*, March 2017.

(The following graphic is classified U//FOUO)

Graph 3: Maturity Schedule of Sovereign Bond Debt



Source: Bloomberg, Treasury staff calculations

(U) *Russian Derivatives Market*

(U//FOUO) The derivatives market in Russia is utilized by banks, large institutional investors (e.g. major western mutual funds, hedge funds, pension funds, and insurance companies), and other corporations to hedge market risks, such as currency and interest rate fluctuations, to hedge against the risk of Russia defaulting on its OFZs and Eurobonds, and to speculate on market movements. According to the Bank for International Settlements (BIS), global banks' derivative contract exposure to Russian counterparties totaled over $2.7 billion in the third quarter of 2017, down from $4.3 billion in the third quarter of 2016 (a 37 percent decrease) (see Table 2 below). Although the precise characteristics of these derivative contracts is unclear, the vast majority of these contracts likely reference rubles or Russian interest rates. Reported U.S. derivative exposure to Russian counterparties is also down. U.S. derivative exposure in the third quarter of 2017 totaled $205 million compared to $445 million in the third quarter of 2016, a 54 percent decrease. European derivative exposure has also fallen, reaching approximately $1.7 billion in the third quarter of 2017, a 33 percent decrease from the third quarter in 2016.[7]

(U//FOUO) Importantly, BIS data does not precisely capture the size and scope of the market for Russian interest rate, currency, and credit derivatives market as it only notes exposure of reporting banks. As many of these contracts are traded over-the-counter or not reported, accurate measures of total notional outstanding are not available for most products. However, the International Securities and Derivatives Association (ISDA) estimates that the gross outstanding notional value of CDS that references Russian sovereign debt was $72 billion as of December 2017.

[7] (U//FOUO) European derivative data is based on reporting banks in France, Germany, Italy, and the United Kingdom.

(The following graphic is classified U//FOUO)

Table 3: Notional Derivative Exposure to Russian Counterparties *(Bil. US$)*

	2012	*2014*	*2015*	*2016*	*3Q2017*
All Reporting	**3.0**	**11.3**	**4.9**	**3.7**	**2.7**
United States	1.2	2.3	0.8	0.3	0.2
France	0.6	3.0	1.2	0.8	0.7
Germany	0.2	0.7	0.1	0.1	0.0
Italy	0.0	0.1	0.0	0.6	0.6
United Kingdom	0.5	2.5	1.6	0.9	0.4

Source: Bank for International Settlements; End of Period

(U) **SECTION III**

(U//FOUO) Expanding Directive 1 to include dealings in new Russian sovereign debt and the full range of related derivatives would likely raise borrowing costs for Russia; prompt Russian authorities to alter their fiscal and monetary strategies; put downward pressure on Russian economic growth; destabilize financial markets, including Russia's repurchase market, which is critical for overnight bank funding; increase strain on Russia's banking sector; and lead to Russian retaliation against U.S. interests. However, because Russia's economy has extensive real and financial sector linkages to global businesses and investors, the effects of the sanctions would not be limited to Russian authorities and businesses. In particular, expanding sanctions could hinder the competiveness of large U.S. asset managers and potentially have negative spillover effects into global financial markets and businesses, although competitive distortions could be partially mitigated if the EU implemented similar sanctions. Expanding U.S. sanctions to include dealings in new Russian sovereign debt without corresponding measures by the EU and other U.S. partners could undermine efforts to maintain unity on Russia sanctions. Given the size of Russia's economy, its interconnectedness and prevalence in global asset markets, and the likely over-compliance by global firms to U.S. sanctions, the magnitude and scope of consequences from expanding sanctions to sovereign debt and derivatives is uncertain and the effects could be borne by both the Russian Federation and U.S. investors and businesses.