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Can China's CIPS help Russia after its ban from SWIFT?

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In response to Russia's invasion of Ukraine, several governments are taking coordinated action to cut off the access of several Russian financial institutions and wealthy individuals to international financial systems. The objective is to disrupt Russian financial institutions' ability to conduct cross-border business, weaken Russia's economy and reduce Russia's ability to continue to finance the war in Ukraine. Among the sanctions announced thus far are the bans being placed on selected Russian banks and financial institutions on accessing SWIFT. On 3 March 2022 seven Russian banks were given 10 days to stop using SWIFT, after which they would be disconnected from the system.[1] Sanctions have also been announced on Russia's central bank, sovereign wealth fund and ministry of finance,[2] severely constraining their ability to conduct financial transactions in global markets.

SWIFT, the Society for Worldwide Interbank Financial Telecommunications, established in 1973, is a Belgium-based member-owned cooperative institution and the dominant global messaging network for international or cross-border payments. It is an institution that is often considered to be at the heart of the "plumbing" of the global financial system. SWIFT provides its more than 11,000 members across 200 countries and territories with a standardised, secure, accurate and fast communications platform to send and receive, among others, money transfer instructions. By communicating through SWIFT, its members, which include almost all major financial institutions worldwide, can quickly and efficiently provide cross-border services to their clients. In 2021, 42 million messages per day went through SWIFT's network, growing by more than 11% over 2020.[3] SWIFT is not a financial institution or a payment platform and does not by itself deal in payments or transfers.

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[1] https://home.treasury.gov/system/files/126/new_debt_and_equity_directive_3.pdf (accessed 3 March 2022) and https://time.com/6153951/swift-sanctions-russia/ (accessed 3 March 2022).

[2] https://home.treasury.gov/system/files/126/eo14024_directive_4_02282022.pdf (accessed 3 March 2022).

[3] https://www.swift.com/about-us/discover-swift/fin-traffic-figures (accessed 3 March 2022).

Banning Russian financial institutions from accessing SWIFT significantly limits their ability to undertake international financial transactions and therefore has the potential to impose "…..severe economic costs that will have both immediate and long-term effects on the Russian economy and financial system".[4] While some Russian banks and financial institutions had been under sanctions since 2014 when Russia annexed Crimea, the inclusion of the Russian central bank, its sovereign wealth fund and its ministry of finance in the current round of sanctions significantly expands their scope. Nearly half of the Russian central bank's reserves were held in investments in Euro and the US dollar (as of 30 June 2021) and nearly three quarters were geographically located in investments in countries that have imposed sanctions on Russia.[5] About a fifth of Russian reserves are in gold that is physically located in Russia and any trading in this component of its reserves is also likely to be impacted by the sanctions. Russia's inability to easily access a large share of its nearly $630 billion foreign exchange reserves, due to the sanctions on its central bank, will undoubtedly impose large immediate economic costs and could have significant long-term effects on the Russian economy and financial system.

Given this situation, therefore, Russia could be looking for alternatives to SWIFT. At least two immediately come to mind. The first is Russia's own answer to SWIFT, the six-year old SPFS (Sistema Peredachi Finansovykh Soobscheniy, the Financial Message Transfer System) of the Bank of Russia, created after sanctions were imposed on Russia after its annexation of Crimea in 2014. This system currently has about 400 users, mostly Russian financial institutions, and about a dozen foreign banks from countries such as Armenia, Belarus, Kyryzstan and Kazakhstan. According to the Russian data, the SPFS accounted for 17% of all Russian international payment messages in 2020.[6] While the governor of Russia's central bank has recently announced[7] that SPFS is now open to more international participants, there is unlikely to be a stampede of major foreign financial institutions wanting to join. First, joining the SPFS now could potentially be construed by the United States, Europe and other sanctioning countries as financial institutions trying to help Russia evade sanctions. This could lead to those financial institutions being subject to secondary sanctions such as being banned from SWIFT themselves. Second, there are currently just a few countries represented in the SPFS. Third, the SPFS primarily supports ruble-based domestic transactions and it is unclear how many international market participants would want to settle their transactions in ruble, especially in the current environment.

The second alternative to SWIFT for Russia is China's Cross-Border Interbank Payment System (CIPS) for RMB-based payments settlement. Russia has over 13% of its foreign exchange reserves in RMB, its largest exposure to any single country. Since 2014, Russia has steadily reduced its dollar share of its reserves, and switched more to gold and RMB. China and Russia have also articulated their strategic partnership at the highest levels, including at the recent Winter Olympics in Beijing. Thus, trying to use China's CIPS in the face of the SWIFT ban would be logical for Russia. China has been making efforts to internationalise the RMB since the 2008 global financial crisis and CIPS is an integral part of China's plans to have more global financial transactions settled in RMB. Therefore, having greater international usage of CIPS would be in China's long-term interest too.

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4 https://home.treasury.gov/news/press-releases/jy0608 (accessed 3 March 2022).

5 https://www.reuters.com/world/europe/russian-central-bank-reserves-what-are-they-made-2022-02-28/ (accessed 3 March 2022).

6 https://www.ft.com/content/e8705d48-bfea-4f95-af3b-af13c1e4305d (accessed 3 March 2022).

7 https://finance.yahoo.com/news/central-bank-russia-launches-swift-154004953.html (accessed 3 March 2022).

CIPS, established in 2015, is an international RMB payment and clearance system, similar to the Clearinghouse Interbank Payments System (CHIPS) of the United States (the most widely used payment system in the world). While SWIFT and CHIPS are both cooperatives owned by their members, CIPS is overseen by the People's Bank of China and has both government and private sector shareholders, including some foreign banks. In addition to its payment capabilities, CIPS has messaging functioning that, in theory, could be used in place of SWIFT. However, until now, CIPS continues to use SWIFT as its messaging platform. Therefore, for Russia to be able to use CIPS to bypass SWIFT, CIPS' nascent messaging functionality would need to be developed, tested and made fully operational. This is likely to take time.

Payments through CIPS have been growing rapidly. However, they are still small compared to CHIPS (less than 5%). SWIFT data shows that the RMB accounted for 3.2% of global payments in January 2022, compared to nearly 40% for the US dollar, 37% for the Euro and 6% for the pound sterling. Although membership in CIPS has also been growing, participation of major foreign financial institutions in CIPS still remains limited. As of 31 January 2022, the system had 1,280 users across 103 countries, including 75 directly participating banks and 1,205 indirect participants.[8] SWIFT, in comparison, has 600 banks from China alone among its 11,000 members. Thus, for now, CIPS remains relatively limited in scope and coverage and does not replace SWIFT as a messaging platform.

Even though China announced on 3 March 2022 that it would not impose financial sanctions on Russia,[9] actively encouraging Russian financial institutions to make greater use of its financial infrastructure, including CIPS, at this time could still pose challenges for China. Western regulators could take a less-than-kind view of CIPS permitting Russia to sidestep Western sanctions. SWIFT and CIPS, as of today, are also cooperating on several fronts. SWIFT has set up a subsidiary in China in 2019 and formed a joint venture with CIPS. China may therefore consider carefully any steps that it takes to unilaterally undermine this ongoing cooperation. Finally, while Russia's exposure to China is large, the reverse is not the case. Chinese financial institutions and financial infrastructure would have less incentive to make things easier for Russian financial institutions, particularly at this time, and take on the risk of alienating their more important and larger trading and economic partners such as the United States, EU and Japan. The threat of potential secondary sanctions on institutions assisting Russian entities evade sanctions also exists.

For all these reasons, while CIPS, with an enhanced messaging functionality independent of SWIFT, may offer a way for Russian financial institutions to make and receive payments for transactions denominated in RMB, and cushion the impact of some of the sanctions, this is unlikely to significantly impact the overall effects of the SWIFT ban. CIPS could provide a minor reprieve for Russia, but the impact of the SWIFT ban, especially if expanded to more Russian banks, will be much larger. For the Russian central bank, CIPS will continue to provide access to the roughly $80 billion of its reserves in RMB. However, given that the RMB is not yet convertible and Russian central bank transactions with United States, EU, Canada and the UK are banned, this would be only a partial solution to the problems arising from the sanctions. For China, its larger objective of a more international RMB, of which CIPS is a part, will continue to depend on its own policy actions and the trust of international financial markets therein, deeper financial markets and further liberalisation of its capital account and exchange regimes. While the war in Ukraine and Russia's SWIFT-related problems may enable

[8] https://www.scmp.com/economy/china-economy/article/3168684/what-chinas-swift-equivalent-and-could-it-help-beijing-reduce (accessed 3 March 2022).

[9] https://www.reuters.com/markets/europe/china-banking-regulator-sees-limited-impact-sanctions-russia-2022-03-02/ (accessed 3 March 2022).

somewhat greater usage of CIPS, it is unlikely to be a game-changer for China. Russia's SWIFT ban will, however, almost certainly provide China with even more motivation to further develop CIPS and push to expand its usage globally. The Chinese authorities have no doubt already realised the urgent need for China to have its own payments and messaging platform, independent of SWIFT, to deal with any eventuality that China itself may face from the West in future.

Some other issues are useful to keep in mind in this context. First, Europe's dependence on Russia for its energy needs is already raising issues about how the SWIFT bans will actually be implemented. If Europe is to continue receiving Russian energy supplies, it needs a way to pay for them. Cutting off Russia entirely from SWIFT would make it very difficult to do so. This concern has led to the initial statement that "selected" Russian banks would be expelled from SWIFT, mostly banks that are already under sanctions by the United States and Europe. On 3 March 2022, it was announced that seven Russian banks, including its second largest bank, VTB, would be banned from SWIFT.[10] Interestingly, neither Sberbank nor Gazprombank, which are responsible for the largest share of Russia's energy-related financial transactions, have yet to been banned from SWIFT. There are also ongoing discussions aimed at trying to find other ways to exempt payments for energy from the SWIFT ban, though no simple solution has yet been found.

Second, because SWIFT is a messaging system and not a payment platform, workarounds to bans from SWIFT do exist. Institutions could potentially go back to the pre-SWIFT era where telex messages were the way institutions exchanged such messages. Internet-based modes such as email and other communications apps could also be used. However, the security, speed and cost of these alternate modes would need to be assessed and they could end up being potentially less secure and costlier compared to SWIFT.

Third, the experience of Iran, whose banks faced a SWIFT ban in 2012,[11] is illustrative of what the ban may hold for Russia. Iran's experience showed that such a ban undoubtedly and significantly increases frictions and costs for international financial transactions. However, unless a country is completely banned from SWIFT, often considered the "nuclear option" of economic sanctions,[12] it is possible for institutions to find ways around the bans. Iran continued to trade in oil with key partners such as China, India and Turkey, even after the imposition of the SWIFT ban on its banks. These oil-importing countries found ingenious ways to pay for Iranian oil. Russia could go a similar route.

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10 In addition to VTB, the EU said the other affected banks are Bank Otkritie, Novikombank, Promsvyazbank, Bank Rossiya, Sovcombank and VEB.

11 https://www.swift.com/about-us/legal/compliance-0/swift-and-sanctions#has-swift-ever-disconnected-banks-for-sanctions-purposes? (accessed 3 March 2022).

12 https://www.cnn.com/2022/02/28/business/swift-sanctions-explainer/index.html (accessed 3 March 2022).