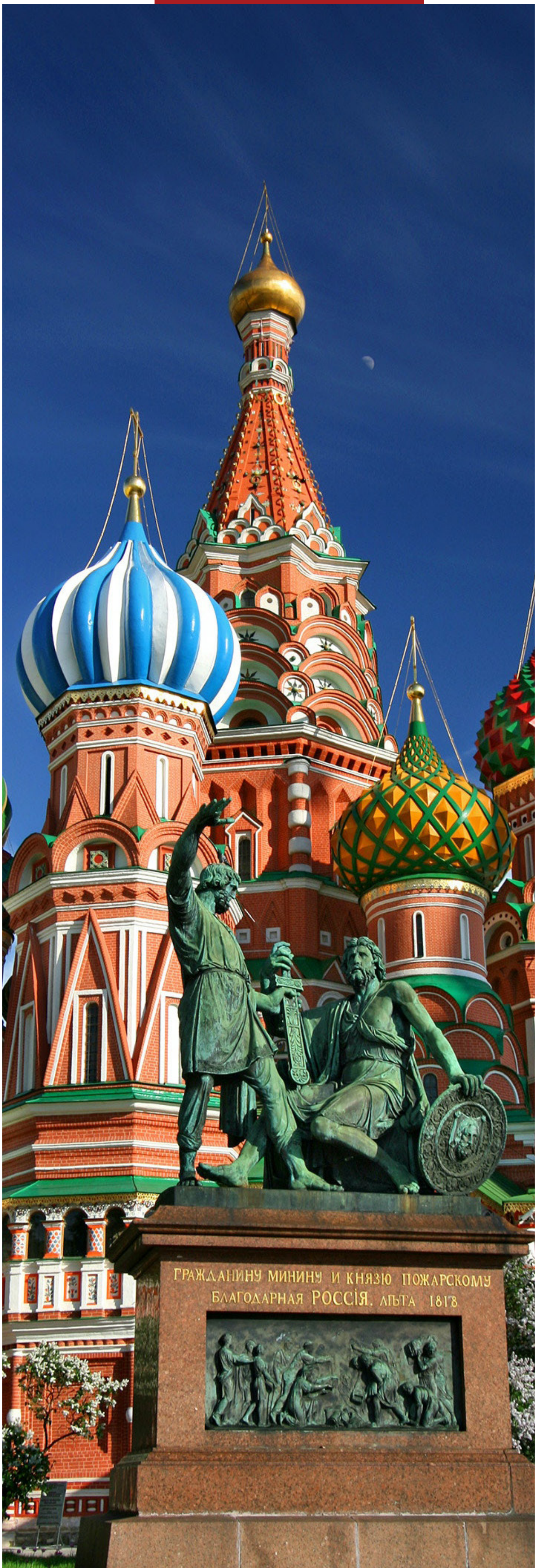
Agpaytech's Research
30th September, 2022

Dedollarisation of Russian Energy Trading:

Implication of Payment Flow and Settlement in Ruble



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Introduction

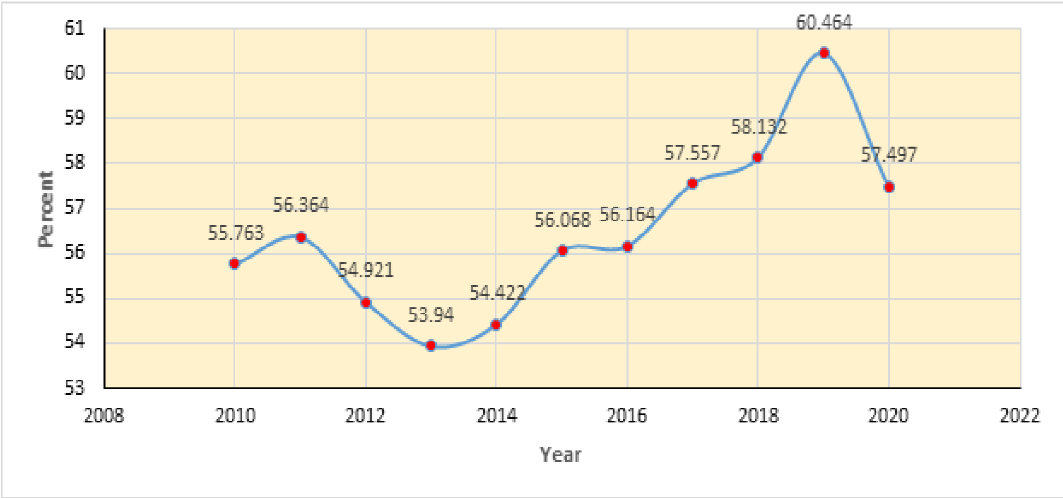
The global energy trading market experienced unusual demand growth in 2022 largely due to Russia's invasion of Ukraine on 24 February. Besides the colossal human tragedy, the invasion caused a major energy supply and demand crisis, impacting the global and regional economies. The high price and tight supply environment that built up during the Russia-Ukraine war was disrupted badly when the European Union (EU) imposed a series of sanctions against Russia in March.

Today's record prices and supply disruptions are damaging the reputation of natural gas as a reliable and affordable energy source, casting uncertainty on its prospects, particularly in developing countries where it had been expected to play a growing role in meeting rising energy demand and energy transition goals. Global gas consumption is forecast to contract slightly in 2022, with limited growth over the next three years, resulting in a total increase of about 140 bcm between 2021 and 2025 (Gas Market Report Q3, 2022).

The Paradigm Shift in Russia's Energy Reliance

In the EU in 2020, the dependency rate was equal to 58%, which means that more than half of the EU's energy needs were met by net imports (Eurostat, 2022). Russia is the main EU supplier of crude oil, natural gas and solid fossil fuels. In 2020, almost three quarters of the extra-EU crude oil imports came from Russia (29%), the United States (9%), Norway (8%), Saudi Arabia and the United Kingdom (both 7%) as well as Kazakhstan and Nigeria (both 6%). A similar analysis shows that over three quarters of the EU's imports of natural gas came from Russia (43%) according to Eurostat. The drop in Russian pipeline supplies continued in H1 2022, falling by 30% year on year. Gazprom's unilateral supply cuts to several EU member states in Q2 further contributed to lower deliveries and heightened market uncertainty.

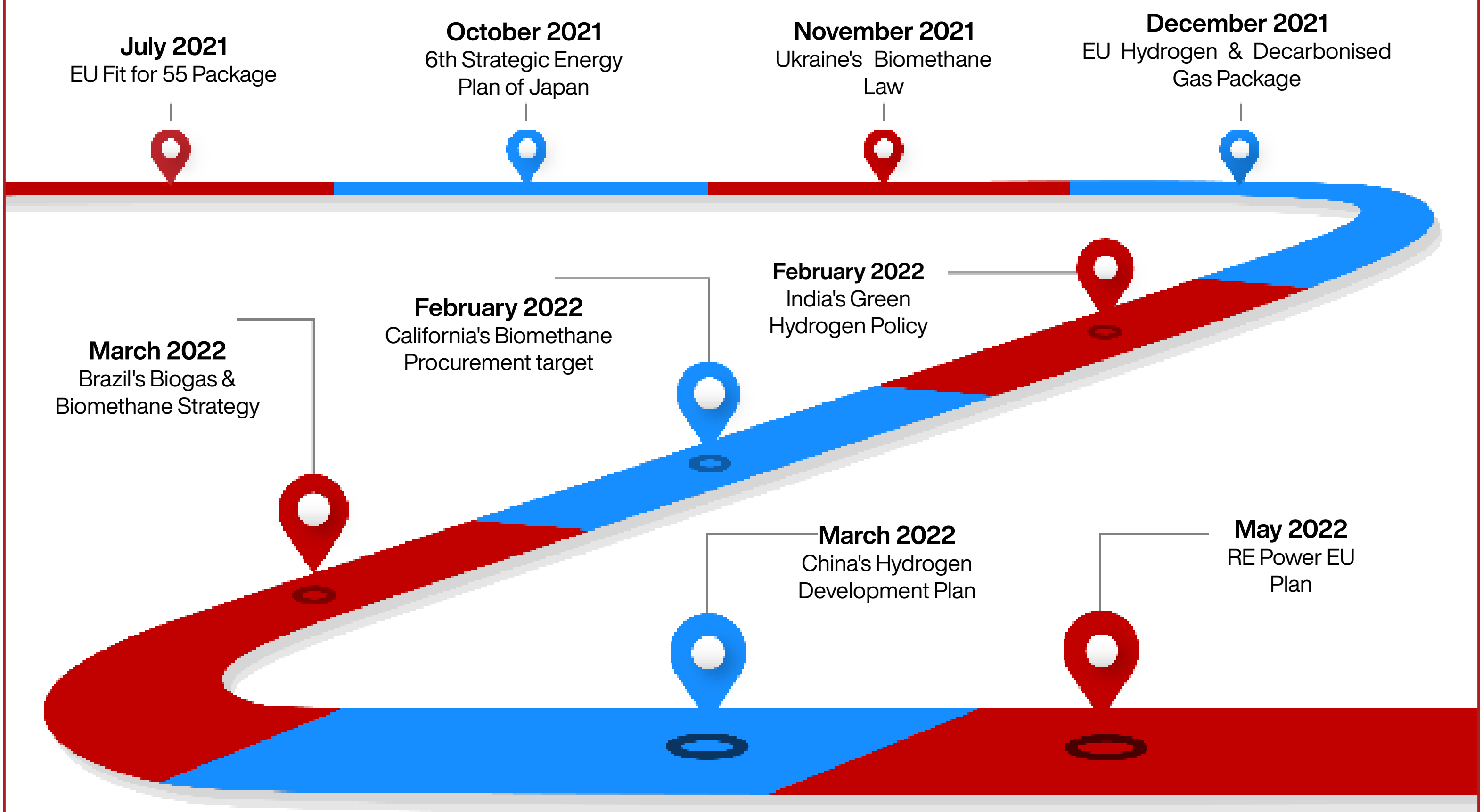
Figure 1: Energy dependency rate 2010-2020



Source: Eurostat

Since 2021, the EU has initiated several gas policies to boost its product and reduce the over-reliance on Russian energy. The Russian-Ukraine war catalyst the EU to swiftly employ effective policy initiatives, targeted sector-specific regulations, and enhanced international cooperation implemented to fast-track their production and deployment in the short to medium term.

Figure 2: Key gas policies adopted since mid-2021



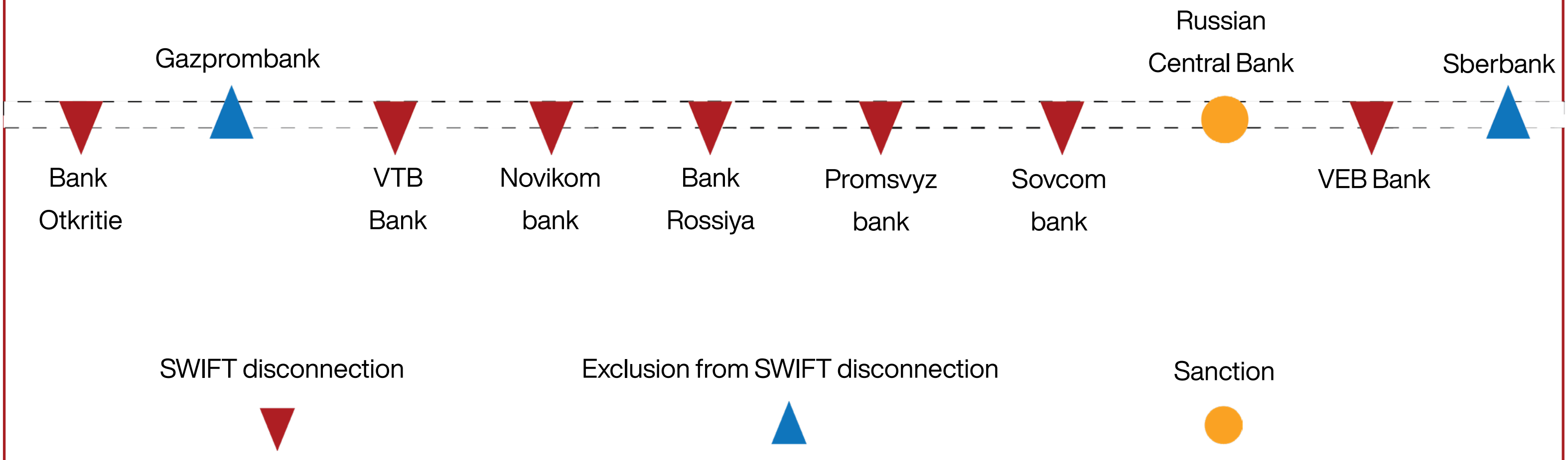
Source: Gas Market Q3 Report, 2022

The Western Sanctions on Russia: Payment Perspective

Several Western countries including Canada, the United Kingdom, the United States of America, and the European Union proposed both business and diplomacy sanctions on individuals, and entities from Russia or with strong ties with President Putin. Besides the broken relationship with business and international economic bonds, European Commission decided to disconnect key Russian banks from the SWIFT network. Seven key banks were removed from SWIFT, excluding two of the country's biggest institutions, Sberbank and Gazprombank.

Secondly, the European Union has prohibited all transactions with the Central Bank of Russia related to the management of the Russian Central Bank's reserves and assets. As a result of the central bank asset freeze, the central bank can no longer access the assets it has stored in central banks and private institutions in the EU. Meanwhile, in February 2022, Russia's international reserves accounted for $643 billion (€579 billion) according to BBC.Com.

Figure 3: SWIFT disconnection and sanction banks in Russian



Source: Agpaytech

Implications of the Western Sanctions on Payment

The disconnection of Russian banks from SWIFT was to lose access to the normally smooth and instant transactions provided by SWIFT, thereby disrupting payments for its prized energy and agricultural exports. The monetary settlement sanctions through the disconnection of SWIFT imply that the affected financial institutions or banks can neither get foreign currency (as a transfer of foreign currencies between two banks is generally processed as a transfer abroad involving a foreign intermediary bank) nor transfer assets abroad. This has negative consequences for the Russian and Belarusian economies.

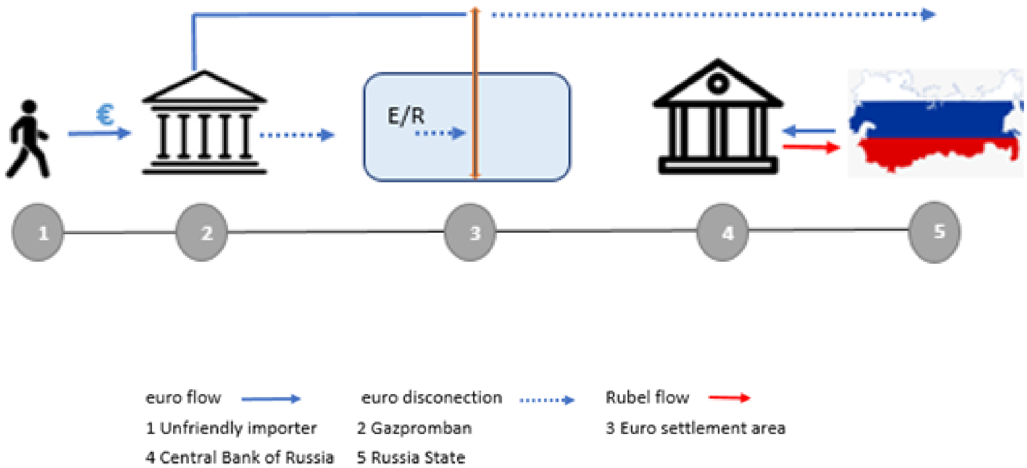
In practice, banks could carry out international transactions without SWIFT, but it is expensive, complex, and requires mutual trust between financial institutions. It brings payments back to the times when telephone and fax were used to confirm each transaction. Banks now have to deal directly with one another, adding delays and extra costs, and ultimately cutting off revenues for the Russian government. This follows a simple procedure as described below;

✺ Importer entity/individual [1] deposits euros/dollars into [2] Gazprombank

✺ Gazprombank cannot make direct payment to Gazprom due to sanctions at the zone [3], thus the euro settlement area. The Euro area settlement does not support euro exchange (frozen)

✺ The Russian Central Bank [4] and [5] State has a euro claim on Gazprombank that can be exchanged for rubel but the Euro area settlement does not support euro exchange (frozen)

Figure 4: How sanctions can affect Payments



Source: Agpaytech

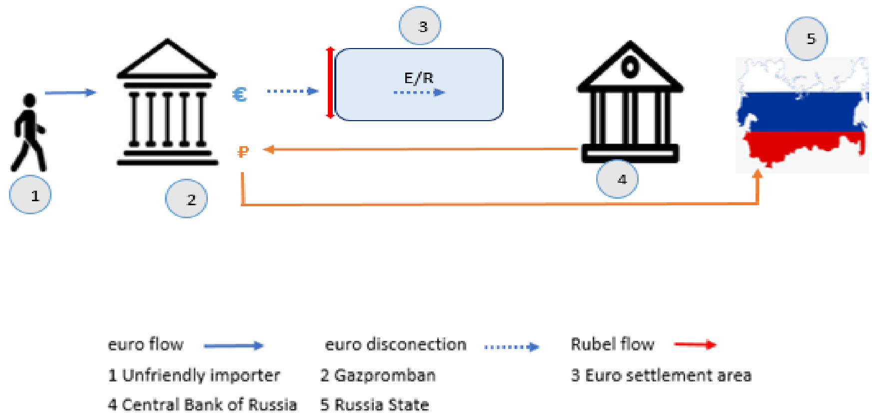
The Ruble Clause: De-dollarization Response

The SWIFT system and foreign trade currency (dollar and euros) are by far the leading intermediary for financial transactions, and the most traded international currencies respectively. In addition, about 50% of Russia's banks are connected and use SWIFT, while others rely on SPFS and other bilateral instruments.

In response to improve and stabilize the Russian economy, the Russian authorities enforced capital controls, restricting convertibility and offering more Rubles to support the banks' liquidity and rising interest rates. Russian President Vladimir Putin said “the world's largest natural gas producer would soon require "unfriendly" countries to pay for their fuel in Russia's currency, the Ruble”.

This new Russian payment system requires foreign importers to deposit euros or dollars into an account at the private Russian bank Gazprombank. The bank will then convert the cash into Rubles, place the proceeds in another account owned by the foreign buyer and transfer the payment in Russian currency to Gazprom. The changes will only affect the currency of payment.

Figure 5: Payments in rubles to bypass sanctions



Source: Agpaytech

Foreign importer entity [1] opens two accounts [€/$] Euros/ Dollars Rubel account with Gazprombank [2]. The importer deposits euros or dollars in the account [A] Euros/ Dollars

Gazprombank [2] used the dollars or euros received as collateral to get rubel from the Central Bank of Russia [4], and then deposits the rubels in the importer's account Rubels,

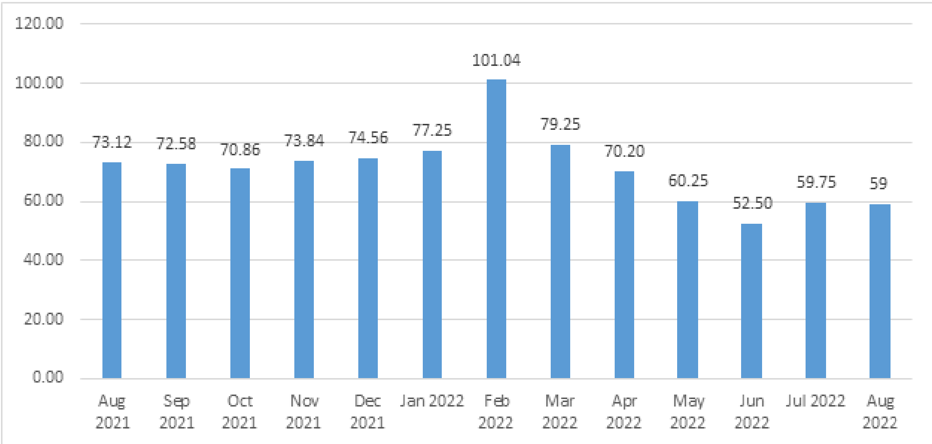
Gazprombank [2] makes direct payment to Russian State [5] for energy from the Gazprom

The euro/dollar area settlement [3] does not support euro exchange (frozen) due to sanctions therefore Central Bank of Russia [4] cannot access the money.

The Ruble Clause Implications

The Ruble clause requiring payments in Ruble barely changes the Western expectations on the outcome of the sanctions against Russia. The Ruble clause de-dollarized and reduced euros making Rubles more powerful as international means of payment. The presence of the Ruble clause implies that importers are to pay Russian exporters in Rubles, which are also limited in the international market. The only way to buy enough Rubles is to get them from the Central Bank of Russia and at their given exchange rate.

Figure 6: USD to Russian Rubel exchange rate (August 2021-August 2022)



Source: Agpaytech [Data retrieved from Statista on September 6]

Payment and Settlement Without SWIFT, Euros and Dollars

SWIFT, which stands for the Society for Worldwide Interbank Financial Telecommunication, links more than 11,000 financial institutions in more than 200 counties and territories. It sends over 42 million messages per day that facilitate domestic and international business deals. Russia was threatened with a SWIFT expulsion before in 2014 when it annexed Crimea.

Russia has developed its own, very fledgling, cross-border transfer system called the System for Transfer of Financial Messages (SPFS). The SPFS is the Russian equivalent of SWIFT and was developed by the Central Bank of Russia in 2014 after the United States government threatened to disconnect Russia from the SWIFT system. As of March 2018, over Russian 400 institutions (mostly banks) are part of the network. Few countries are considering using SPFS.

Besides, Moscow is working with Beijing to connect to China's Cross-Border Interbank Payment System (CIPS) - another alternative to SWIFT which processes payments in Chinese yuan. Since 2019 many agreements have also been reached to link SPFS to other countries' payment systems in China, India, and Iran, as well as the countries within the Eurasian Economic Union (EAEU) which includes Armenia, Belarus, Kazakhstan, Kyrgyzstan. The EAEU also has Free Trade Agreements with Serbia, Singapore, and Vietnam with multiple other deals pending.

Conclusion: Lessons for Least Developed Countries (LDC)

Currently, Russia and China have an alternative SWIFT system for international financial messages, which is in the early stage of development. In Africa, all the regional payment systems depend on SWIFT messages for both high-value payment (HVP) and low-value payment (LVP) systems. SWIFT constituent countries and dependent territories include Eastern Africa, Northern Africa, Southern, Central Africa, and Western Africa; regional payment systems like EAPS, SADC-RTGS, West African States (BCEAO) Central African States (BEAC), COMESA, East African Payment System (EAPS). SWIFT is also supporting the development of regional payment infrastructures that have cross-border reach and support multiple currencies in Africa (SWIFT White Paper, 2018)

While SWIFT supports both domestic and international settlements, a disconnection of financial institutions in LDC means a total catastrophe in the country's international payment system. This is the main reason China and Russia are keen on developing their alternative SWIFT. According to the African Development Bank, 30% of African trade was carried out with the EU in 2015. The strong Africa-EU tie is reflected in SWIFT's data, with commercial payments increasing from 26.4% in 2013 to 28.6% in 2017, and the use of the euro increasing from 26.5% to 29.4% of all payments from Africa.

Another challenge with SWIFT is no clearing house or Bank in Africa for most transactions to the Asian countries from Africa. All the commercial and central banks act as intermediaries to the sending or receiving person or institution. A careful observation of the commercial and financial flows illustrated in figure 7 denotes that with an African import from Europe where the payment is directly routed to a European bank, or show a disconnect with an African import from Asia intermediated by a clearing bank in the United States.

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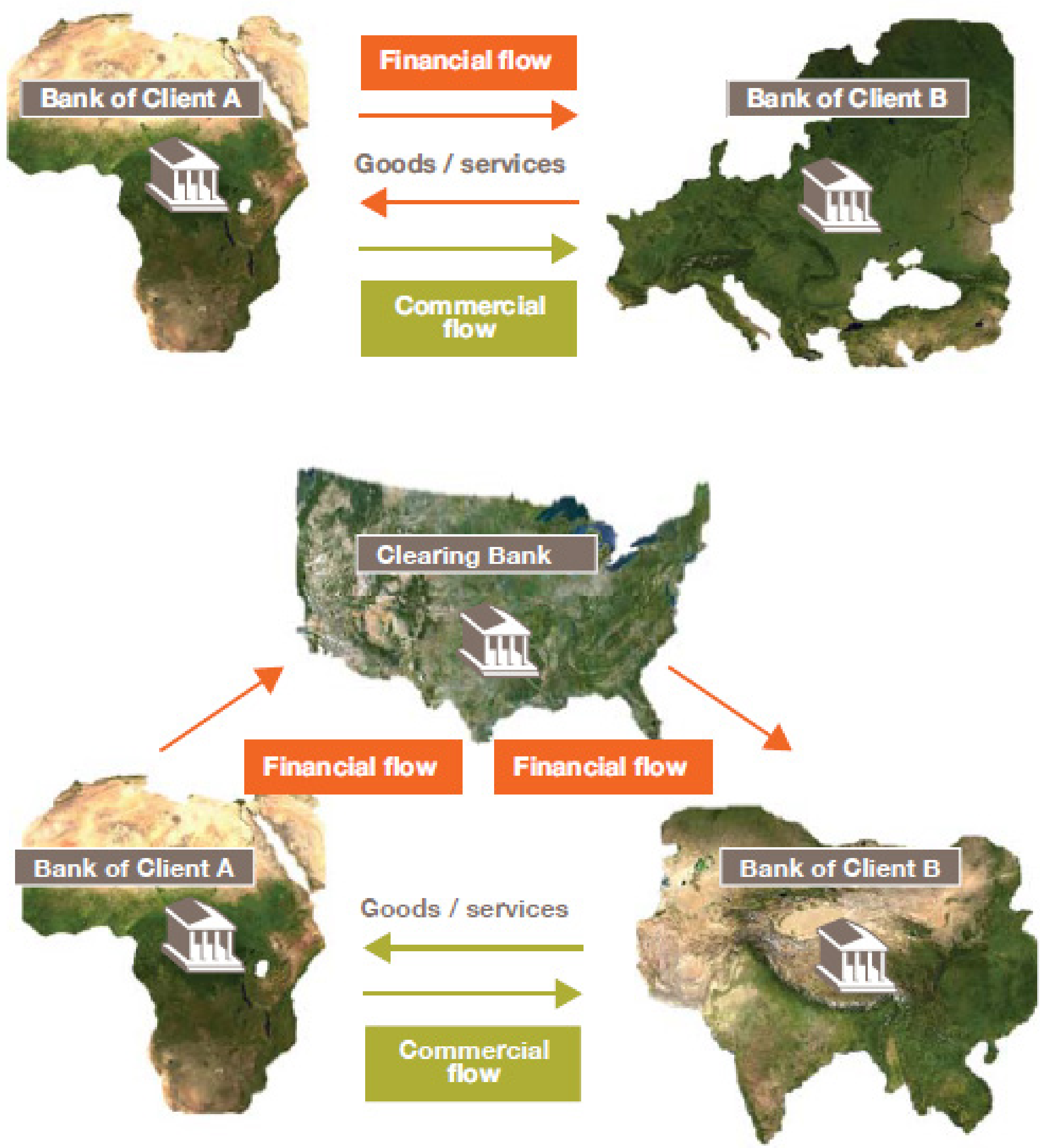
Figure 7: SWIFT Transaction flow



Source: CPMI (2022)

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About Agpaytech

Agpaytech Ltd. is a company pioneering in the Fintech Space with a focused approach to building robust technologies for eCommerce Card Processing Solutions for Payment Service Providers (PSPs). Additionally, we provide Compliance and Regulatory Umbrella, Remittance-as-a-Service White-Label Solution, Foreign Exchange, Cross Border Payments, and digital currency technology. We have partnered with multiple banks, non-banking financial institutions, and corporate organizations to create a solid service delivery model for them and their customers to ease their international remittances and payments concerns. Website www.agpaytech.co.uk

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