REPO Act Risks American Financial System

At a time when the U.S. is issuing debt at unprecedented levels, seizing the assets of one of the world's largest central banks poses a significant threat of exacerbating the perilous financial situation of the U.S. by making U.S. Treasuries less attractive to foreign buyers.

House and Senate offices who would like to learn more about the consequences of this legislation are invited to solicit technical assistance from the Federal Reserve.

Summary: Earlier this year, the Senate Foreign Relations Committee (SFRC) marked up legislation to seize and repurpose sanctioned Russian central bank assets to provide further aid to Ukraine, a multi-Congress priority of Senators Risch and Whitehouse. Although financial sanctions and asset seizures both fall within Senate Banking Committee's jurisdiction, the Senate practices single committee referral and the legislation—short-titled the REPO for Ukrainians Act (REPO Act)—contains a number of provisions that tip it into SFRC's jurisdiction.

More recently, the National Security Council, Speaker Johnson, Treasury Secretary Yellen, and other proponents of further Ukraine aid proposed using REPO as a "pay-for" to offset U.S. assistance to Ukraine. While pay-fors traditionally utilize offsets of less consequence, the REPO Act poses potentially dire consequences for the Western financial system and could hinder a future President's ability to negotiate an end to the Russia-Ukraine conflict.

Key Provisions of the REPO Act:

- The REPO for Ukrainians Act would give the president authority to confiscate Russian sovereign assets that have been wrapped up in our Russia sanctions regime, and instead deposit them in a "Ukraine Support Fund" established by the bill that would be used to assist in Ukraine's "reconstruction efforts."
    - For the purposes of the bill, "Russian sovereign assets" also includes any funds or property of the Russian Central Bank.
- The Ukraine Support Fund ("USF") established in the bill would be housed within the U.S. Department of State for the purpose of:
    - Rebuilding efforts in Ukraine;
    - Humanitarian assistance to the Ukrainian people; or
    - Other purposes which support the recovery of Ukraine and the welfare of the Ukrainian people.
- In addition to the USF, the bill directs the President to work with foreign allies to set up an international version of the USF that provides compensation to Ukraine using any Russian sovereign assets confiscated by foreign partners.
- REPO, as drafted, seeks to preclude the funds and provisions from any judicial review—explicitly stating that "any action taken under this section shall not be subject to judicial review[.]"
- Lastly, and perhaps most consequentially, REPO would freeze in place the current Russia sanctions regime and restrict any future president from unfreezing the sanctioned Russian assets without an act of Congress, or until the President certifies to Congress in writing that:
    - Russia has reached an agreement to withdraw from Ukraine, and

- Full compensation has been made to Ukraine for "harms resulting from the invasion of Ukraine by the Russian Federation."

Analysis:

Impact to U.S. Treasuries markets and meeting U.S. debt obligations: The core concern with the REPO Act is its impact on the auctionability of, and global interest in, U.S. Treasuries.

Sustaining the U.S. fiscal and monetary system relies on the auctionability of, and interest in, U.S. Treasury bonds. If a central bank's holdings in Treasuries, or any other asset, could vanish at the snap of a finger, it is likely that there will be a decline in parties willing to both attend Treasury's weekly auctions and purchase Treasuries through dealers.

In most instances, when an institution or individual buys a Treasury security, bond, or note from the U.S. government, the actual security itself is custodied by either the U.S. Treasury through the TreasuryDirect system,[1] or by a financial institution or broker-dealer in the U.S. who is a part of the Commercial Book-Entry System.[2] Foreign central banks and financial institutions alike invest in U.S. Treasuries for both reliable returns and to have safe asset vehicles in which to park capital. However, if foreign governments perceive a risk that their assets will not only be frozen but actually seized and repurposed outright, it is unlikely that foreign governments would continue to view American Treasuries as favorably as they have in the past.

Losing our capacity to auction off Treasuries would render the United States unable to meet its federal debt obligations—potentially threatening the U.S. ability to finance the national debt and avoid default risk. In recent memory, there has been no serious Committee hearings or policymaking on the state of the U.S. Treasuries market and/or how foreign central bank asset seizure would impact long-term interest in U.S. Treasuries.

While foreign central bank interest in U.S. Treasuries has long been dwindling—due in part to international sanctions policies—U.S.-based financial institutions have been filling the void left by global central banks.[3] As of January 2024, foreign central banks' holdings of Treasuries are down to around $3.4 trillion—and that footprint has rarely been smaller—with their share of outstanding bonds at just 14 percent, down from 25 percent before the pandemic and a record 40 percent in 2008.[4] An April 14 Wall Street Journal Article details the views of experts who believe that U.S. financial institutions have peaked in their ability to participate in Treasuries auctions and that the United States simply can't afford to lose more foreign central bank partners.[5]

[1] https://treasurydirect.gov/auctions/how-auctions-work/where-you-hold-securities/#id-treasurydirect-552534
[2] https://treasurydirect.gov/auctions/how-auctions-work/where-you-hold-securities/commercial-book-entry-system/
[3] https://www.investopedia.com/treasury-auction-shows-lagging-demand-for-bonds-8357802
[4] https://www.reuters.com/markets/us/foreign-central-banks-think-twice-us-treasuries-mcgeever-2024-01-23/#:~:text=Right%20now%2C%20foreign%20central%20banks,a%20record%2040%25%20in%202008.
[5] https://www.wsj.com/finance/americas-bonds-are-getting-harder-to-sell-c3fde4de

Unprecedented in peacetime: This would be the first time that the United States has seized and repurposed frozen sanctioned assets owned by a foreign state despite the absence of any direct military engagement by that state against the United States.

In recent memory, the U.S. government began exploring this option during the Iraq-Kuwait war of the 1990s, but instead opted to collaborate on a U.N. Security Council approved plan to pay reparations to Kuwaiti victims of the Iraqi invasion.[6] In 2003, President Bush ordered the seizure of $1.7B of Iraqi funds held in American banks.[7] And in 1996, the United States seized Cuban funds following the Cuban military's shooting down of American planes.[8] Those funds were used to compensate the families of the three Americans killed.[9]

These situations were significantly different than the Russia-Ukraine conflict. In the 1990s, the United States and our European allies did not unilaterally seize and repurpose assets. Rather, the U.N. Security Council passed an international plan to use some Iraqi assets to compensate Kuwaiti victims through the U.N. Compensation Commission.[10] In 2003, the United States was engaged in direct hostilities with Iraq,[11] and in 1996, U.S. citizens were killed as a result of Cuban military activity.[12] But Russia has yet to directly engage U.S. forces or civilians, the U.N. Security Council has not passed any compensation agreement, and seizing sanctioned assets would mark a significant escalation in the U.S.'s approach to the Ukraine conflict.

Tying the hands of a future U.S. president: Under Article II of the Constitution, the president is the "Commander in Chief."[13] And, although the Constitution creates a role for the Senate in the ratification of treaties,[14] the President, as Commander in Chief, wields the executive authority necessary to negotiate with foreign powers. Negotiating peace is a delicate matter. To be successful, the president requires leverage and flexibility.

Removing the president's ability to end or alter a sanctions regime, especially in the context of such a significant conflict, would dramatically limit U.S. negotiating leverage, thereby undermining the prospect of reaching a peace deal in the Russia-Ukraine war.

Empowering China, Russia at the expense of the U.S. financial system: As a result of the Russia sanctions regime and a fear of further heightened sanctions from the West, Russia and China have built alternatives to the Western information transfer and payment settlement systems (SWIFT and the Fed's CHIPS).

Following the U.S. government threatening to cut Russian banks off from SWIFT in 2014, Russia began building up their SWIFT-alternative, the System for Transfer of Financial

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[6] https://www.nytimes.com/2024/04/09/opinion/us-aid-ukraine-war.html
[7] https://www.nytimes.com/2003/03/22/world/a-nation-at-war-iraqi-assets-bush-asks-seizure-of-1.7-billion-held-in-us.html
[8] https://www.chicagotribune.com/1999/03/19/cuban-funds-face-seizure/
[9] https://www.nytimes.com/1996/11/11/us/downed-pilots-kin-receive-cuban-assets.html
[10] https://news.un.org/en/story/2022/02/1111632
[11] https://www.pbs.org/newshour/economy/middle_east-jan-june03-treasury_03-20
[12] https://www.chicagotribune.com/1999/03/19/cuban-funds-face-seizure/
[13] U.S. Const. art. II, § 2, cl.1.
[14] U.S. Const. art. II, § 2, cl. 2.

Messages ("SPFS") and in 2015 China launched their alternative to the Fed's CHIPS, CIPS. SPFS now has 20 participating countries and CIPS now has 1484 participants in 109 countries.[15][16]

Since the imposition of the West's sanctions on Russia and Russian financial institutions, the popularity of CIPS and SPFS has skyrocketed. Participating countries no longer include just typical U.S. adversaries. India, Switzerland, and other countries typically considered allies—or at least Western-aligned countries—are now joining both systems.[17]

While U.S. sanctions have largely been viewed as the primary reason for the growing popularity of SWIFT and CHIPS alternatives, the threat of having assets confiscated and repurposed on top of sanctions risk would make U.S.-controlled payment systems even higher-risk for other countries, driving them further into the arms of competing networks.

The dominance of the western financial systems not only serves as a backstop to ensure the continued reserve currency status of the U.S. Dollar, but also acts as a powerful counter-terrorism tool. SWIFT currently partners with the FBI, FinCEN, and other U.S. law enforcement agencies to identify transactions of concern. Further pushing countries away from SWIFT would mean losing valuable insights and mechanisms to track terrorists, drug cartels, and other international criminals.

Risks to U.S.-Based Global Financial Institutions & Banks: Following the imposition of the U.S. sanctions regime against Russia, banks with operations in Russia began to exit the country. However, at the request of President Biden and his administration, Citi and JPMorgan have continued their operations in Russia.[18]

While these financial institutions, along with State Street and others, have tried to begin pulling back on their exposure to Russia, they face a two-pronged hurdle. First, the U.S. government has requested they continue to maintain some level of operations in Russia. Second, Russian M&A and banking laws continue to change. Most recently, Russia has made changes to their laws to require Putin's approval for all sales of subsidiaries by foreign companies.

Russia has also made changes to place punitive measures on companies scaling back operations or exiting the country. First and foremost, Russia is now requiring banks to unfreeze Russian assets if they wish to exit the market. Second, they are now charging exiting companies an exit fee of at least 10 percent of the sale value.[19] Third, Moscow is also requiring sellers from

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[15] https://interfax.com/newsroom/top-stories/98475/

[16] https://today.thefinancialexpress.com.bd/first-page/bd-joining-alternative-global-payment-system-cips-1711649921

[17] https://thewire.in/diplomacy/india-signs-deal-to-adopt-moscows-spfs-system-for-banking-payments-to-russia-report

[18] https://archive.ph/9k4qf

[19] https://finance.yahoo.com/news/foreign-firms-russian-exit-tax-085548260.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAMChsvNnnclRgO7mKyc6jrGgqqn7YcRApcwY2cyENBA1La5l6BAzwO_x2SpL7r4X1uNUDDUZiIyoNnjkJ

"unfriendly countries" (which includes the U.S.) to donate at least 10 percent of the sale proceeds to the Russian treasury.[20] Additionally, companies owned by a Russian-designated unfriendly company may not transfer proceeds from the sale of its Russian business outside of Russia. New owners of the business must place up to 20% of the purchased assets on the Russian stock market within a year and finish the listing within three years.[21]

In addition to the capital loss issue, American firms also face the question of whether compliance with Russia's punitive measures for exiting companies may actually place these firms in direct violation of the U.S. sanctions regime.

Lastly, Russia's banking and financial laws are fluid. Given Moscow's willingness to impose punitive measures on companies seeking to exit the Russian market, and Moscow's insistence on the unfreezing of assets before companies can exit the market, it is unclear how Putin and Moscow would respond to the U.S. seizing and repurposing frozen assets. However, one can anticipate that there would be some level of retaliation—and it's within reason to expect that this may include Russia seizing the assets of U.S. firms still operating in Russia.

No Possible Judicial Review: In addition to the asset seizure and Ukrainian Support Fund provisions, the bill carves out a majority of the bill's provisions from judicial review.

State of Play & Legislative History: Legislation allowing sanctioned Russian assets to be seized and repurposed for further Ukraine assistance has been a multi-Congress priority of Senators Risch and Whitehouse. It was first put forward in the 117th Congress when the Senators offered the legislation as an amendment to the FY23 NDAA.[22] During ash and trash exercises for that NDAA, Senate Banking Committee leadership blocked the addition of REPO.

During the consideration of subsequent NDAA and Omnibus packages, Senators Risch and Whitehouse continued their efforts to have REPO ride on those packages during both the 117th and 118th Congresses. However, Senate Banking Committee leadership during both Congresses has continued to block the addition of REPO during ash and trash exercises. Given that obstacle, and concerns from the financial sector, the legislation was recrafted—without technical assistance from SBC—during the 118th Congress in a way that ensured its referral to SFRC rather than SBC. The bill was then introduced in June of 2023 and marked up by SFRC this January, ultimately passing out of the committee.

Leading up to SFRC's consideration of the bill, the National Security Council began efforts to support the legislation. And more recently, Treasury Secretary Yellen has come out in support of the bill.[23]

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[20] https://www.businessinsider.com/russia-foreign-banks-exit-not-easy-unfreeze-russian-assets-sanctions-2023-9

[21] https://www.themoscowtimes.com/2023/07/14/russia-tightens-exit-rules-for-foreign-businesses-vedomosti-a81842

[22] https://www.foreign.senate.gov/press/rep/release/risch-whitehouse-offer-legislation-to-repurpose-sovereign-russian-assets-for-ukraine

[23] https://economictimes.indiatimes.com/news/international/world-news/moves-to-unlock-value-of-frozen-russian-assets-necessary-and-urgent-janet-yellen/articleshow/108051134.cms?from=mdr