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Lessons from the Ukraine crisis

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The Ukraine crisis has presented unprecedented challenges to the finance sector. We explore the issues raised by the Western political response to the conflict, as well as Russian countermeasures, then look at how financial institutions can manage the resulting risks.

Future developments in Ukraine and the finance sector

The UK, EU and US have utilised sanctions and financial penalties targeting the Russian economy with unprecedented breadth, speed, and coordination in response to the Ukraine crisis. These actions represent the developing trend of the large-scale proliferation of sanctions and trade controls by states in response to global developments. For example, geo-political factors also triggered China to strengthen its sanctions countermeasures in light of US-China tensions. Global companies should be prepared to deal with the complexity arising from Russia and China related sanctions and counter-measures for some time to come. We have shared our insights on recent events on our Ukraine hub.

Rapid economic sanctions and other restrictions on Russian financial institutions (such as the removal of Russian banks from SWIFT) have been followed by long-term measures to move away from dependency on Russian energy and defence resources. For example, the UK recently announced its intention to phase out the import of Russian oil over the current year. The EU has also confirmed its sixth round of sanctions to limit dependency on Russian oil. These and similar steps by many states have added further uncertainty to the geo-political landscape, particularly the feasibility of the path to net-zero targets with states replacing Russian fossil fuels with local alternatives in turn jeopardising their own low emission targets. Nonetheless, in the long term, the war in Ukraine may accelerate green ambitions as leading nations look to move away from reliance on fossil fuels.

The conflict has also acted as a catalyst for regulators' ongoing efforts to strengthen financial crime defences, especially anti-money laundering (AML) laws against entities and individuals linked to Russia. The ECB has requested details of banks' internal assessments and contingency plans including financial crime measures. The UK's Economic Crime Act 2022 enhances

AML requirements in the business sector. The FCA also issued a reminder that exploiting crypto-assets to circumvent economic sanctions is a criminal offence under AML regulations, and we predict the use of cryptocurrencies as part of financial crime will continue to come under increased scrutiny. US regulators, such as FinCEN, have also focused on AML compliance as a tool for enforcing Russia-related sanctions. In this context, the risk of handling proceeds of crime comprising funds transferred in breach of sanctions may require financial institutions to enhance their systems and controls to avoid penalties for failing to have sufficient safeguards in place.

Collateral consequences have also flowed from the Ukraine crisis and the G8 counter-response, creating further difficulties for financial institutions; the sector is also tackling market volatility, commodity price increases and supply chain disruption. There are also ongoing cybersecurity risks. The US government has issued warnings that the critical infrastructure sector, including financial services, is most likely to fall victim to cyber-attack, while the UK FCA has sent a direct "Dear CEO" message warning of the heightened risk of cyber threats as a result of the conflict. There are also looming fears of a Russian default on foreign debt in the future, similar to the significant default of the late 1990s.

Russian countermeasures and reactions

In light of Western sanctions, Russia continues to escalate penalties imposed upon those complying with foreign measures and is considering further countermeasures. These include:

- raising hurdles for those pursuing strategic exits from the region including the prior approval of the relevant authorities for such exits, alongside steps to mitigate the devaluation of the national currency.

- proposing to criminalise compliance with Western sanctions (*the relevant bill is still pending*) by imposing significant fines and prison terms of up to 10 years for adhering to Western sanctions in the country.
- nationalising assets (*the relevant bill is still pending*). Proposed reforms include giving the Russian government temporary control of businesses exiting the country where foreign ownership based in “unfriendly” states exceeds 25%.
- prohibiting certain transactions between Russian entities and foreign parties without approval.

Reactions to these measures in different jurisdictions should be closely monitored. As we have explored in earlier editions, we are seeing the tension between convergence of certain states contrasting with policies by other states in response.

What’s next?

In the fast-moving environment of sanctions imposition and counter-responses, financial institutions should prepare for a continued period of geo-political uncertainty. Challenges arising from dealing with Russian assets must be considered alongside heightened regulatory scrutiny and protecting employees against sanctions liability. An opaque area that should not be neglected is the emerging policies of Asia-Pacific states that may added further complexity to the crisis in due course.

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Areas of focus for financial institutions

In response to the conflict, areas of focus for financial institutions should include assessing the following issues (amongst others):

1. *Revisiting investment portfolios*. When assessing market participation, institutions should be aware that simple engagement in otherwise routine activities such as payment of dividends, share repurchases and new equity issuances could lead to a breach of sanctions measures. We assess the implications for UK listed companies in a blog on these issues.

2. *Contractual principles*. The risks of parties attempting to circumvent contractual obligations and, on the other hand, the need to exit contracts due to illegality and regulatory obligations should be considered by all businesses affected by the conflict. Our recent blog assesses arguments of illegality and force majeure to anticipate in light of the ongoing situation.

3. *Financial crime risk*. There is no doubt that immediate action on sanctions compliance and mitigation of related litigation risk

is essential. In addition, it is necessary to ensure adequate systems and controls to address the evolving AML challenges (particularly with the increasing risk of funds transferred in breach of an expanded range of sanctions) and crypto-asset risks. A broad and cautious interpretation of governmental guidance may be an effective way to respond, although there remain complex issues to resolve, and uncertainty is inevitable.

4. *Operational resilience and cybersecurity*. The heightened risk of cyberattacks and the potential disruption to payment systems require an increased focus on elevating operational defences (including business continuity and third party exit plans), reassessment of outsourcing arrangements and ongoing analysis of the appropriateness of certain operations. The FCA has released new guidance on points to consider regarding cyber resilience and President Biden's statement confirms US efforts to improve domestic cybersecurity frameworks.

5. *Compliance with regulatory guidance*. As the conflict continues, regulatory guidance is constantly updated and revised and thus must be monitored. The ESMA, for example, issued a statement underlining its supervisory role in coordinating the EU regulatory response, drawing attention to managing market volatility, CRA transparency, investment management, cyber security and risk assessments. The EBA similarly also called for financial institutions to ensure compliance measures are reassessed, encouraging careful consideration of short and longer-term risks such as economic uncertainty and vulnerabilities regarding cyberattacks and business continuity plans.

6. *Consumer protection*. Financial institutions should consider assessing steps to protect consumers affected by the crisis as this area poses significant reputational and regulatory

enforcement risks. The EBA recently called on financial institutions to provide access for Ukrainian refugees to the EU's financial system as part of wider consumer protection efforts. Such measures have included a recommendation by the European Council which endorsed the conversion of Ukrainian banknotes into the local currency of member states. As such, financial institutions may consider efforts to ensure the financial system is accessible to those fleeing the region in response to the conflict.

7. *Reassessment of ESG and defence investment*. Several banks have overhauled their sustainability policies, for example excluding certain defence and energy stocks from their investment funds. Banks and fund managers should remain aware of the nuances of ESG and defence pressures, taking care not to contravene international conventions by supporting particular classes of investment. For example, pension scheme trustees may reassess their investment portfolios in light of developments before employees and shareholders begin to raise difficult questions.

8. *Dispute management*. Where disagreements do arise, institutions may wish to consider alternative dispute resolution as well as litigation strategies both in the short and long term. Russian courts remain unfavourable to overseas investors, meaning overseas forums, anti-suit injunctions and BIT arbitration are potentially necessary tools to contemplate. Protective measures such as injunctions may protect assets against expropriation and/or devaluation. Whilst investment treaty protection may be an effective way to manage risk and recoup damages, companies should be careful not to act in a manner that hinders prospects of a successful claim in the future. Financial institutions should also be aware of the risk of claims from within Russia and Ukraine, as evident from the US

Government facing two ICSID claims by companies linked to the conflict.

To manage the continued disruption triggered by the evolving macroeconomic and political landscape, review insights on our Ukraine hub, Risk blog posts and FS insights newsletters. For insights on other financial services topics, you can review our earlier editions here.

If you would like to provide feedback on this or other editions, please contact Laura Feldman.