SCOPE

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Two weeks ago, I wrote that European banks should consider pulling out of Russia and Russian business[1]. The writing was already on the wall as most Western businesses – with some notable exceptions – were already moving out of Russia, from oil, food and beverage, consumer goods, electronics and technology to insurance, auditing, cards and payments, media and entertainment.

In the last 10 days or so, most Western banks have either announced or hinted that they will be doing exactly that. For me, pulling out of Russia and exiting Russian business is the only sensible option, given the wanton destruction Vladimir Putin is raining on Ukraine. Helping the banks make the decision to quit is the fact that as the rouble melts down, Russia's economy craters and its financial system stumbles, the days of high profits from banking activities with only modest local risks will be gone and won't come back any time soon.

Exiting Russia becomes a must

In practical terms, carving Russia out of European banking will be far easier than carving it out of European energy. Both are necessary. No bank domiciled in a democratic free-market economy should even consider current-day Russia as a suitable place to conduct activities and make profits. I lay out several reasons why.

1. As Russia's war and potentially longer-term occupation of Ukraine (even if partial) continue, there could be fewer controls on the true destination of business loans extended in Russia by Western banks indirectly through local subsidiaries or directly through cross-border facilities. Neither European nor US banks would presumably knowingly finance the country's defence sector. But as opacity, tension and misinformation intensify, more Russian private businesses may be pulled willy-nilly, even indirectly, into the Russian State's vast war and disinformation effort.

2. A portion of the liquidity of Russian bank subsidiaries consists of Russian public-debt holdings (carrying AAA ratings from local rating agencies). This explicitly means that such funding is contributing to the financing of the invasion of Ukraine. The same rationale is true for international investors and banks holding

[1] https://bit.ly/3JB7p3u

domestic and foreign-currency Russian sovereign and parastatal bonds.

3. The same argument goes for the taxes Western banks pay on their subsidiaries' profits and activities.

4. As most Western businesses pull out, those staying behind (including the occasional European bank) could be flagged for propaganda purposes by the Kremlin ("they chose to stay because they are unbiased, unlike the others"). As someone born and spending formative years in a Soviet-bloc totalitarian system, I know such a scenario is not just plausible but very likely.

5. Concerns about employees and customers "left behind" do not hold water. The most likely scenario if the Western parent walks away is for the Russian bank left behind to be acquired by a local competitor or nationalised rather than be liquidated and shut down. Especially since the Western bank subsidiaries have been profitable and relatively well managed entities, not zombies.

6. European and US banks with material Russian businesses should be very concerned about the detrimental impact these will have on their image with core constituencies – customers, counterparties and investors in their home or core foreign markets. Banks have struggled hard, and in large part succeeded during the pandemic years, to shed the bad-actor reputation they had during and after the Global Financial Crisis.

Being seen as indifferent to what is happening to Ukraine will not help their image. Merely posting statements of solidarity will not cut it. Notably when facing social media, coupled with heightened social and political activism especially among Millennial and Gen Z bank customers. At a time when, in the digital age, changing banks is easier than ever.

In fact, concern about brand image with a large range of stakeholders is valid not just for international banks with a physical presence in Russia but also for those engaged in Russia-related activities elsewhere. This is a much larger group and covers a wide range of business activities, including not just standard corporate and investment banking but also the financing of Russian oligarchs and top politicians. Many of these transactions and activities are inherently opaque. Nevertheless, they will affect banks' image if they become transparent. And they will, as politicians, policymakers and investigative journalists are in overdrive on the topic.

Another area which remains highly fuzzy, with only scarce financial information publicly available, is the trading of Russian-generated commodities – oil, base metals, grains – through commodity dealers. Many of these dealers are based in Switzerland and the business remains brisk, often financed with bank letters of credit and other credit facilities. Besides being opaque, these transactions are insufficiently regulated as financial activities. In addition, as most of these commodity traders are privately held, the ultimate owners are not easily identifiable.

The S in ESG needs retrofitting

The scenario of an illegal and lethal invasion by one country of another seems to have been overlooked when ESG principles were drafted. This needs to be looked at.

In general, the ESG focus related to banks is heavily leaning towards the overwhelming challenge of climate change. This reflects our societies' concerns about the climate and the natural environment, and the way institutions and markets adjust their lending and investments towards these global goals.

But at the same time, banks' ESG focus includes social goals. This is reflected in their ESG disclosures, although the S accounts for a far smaller slice than the E. Nevertheless, it is there, and it matters.

Regarding social aspects, most banks disclose details about diversity and inclusion related to staff, management, and the board of directors. Many also refer to priorities related to their responsibilities towards the customers and communities they serve. Some banks just list aspirational goals: affordable housing, access to essential services, employment, food security, socioeconomic empowerment etc. Others are more specific, with numeric targets for social projects such as building digital skills and employability skills for women. Identifying and addressing social ills – modern slavery, forced labour, or human trafficking – is a key priority.

But the right to peacefully live, work, and raise a family in your country within internationally recognised borders and not become a victim of destructive aggression by a hostile foreign power is perhaps the most fundamental human right.

Banks and companies need to seriously reflect on how to adjust ESG targets to the tragic situation brought about by Russia's invasion of Ukraine. Such a situation would be defined by analysts and commentators simply as geopolitical risk. From the ESG angle, however, it should get much more personal than that, for banks and markets.

One additional avenue could be for banks to establish a roster of blacklisted companies with which they would not do business and publish it. KBC does exactly that, listing companies "involved in controversial weapon systems and companies considered worst offenders of UN Global Compact Principles". The largest number of such companies are from China, India, Russia, and the US, but many other countries are also represented. The concept of blacklisting by banks could be broadened and adjusted, potentially including specific countries according to specific actions they undertake, based on criteria spelled out publicly in advance.

For a country and a regime hell-bent on engaging in foreign aggression, knowing that its financial system will be decimated – including by the departure of key institutions from its domestic market – is probably not a key element of deterrence. But equally, it is not entirely inconsequential.

A refreshing approach by ECB Banking Supervision

As a postscript, I was pleasantly surprised by the presentation given by Andrea Enria, ECB's chief bank supervisor, at a recent European financial conference[2]. As a rule, presentations by senior regulators at investor events tends to be relatively general, not always open and informative, and hedging a lot of bets. Especially when they relate to events that are still developing and for which they believe an abundance of caution in communication is required. The effect of the invasion of Ukraine on the euro area (EA) banking system clearly fits the definition of such an event.

However, Mr. Enria's presentation was anything but. It was transparent, informative and explicit and addressed investors' main concerns head on. When it comes to being helpful to investors and other market participants interested in the banking sector, ECB Banking Supervision appears more transparent and informative than other major supervisors. Which is a plus, mainly when the market fears another banking downturn created by the impact of Russia's war. The presentation highlighted the following:

- EA banking sector performance improved in 2021 and asset quality-deterioration was contained, with cost of risk below pre-pandemic levels: sector CET1 was at 15.5%, NPLs at 2.2%, RoE at 7.2% (Q3 2021).
- Markets have been pricing uncertainty related to the Ukraine invasion, but the sector's

[2] https://bit.ly/3LboOjM

exposure to Russia appears contained. Even an extreme walk-away by EA banks is manageable given their solid capital levels.

- The Russia exposure of non-bank financial institutions also appears manageable, as is market volatility that could trigger counterparty credit risk (margin call) losses.
- Cyber risk remains a clear threat but no major events so far.
- Headwinds to EA growth are likely, due to soaring energy prices and rising inflation risks for 2022.
- Capital distributions – share buybacks and dividends – are acceptable for those banks that can preserve sound capital targets, including minimum thresholds (management buffers) above supervisory requirements.

The clarity and promptness of the last point was appreciated by the market based on subsequent comments and positive share-price trajectories.

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