THE INFLUENCE OF THE EU'S COLLECTIVE IDENTITY ON SMART SANCTIONS IMPOSED
ON RUSSIA AND THEIR EFFECT ON RUSSIAN FINANCIAL INSTITUTIONS

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อิทธิพลของอัตลักษณ์ร่วมของสหภาพยุโรปในการคว่ำบาตรที่กำหนดใช้กับประเทศรัสเซียและ
ผลกระทบต่อสถาบันทางการเงินรัสเซีย

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แรกเริ่มในช่วงต้น ค.ศ. 2014 สหภาพยุโรปได้เริ่มและขยายขอบเขตการคว่ำบาตรต่าง ๆ
ต่อประเทศรัสเซีย เพื่อป้องกันการมีส่วนร่วมของประเทศรัสเซียในการทำให้เกิดความไม่มั่นคงและ
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ธนาคารรัสเซียที่ถูกคว่ำบาตร จำนวน 6 แห่ง และที่ไม่ถูกคว่ำบาตร จำนวน 31 แห่ง ธนาคารที่ถูกคว่ำ
บาตรนั้นระบุได้จากการตรวจสอบบัญชีรายชื่อการคว่ำบาตรรายภาคของสหภาพยุโรปและ
สหรัฐอเมริกา รวมถึงธนาคารที่ร่วมมือกับบุคคลที่อยู่ในบัญชีรายชื่อมาตรการกีดกันของสหภาพยุโรป
และบัญชีรายชื่อประเทศที่ถูกจับตามองเป็นพิเศษของสหรัฐอเมริกา ผลของการถดถอยชี้ให้เห็นว่า
หลังจากเผชิญกับการคว่ำบาตรแล้ว ธนาคารที่ถูกคว่ำบาตร หรือ ธนาคารที่มีส่วนเกี่ยวข้องกับบุคคลที่
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ของรายงานประจำปีของธนาคารที่ถูกคว่ำบาตรได้สะท้อนให้เห็นถึงความไม่มั่นคงของภาคธนาคาร
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ด้วยเหตุนี้การคว่ำบาตรที่กำหนดใช้กับประเทศรัสเซียจึงดูค่อนข้าง “ชาญฉลาด” ในการจับเป้าหมาย
เป็นสถาบันทางการเงินรัสเซีย

สาขาวิชา ยุโรปศึกษา	ลายมือชื่อนิสิต	....
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SUNIL KUMAR DASH: THE INFLUENCE OF THE EU'S COLLECTIVE IDENTITY ON SMART SANCTIONS IMPOSED ON RUSSIA AND THEIR EFFECT ON RUSSIAN FINANCIAL INSTITUTIONS. ADVISOR: ASST. PROF. CHANTAL HERBERHOLZ, pp.

Beginning in early 2014, the EU introduced and extended a range of smart sanctions against Russia in protest at Russian involvement in destabilizing Ukraine and violation of Ukraine's territorial integrity. By utilizing theoretical elements of constructivism with process tracing method, this thesis examines the influence of the EU's collective identity on smart sanctions on Russia. The analysis finds that the EU's "collective identity" stipulated the "objective interests" and "subjective interests" to its actors and influenced the "actions" of smart sanctions by extending extra restrictive measures for Russian financial institutions to increase the cost of smart sanctions imposed on Russia. Thus, the thesis then analyses the impact of smart sanctions on Russian financial institutions. This was done through regression analyses with a dataset that covers 6 sanctioned and 31 non-sanctioned Russian banks. Sanctioned banks are identified by examining the EU's and the US's sectoral sanctions lists and those associated with individuals on the EU's restrictive measures lists and the specially designated nationals lists of the US. The regression results suggest that after facing smart sanctions, sanctioned banks or banks associated with sanctioned individuals are less profitable compared with non-sanctioned banks. Furthermore, content analysis of annual reports of sanctioned banks reflects the vulnerability of Russian banking sector towards smart sanctions; which curbed the financial position of Russian banks. Thus, smart sanctions on Russia appear to be "smart" in targeting the Russian financial institutions.

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จุฬาลงกรณ์มหาวิทยาลัย

CHULALONGKORN UNIVERSITY

CONTENTS

จุฬาลงกรณ์มหาวิทยาลัย
CHULALONGKORN UNIVERSITY

LIST OF TABLES

LIST OF FIGURES

จุฬาลงกรณ์มหาวิทยาลัย
CHULALONGKORN UNIVERSITY

ABBREVIATIONS

CFSP   Common Foreign and Security Policy

DP   Designated Persons

EA   Euro Area

EEAS   European External Action Service

EU   European Union

GDP   Gross Domestic Product

FE   Fixed Effects

HH   Herfindahl-Hirschman Index

IFRS   International Financial Reporting Standards

MOEX   Moscow Stock Exchange

OLS   Ordinary Least Square

RE   Random Effects

ROA   Return on Assets

ROE   Return on Equity

SDN   Specially Designated Nationals

SSI   Sectoral Sanctions Identification

SVAR   Structural Vector Auto Regression

US   United States

CHAPTER I INTRODUCTION

This section outlines the research problem, research objectives, contribution to the existing literature, defines the core research questions and hypotheses, scope of the paper and finally, describes the structure of the paper.

1.1   Research problem

All the reviewed literature related to both traditional and smart forms of economic sanctions facilitate realism as a more compelling analysis than concepts from other theoretical traditions. This is because, they define economic sanctions as a coercing or constraining attempt, not as institutional structures or a measure of law enforcement (Hufbauer et al. 2009, Jones 2015, Pape 1997, Tostensen and Bull 2002) and they are interested in materialistic gain and loss (Ahn and Ludema 2017, Crozet and Hinz 2016, Kholodilin and Netsunajev 2016, Moret, Giumelli, and Bastiat-Jarosz 2017). Thus, they fail to recall the larger motives behind the economic sanctions and ignore to the fact that economic sanctions are institutional structures and a measure of law enforcement in fulfilling the foreign and security policy objectives.

For example, European Union, as an institutional structure employs both traditional and smart forms of economic sanctions to promote its Common Foreign and Security Policy (CFSP) objectives, i.e. "peace, democracy and respect for the rule of law, human rights and international law" and European Union sanctions are not coercive in nature. (Union 2014a) The primary source of these objective interests comes from the article 215 of the TEFU, which provides a legal basis for constraining the EU's economic and financial relations with third countries. Thus, economic sanctions are from within the institutional structure of the EU. These objective interests are not only normative guidelines for action, but causal powers that predisposes the European Union to act in certain ways because of the common foreign policy and security needs of the Union. In international relations, the theory of "Constructivism" explores the influence of identity over actions and suggests that these objective interests are stipulated by "identity" and are necessary to be fulfilled in order to reproduce the identity. (Wendt 1999)

Furthermore, empirical studies of smart sanctions are much fewer compared to comprehensive sanctions in general, partially due to the relatively short history of smart sanctions and availability of fewer examples involving purely smart sanctions compared to comprehensive sanctions.(Ahn and Ludema 2017, Fritz Oliver 2017) Additionally, most empirical analyses of smart sanctions imposed on Russia are cross-country studies.(Crozet and Hinz 2016, Kholodilin and Netsunajev 2016, Moret, Giumelli, and Bastiat-Jarosz 2017). There is need of in-country empirical analysis of the target economy to understand the impact of smart sanctions imposed on Russia, which has been recognized by the Policy Department of European Parliament as well. (Fritz Oliver 2017, 37)

1.2   Research objectives

In early 2014, European Union imposed smart sanctions on Russia through council decision (2014/512/CFSP) in respect of actions undermining or threatening the territorial integrity, sovereignty and independence of Ukraine which has been further strengthened in September 2014 with extra restrictive measures for financial and defense sector of the Russian economy, while the energy sector restrictions remains unchanged. (Union 2014d) After the Russian aggression in eastern Ukraine, the Council urged Russia to stop the increasing flow of weapons, equipment and militants across the border to achieve rapid and tangible results in de-escalation of situation in eastern Ukraine. As full and immediate cooperation from Russia on the abovementioned demand failed to materialize, European Council, as the "actor" of the EU decided on extending the restrictive measures on financial and defense institutions with a view of increasing the costs of smart sanctions imposed on Russia. The extended restrictive measures prohibit the issuance or trade in financial instruments including bonds with maturity exceeding 30 days within the EU territory. (maturity lowered from 90 days to   for instruments issued on or after 12th Sept 2014) The desired implication of this leads to stricter access to capital market of the EU, for the financial and defense institutions of Russia; by limiting the foreign intermediate inputs for their operations. With limited foreign intermediate inputs, the cost of operations increases, thus leading to lower profitability.(Ahn and Ludema 2017, 3)

The first objective of this paper is on establishing the link between the "collective identity", "interests" and "actions" of the EU through constructivism by examining the influence of the EU's collective identity on smart sanctions imposed on Russia and how the EU actors imposed smart sanctions on certain sectors of the Russian economy and extended extra restrictive measures on Russian financial institutions. This is because, "identity" guides the interpretation of reality that helps state actors make sense of the situation and the interpretative framework allows the actors to understand the kind of threat they may face which becomes the basis of their actions. Therefore, they make actions that are more reasonable, justified and appropriate.(Duvall et al. 1999, 13) O'Hagan emphasizes that the discourses of identity play an important role in framing and constituting the political processes. They not only help the constitute actors, they establish the actions that is possible, desirable and legitimate. (O'hagan 2007)

Realizing the EU's collective decision on targeting Russian financial institutions with extra restrictive measures, the second objective of the thesis is to empirically estimate the impact of smart sanctions on Russian financial institutions, with a bank-level analysis. As the US smart sanctions on Russia happened during the same period as the EU smart sanctions, it's difficult to examine the impact of EU smart sanctions imposed on Russia, separating the US contribution. Thus, the empirical analyses consist of the bank-level data from both the sanctions lists, i.e. the EU and the US. To measure the "smartness" of the smart sanctions' impact on Russian financial institutions, this paper uses bank-level data of individual banks and presents an econometrical research to suggest that the sanctioned banks have had significant negative effects because of smart sanctions. To do so, regression analyses is done to find out if sanctioned banks or those associated with sanctioned individuals have lower profitability than non-sanctioned banks controlling for other factors. Here, the sanctioned banks are identified by examining the EU's and the US's sectoral sanctions lists and banks associated with individuals on the EU's restrictive measures list and the specially designated nationals list of the US; and these are the substantial shareholders having more than 5% share.

1.3   Contribution to the literature

Firstly, with the background of EU's smart sanctions imposed on Russia, this paper seeks to present a convincing case for the application of constructivism to the EU actors' decision on imposing smart sanctions on certain sectors of the Russian economy and extending extra restrictive measures on Russian financial institutions; by moving beyond a general theoretical debate and demonstrate how a constructivist conceptualization of "identity" and its influence over the "actions" can be applied to the study of the smart sanctions imposed on Russia and can illustrate it in ways that have generally not been attempted.

Secondly, recognizing the need of in-country firm-level analysis on smart sanctions imposed on Russia, this paper contributes to the literature by focusing on impact of smart sanctions on Russian banks through regression analyses, where data from 37 banks (6 sanctioned and 31 non-sanctioned) were examined from their IFRS financial reports at an annual frequency. This study argues that the effect of smart sanctions on financial sector should be examined separately as the intensity and scope of smart sanctions vary across the sectors. Furthermore, there will be spillover effects to other sectors of economy if financial sector is hit because of smart sanctions. So far, this paper represents the only paper that examines in-country data of individual Russian Banks to provide empirical facts on impact of smart sanctions on Russian financial institutions. The closest to this paper is by Ahn and Ludema who used firm-level data of Russian companies with a regression model to estimate the impact of smart sanctions across all the sectors of Russian economy and they don't capture the impact on Russian banks. (Ahn and Ludema 2017)

For research, the case of smart sanctions imposed on Russia was selected because, The EU and US led smart sanctions imposed on Russia for undermining and violating Ukraine's sovereignty, represents a new type of sanctions which targets specific individuals, entities and sectors rather than targeting the entire economy of the target state. As the objective of this paper is on establishing the link between "identity", "interests" and "actions" through a theoretical approach of international relations, constructivism was selected compared to other traditional international relations theory of realism which dominates the sanctions literature. Table 1 gives a

comparative of international relations theories of realism and constructivism and associated main instruments of analysis.

Competing Paradigms	Realism	Constructivism
Main Theoretical Proposition	Self-interested states compete for power and security	State behaviour shaped by actors' beliefs, norms and social identities
Main units of analysis	States	Individual Actors or Agents, where rules or norms make agents out of human beings by giving them opportunity to act
Main instruments	Economic and especially military power	Identities and interests
Focus	National security	Socialization, where people make society, and society makes people

Table 1 Comparative of IR theories and main instruments of analysis
Source: (Walt 1998)

1.4   Research questions and hypotheses

To address the problem described in the previous section and understanding the influence of the EU's collective identity on smart sanctions imposed on Russia, the first research question which will guide the thesis is mentioned as:

"How can constructivism provide an explanation for the collective decision taken by the EU actors (i) to impose smart sanctions on certain sectors of Russian economy following Russia's involvement in Ukraine with the annexation of Crimea and (ii) extending extra restrictive measures towards the Russian financial institutions following the aggression of Russian armed forces in eastern Ukraine?"

The second research question will lead to understanding the impact of smart sanctions on Russian financial institutions and expressed as:

Whether the smart sanctions against Russia are quite "smart," in the sense of hitting the sanctioned Russian Banks in terms of lowering their profitability compared with non-sanctioned banks?

Thus, two hypotheses are formed about the influence of the EU's collective identity on smart sanctions imposed on Russia and their effect on Russian financial institutions those will be tested in this thesis. The hypotheses are as follows:

1st: The "collective identity" of the EU stipulated the "objective interests" and "subjective interests" to its actors and influenced the "actions" of smart sanctions on Russian financial institutions.
2nd: Sanctioned banks have lower profitability than non-sanctioned banks controlling for other factors.

1.5   Scope of the paper

Firstly, the paper will establish "collective identity", "objective interests" and "subjective interests" as the principle elements of constructivism and strive to establish a connection between the EU's collective identity, objective interests and subjective interests, in relation to its common foreign and security policy. In view of these concepts, the EU's "actions" of smart sanctions imposed on Russia will be analyzed, particularly in imposing smart sanctions on certain sectors of the Russian economy and extending extra restrictive measures against Russian financial institutions. Then, Wendt's proposed identity and interest formation model (Wendt 1992, 406) will be adopted to explaining the link between the EU's collective identity, objective interests, subjective interests and actions on smart sanctions imposed on Russia, where EU will be on one hand and Russia, on the other hand. The model will exclude the Russian identity and interests which is beyond the scope of this paper. Recognizing the need of in-country firm-level analysis on smart sanctions imposed on Russia, regression analyses will be done further focusing on Russian Banks which will the main unit of empirical analysis in this paper. The paper will consider the list of Russian banks and banks associated with individuals having more than 5% share,

those explicitly targeted by the EU and U.S. from March 17, 2014 to 31st December 2016. The regression analyses would be accomplished to find whether sanctioned banks or those associated with sanctioned individuals have lower profitability than non-sanctioned banks, controlling for other factors. After the results of empirical analyses on bank profitability, the annual reports of sanctioned banks will be collected and analyzed with a content analysis, which will help in comparing the empirical findings with the literature.

1.6   Structure of the paper

The paper has the following structure. Firstly, on the chapter literature review (chapter 2), it describes the typology of economic sanctions (section 2.1), including a deeper explanation of comprehensive (section 2.1.1) and smart sanctions (section 2.1.2) followed by an understanding impact of sanctions (section 2.2). Then it gives the brief of the smart sanctions imposed on Russia by the EU and US (section 2.3) and categorizes the type of smart sanctions as Specially designated nationals/Designated persons (section 2.3.1) and Sectoral sanctions (section 2.3.2). The literature review proceeds with understanding collective identity of the EU and smart sanctions imposed on Russia (section 2.4) followed by empirical literatures on smart sanctions imposed on Russia (section 2.5). The last section of literature review describes bank profitability and determinants of bank profitability (section 2.6). Next chapter of methodology (chapter 3) explains process tracing (section 3.1), econometric analysis (section 3.2), which includes the data collection and analysis (section 3.2.1), description of variables (section 3.2.2) and finally the method of content analysis (3.3.3). Based on the analysis, results and discussions for process tracing (section 4.1), econometrical analysis (section 4.2) and finally, content analysis (4.3) are explained in detail followed by limitations (section 4.4) and future research (section 4.5). This is in the end followed by the conclusion (chapter 5).

CHAPTER II LITERATURE REVIEW

In the following section, the paper describes the typology of economic sanctions, and classification of sanctions followed by prior literature on understanding impact of sanctions. The paper further proceeds with analyzing the EU's collective identity and its influence on smart sanctions imposed on Russia followed by empirical literatures on smart sanctions imposed on Russia and ends with examining the literatures on bank profitability and determinants of bank profitability.

2.1   Typology of economic sanctions

"Economic sanctions" or sometimes referred as "Sanctions" is an instrument of foreign policy, generally imposed by the States or International Institutions (termed as "senders") to try to change the strategic policy decisions of other states and non-state actors (termed as "targets") that threaten their foreign and security policy interests or violate international norms of behavior. Historically, economic sanctions, date back to Pericle's Megarian decree in 432 B.C, which banned the Megarians to access the Athenian market places in response to the kidnapping of three Aspasian women. (Hufbauer et al. 2009, 9) They were also used during World War I, and following the war, economic sanctions were given extensive attention with the view that sanctions might be the substitute for armed conflicts as a policy alternative. Between 1914 and 1940, most of the cases of economic sanctions were led by the League of Nations to settle disputes. (Hufbauer et al. 2009, 9) However, between 1945 and 1990, economic sanctions were imposed only twice, in 1966 against Southern Rhodesia's white minority government and in 1977 against South Africa's Apartheid Regime, while in the 1990s sanctions were employed in sixteen cases, attributed to the end of cold war. (Drezner 2011, 97) The modern knowledge of economic sanctions as a nonviolent form of coercion with the preference of policy makers has led to a significant increase in the use of economic sanctions all through the latter half of the twentieth century.

The term "Economic Sanctions", sometimes referred as sanctions, is intentionally broad, since it includes all economic forms of influence. Pape mentions economic sanctions as one of the important strategies of international economic pressure excluding trade wars (complete or partial trade suspension or tariff escalation) and economic warfare and these have different effects when applied on target states.(Pape 1997, 93) Trade war happens when countries behave unilaterally and choose levels of protection that maximize their own welfare given the trade barriers of other countries and ignore the impact of their actions in other countries.(Grossman and Helpman 1995, 689) Economic warfare is defined as *"the conscious attempt to enhance the relative economic, military, and political position of a country through foreign economic relations"*. (Allen 1959, 259) Generally, purposes of economic warfare are to increase the economic power than that of other countries in terms of guaranteeing sources of supply and guaranteeing markets, thus improving trade and if possible, economic takeover. (Allen 1959, 263) Thus, the expression "economic sanctions" is distinguished from economic warfare and from other limited forms of adverse measures, such as trade countermeasures (like tariff escalation) or pre-emptive purchase of resources.

Pape (1997, 93) defines economic sanctions as *"international economic weapons- trade restrictions and financial restrictions"*- each of which can be employed with varying intensity and scope. Tostensen and Bull defines economic sanctions as *"temporary abrogation of normal state to state relations to pressure target states in to changing specified policies or modifying behavior in suggested direction."*(Tostensen and Bull 2002, 259) However, Hufbauer et al. defines economic sanctions as *"deliberate, government-inspired withdrawal, or threat of withdrawal, of customary trade or financial relations" and are a key aspect of international relations.*(Hufbauer et al. 2009, 3) Similarly, Jones defines that "*sanctions typically involve states or international organizations attempting to coerce target governments into making political changes by restrictive economic interactions with their territories including trade and finance."*(Jones 2015, 1) Analytically, most of these definitions refers economic sanctions as a coercive attempt or constraining attempt on "target" where trade restrictions and financial restrictions are two integral parts of economic sanctions. However, the definition of Hufbauer et al. differs from other

definitions as they include signaling (threat of withdrawal) as an important tool of economic sanctions along with coercing and constraining. The below table gives a comparative of restrictions under economic sanctions.

ECONOMIC SANCTIONS	
TYPE OF RESTRICTION	DESCRIPTION
TRADE IN GOODS	Limiting exports Restricting imports
TRADE IN SERVICES	Restriction on capital flows (restrict or suspend lending) Restriction on International Payments

Table 2 Comparative of restrictions under economic sanctions
Source: (Hufbauer et al. 2009)

2.1.1   Traditional/Comprehensive sanctions

Traditional or Comprehensive sanctions have historically been imposed on different countries to create pressure on the government which may lead to compliance and help in determining the outcomes as desired by the senders. Often comprehensive sanctions are apparent to serve as twofold purpose; to express disapproval of the target's objectionable behavior and to force the target, through restrictive measures, to change the conduct and bring to compliance. It ranges from oral condemnation to military intervention including economic sanctions and can be unilateral (one state against another) or multilateral (broad front of states against a target state) in nature.

The theory of comprehensive sanctions works with the assumption that hardships inflicted on the civilian population of a target state will lead to grassroots political pressure on that state's leaders to change their behavior. The presupposed hypothesis is that the burden of economic hardship imposed by comprehensive sanctions will become intolerable to the citizens of the target state, who in turn either revolt against their government or pressure their leaders to change undesirable, by initiating and demanding political change. Bergeijk explains that the less democratic a country the more likely is that economic sanctions will fail to change policies. (Bergeijk 2012) This means comprehensive sanctions are likely to be effective in democratic states and transmission mechanism of comprehensive sanctions may fail

to produce expected outcomes, in case of authoritarian regimes, where internal opposition is weak, in most cases.

Looking at the possible objectionable behavior of the target country, there are many causes which may lead to comprehensive sanctions, if broadly classified can be of two types,

 (a) Threat to security, stability or peace of sovereign states

 (b) Human Rights Violation

The major objective of the comprehensive sanctions was to change the behavior of the target states against whom they are employed, thus the effectiveness of sanctions lied; whether the effects of the sanctions will tend to change the policy of the target in the direction desired by the senders, or not. (Drezner 2011) Collateral damage which would be the effect of these sanctions was not calculated prior to the sanctions in most of the cases of comprehensive sanctions. The most common foreign policy goals that have been associated with comprehensive economic sanctions broadly include: changing a target state's internal policies; changing a target state's foreign and security policies; change in target's regime; disrupting target's military potential; and military aggresion.

Regardless of the increase in successful foreign policy outcomes through comprehensive sanctions, concerns about the collateral damage caused by comprehensive sanctions caused a global backlash against the policy instrument. By the mid-90s, it was no longer enough for comprehensive sanctions to achieve foreign policy goals; they had to do so without excessive harm to civilian population in the target state. For example, comprehensive sanctions precipitated humanitarian crisis in Iraq by thrusting severe negative impact on Iraq's economy and sanctions cannot be fully extricated from the human suffering occurred in Iraq.(O'Sullivan 2003, 145) In Later 90s, many scholars advocated, and a series of conferences were convened between policy makers, all embracing organizations, and civil societies to figure out the effectiveness of comprehensive sanctions and how comprehensive sanctions would have a better chance of success without hurting the public.(Drezner 2011, 96) Later half of the 90s, worked on the refinement of comprehensive sanctions which lead to development of "Smart Sanctions" as an alternative.

2.1.2   Smart Sanctions: Modern alternative to comprehensive sanctions

Prompted by the need to mitigate the unintended negative consequences of comprehensive sanctions on civilian populations, senders have shifted their comprehensive sanctions policy to a system of 'smart' or 'targeted' sanctions such as targeting certain sectors of the target economy, asset freezes or travel bans. Being more accurate in targeting than the comprehensive sanctions, smart sanctions are supposed to put political pressure specifically on those responsible for the internationally condemned actions or violation of international law. Tostensen and Bull identified that smart sanctions in theory differ from comprehensive sanctions in two ways (Tostensen and Bull 2002):

(a) Smart sanctions more effectively target and coerce via arms embargoes, financial sanctions and travel restrictions etc.

(b) Smart sanctions protect vulnerable groups by exempting certain commodities such as foods, medicines from the restrictive measures.

Smart sanctions are designed to hit the real target harder and spare the innocent civilian population and likely to avoid unnecessary humanitarian costs. In case of authoritarian regimes, smart sanctions can be more effective by disrupting the ability of its leaders to offer rent-seeking opportunities to their supporters and restrict their personal economic positions. (Jones 2015) For example, targeted financial sanctions can disrupt the ability of individuals to access international finance system rather than the entire target economy. Similarly, targeted nonfinancial sanctions can prohibit specific transactions with specific sectors of the target economy. The most prominent examples of smart sanctions included arms embargoes, restrictions on luxury goods imports, asset freezes, financial restrictions and travel bans. The below table explains the different types of smart or targeted sanctions.

TYPE OF SANCTIONS	CATEGORY		DESCRIPTION
SMART OR TARGETED SANCTIONS	SPECIALLY DESIGNATED NATIONALS	FINANCIAL	Restrict the ability of individual or entity to access international financial system, asset freeze etc.
		NON-FINANCIAL	Travel and visa restrictions for individuals
	SECTORAL SANCTIONS	FINANCIAL	Prohibits specific financial transactions (like issuance or trade in bonds, equity or similar financial instruments) with specific sector.
		NON-FINANCIAL	Prohibits specific transactions (trade in goods or non-financial services) with specific economic sectors like defence, energy sector.

Table 3 Typology of smart sanctions
Source: (Rosenberg et al. 2016)

2.2   Understanding the impact of sanctions

The impact of comprehensive sanctions has been an issue in academic research and has been debated extensively for many decades. There are both quantitative and qualitative methods to measure the impact of comprehensive sanctions. Pape argues that *negative impacts on the target state's aggregate GDP measures the success of sanctions*. (Pape 1997, 93)To estimate the impact of comprehensive sanctions, quantitative methods were used by scholars using measurements such as gross domestic product, gross national product, trade linkage (percent of two-way trade between sender and target). Hufbauer et al. used a gravity model that estimates the impact of comprehensive sanctions on bilateral trade flows by using a regression equation.(Hufbauer et al. 2009)

However, for the qualitative part, the impact of comprehensive sanctions has been discussed in the context of sanctions effects on target's gross domestic product, trade and sanctions success. Baldwin suggests an argument that mere imposition of comprehensive sanctions can be treated partially successful because it makes *the target pay a price for non-compliance*.(Baldwin 2000, 85) Pape notices a standard for

judging the comprehensive sanctions requires that the target state concede to a significant part of senders's demand.(Pape 1997, 97) Hufbauer et al. categorizes the impact of comprehensive sanctions in four possible ways, (1) failed outcome, (2) unclear but possibly positive outcome, (3) positive outcome with sender's policy goals are partly realised and (4) successful when the senders' goals are largely and entirely realised. (Hufbauer et al. 2009, 45) Analytically, most of the literature suggests that the impact of comprehensive sanctions can have two possible outcomes, i.e. successful or unsuccessful.

However, Hovi, Huseby and Sprinz explains the requirement of two level approach to understand the impact of smart sanctions. (Hovi, Huseby, and Sprinz 2005) They argue that analyzing the smart sanctions measures like asset freeze, travel ban, capital restrictions which are secondary objectives, also have the potential influence on the general primary objective, i.e. compliance of target or any prompt significant movement in the target's policy positions as desired by the sender.

For the quantitative research on impact of smart sanctions, most of the researchers used econometric analyses like regression analyses, structural vector auto regression method to estimate the impact on macro level like cost to sender and cost to target, responsive of macroeconomies to sanctions shock (Kholodilin and Netsunajev 2016, Moret, Giumelli, and Bastiat-Jarosz 2017) while others are interested in estimating the impact on firms. (Ahn and Ludema 2017, Crozet and Hinz 2016) To estimate the impact of smart sanctions, quantitative methods were used by researchers using measurements such as extensive and intensive margins of trade, reaction of gross domestic product growth to sanctions shock, operating revenue of firms, value of assets of firms.

Bergeijk and Biersteker outlines the importance of pre-sanctions trade volume between the sender and target as a major (pre) condition for sanctions success and its need to be important enough for economic sanctions to work. (Biersteker 2015) This means that the lower the level of pre-sanction trade, the higher the probability of failure and higher pre-sanctions trade volume gives a higher probability of success of sanctions. They also mention that sanctions tend to succeed if there is strong multilateral political commitment between senders. Analytically, this means that sanctions need to be seen in broader context of entirety of relationships between the

sender and target, as sanctions become only one component of interaction between these two entities. Thus, the impact of sanctions depends on the consistency of sanctions with other type of interactions such as political interactions, trade in goods, trade in services as well.

2.3   Smart sanctions imposed on Russia by the EU and US

The transfer of Crimea to Russia was explicitly condemned by the international community including the European Union. The initial measures of the EU (asset freezes and travel suspensions) were implemented through Council Decision 2014/145/CFSP and Council Regulation (EU) No 269/2014 on March 17, 2014 and have been expanded and tightened with smart sanctions targeting certain sectors of Russian economy in July and Sept 2014 to put additional pressure on the Russian government. (Union 2014b, d) Similarly, the US smart sanctions were implemented through Executive Orders where economic measures are employed and monitored by the Office of Foreign Assets Control and export control by the U.S. Department of Commerce, Bureau of Industry and Security, and the U.S. Department of State, Directorate of Defence Trade Controls.(Register 2014a, b, c) Crozet and Hinz categorized the Russian sanctions episode into three periods, a conflict period in which tensions started between December 2013 and February 2014, followed by a period of "smart sanctions" starting in March 2014. (Crozet and Hinz 2016, 8,9) A third period then started in August 2014 with the implementation of trade restrictions and financial restrictions. A brief timeline of smart sanctions imposed on Russia is as follows:
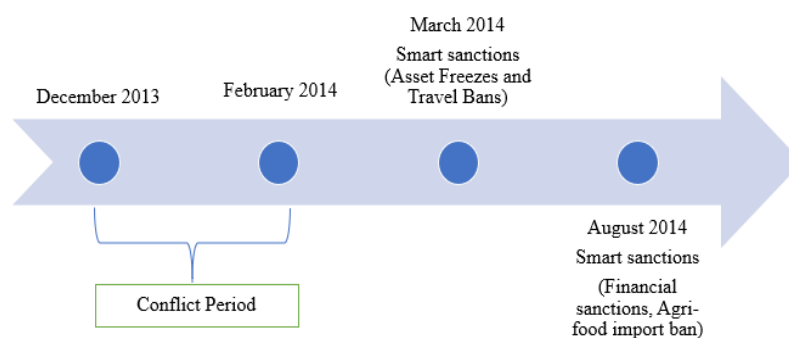
Figure 1 Timeline of smart sanctions imposed on Russia
Reprinted: (Crozet and Hinz 2016)

Those smart sanctions were primarily targeted at individuals and entities taking part in the absorption of Crimea and destabilizing the situations in eastern Ukraine. They are imposed against targets in Russia, Ukraine including the territory of Crimea and include measures imposed against individuals and entities (asset freezes, travel bans) and prohibits the financial transactions with Russian companies operating in specific sectors which includes finance, defense and energy sector. More detailed and categorical explanation of smart sanctions imposed by the EU and US on Russia has been given in the next two sections.

2.3.1   Specially designated nationals/Designated persons

In this type of Smart sanctions, sender countries typically introduce smart sanctions targeting individuals and legal entities, which means they issue a list of "specially-designated nationals" or "designated persons" or entities. Generally, the smart sanctions introduced with respect to SDN's and DP's or entities are similar in nature and require the assets of the sanctioned persons or entities to be blocked and that the listed individual be banned from entering the implementing countries. Smart sanctions affect not only the SDN's and DP's, but also assets and property that are directly or indirectly controlled or owned by them. Under individual restrictive measures, the EU decided to freeze the assets and impose travel bans on 150 people and 38 entities because their actions undermined Ukraine's territorial integrity, sovereignty and independence. (Union 2014c, b, d) These are identified jointly by the European Commission and the Council of the European Union. At European Commission, the Foreign Policy Instruments (FPI) responsible for preparing proposals on sanctions with the scope of sanctioned measures. While at the Council, the proposals are examined and discussed by the relevant Council preparatory bodies:

- the Council working party responsible for the geographical region to which the targeted belongs (for example, the Eastern Europe and Central Asia Working Party for Ukraine or Belarus)

- if required, the Political and Security Committee and the Committee of Permanent Representatives (COREPER II)

Travel Ban of listed persons means the targeted persons cannot enter the EU, or travel beyond their member state of nationality if they are an EU citizen. All their assets in the EU are frozen, which furthermore adds that the EU citizens and entities cannot make any funds available to those on the DPs list. (Union 2014c, b, d)

Similarly, designated SDN individuals and entities under US smart sanctions list face asset freezes and travel bans in the United States, where transactions and other activities by U.S. persons (individuals or entities) with these designated SDN individuals and entities are prohibited.(Register 2014a, b, c) Altogether, the U.S. has designated 111 individuals and 82 entities on its SDN List as related to its Russian sanctions.(Register 2014a, b, c) Ahn and Ludema classifies the sanctioned individuals into two categories (political figures and business figures) and finds that about one fourth of US sanctioned individuals are business figures. Meanwhile, the EU designated persons lists are dominated by political figures.(Ahn and Ludema 2017, 10,11)

2.3.2 Sectoral sanctions

Sectoral sanctions are another type of smart sanctions usually introduced by sending countries by targeting certain sectors of the target economy, primarily in such spheres as finance, energy and defense with the intensity and scope varies across sectors. Usually, sectoral sanctions prohibit the direct or indirect provision of investment services or assistance in the issuance of, or any other dealing with bonds, equity, or similar financial instruments, as well as the supply of certain products and financial or technical assistance relating to such products and the jurisdiction applies to the sender's territory. In the EU, typically, a sectoral sanctions identification list (SSI list) is prepared followed by the Council decision. For example, the sectoral sanctions list issued on 31st July 2014 listed five Russian financial institutions, namely Sberbank, VTB bank, Gazoprom bank, Vneshekonom bank and Russelkhoz bank. (Union 2014b) The European Union's sectoral sanctions were targeted against certain sectors in Russian economy including financial, energy and defense sectors.

Similarly, series of Executive Orders issued by the U.S. accompanying the sectoral sanctions focused on the financial, defense and energy sectors in Russian economy as well. (Register 2014c) The detailed explanation of sectoral sanctions imposed on Russia is given in the next section.

2.4   The EU's collective identity and smart sanctions imposed on Russia

Constructivism, identifies "persuasive ideas, collective values, culture and social identities" as the central forces shaping international politics. According to Onuf, constructivism holds that *people make society, society makes people, and this is a continuous, two-way process. Between people and society, there is a third element, rules, that link the other two elements together.(Onuf 2012, 2)* Alder mentions that theory of constructivism reflects on studying *construction of social reality by norms and the normative application of such constructions.* (Adler, 113) Guzzini argues that constructivism is about *the social construction of knowledge and the construction of social reality.* (Guzzini 2000, 149) Checkel mentions, constructivism, as a theory examines *the role of norms and identity in shaping international political outcomes.* (Checkel 2006, 2) Wendt mentions constructivism as a form of systemic theory in which *identities and interests are the dependent variable.* (Wendt 1999) Identities constitute interests and actions as identities by themselves do not explain action as being is not the same thing as wanting. (Wendt 1999, 231) In the theory of constructivism, *materialistic element is secondary to the intellectual element*, because the intellectual element infuses the former with meaning. (Jackson and Sørensen 2006, 165) In summary, "constructivism" holds the view that (1) social reality is shaped by shared ideas as well as material forces and (2) the identities and interests of agents are shaped primarily by these shared ideas.

Institutional Identities are inherently relational and are basis of interests whereas an institution is a structure (social structure with rules or norms) of identities and interests. Constructivists argue that agency (social condition) and structure (social structure) are mutually constituted, which implies that structures influence agency and that agency influences structures. (Hopf 1998, 172) Social structures are defined by shared understanding, expectations or knowledge and these constitute the actors in the situations and their relationships with structure. (Jackson and Sørensen 2006)

Constructivists also argue that states can have multiple identities that are socially constructed through interaction with other actors. According to constructivism theory there exists four kinds of identities (Wendt 1999, 234): (1) personal identity or corporate identity in the case of organizations, (2) type identity (refers to a social category or label applied to persons who share same characteristics), (3) role identity (depends upon culture and shared expectations and exists only in relation to "Others"), and (4) collective identity (takes the relationship between "Self" and "Other" to its logical conclusion. i.e. identification.)

.   Collective Identity deals with the relation between "Self" and "Other", where the former identifies with the latter. The concept possesses the causal ability to encourage actors to define the "Other" as part of "Self" (Wendt 1999, 229) Wendt suggests this process to be altruistic, since the actors determine their interests on the basis of collectivity to which they belong, hence they are able to overcome the challenges concerning collective action. (Wendt 1999, 229) Collective identity is a prerequisite for the existence of interests (both objective and subjective) and the same applies vice-versa because without interests identities have no motivational force, without identities interests have no direction.(Wendt 1999, 231)

There are two kinds of interests according to the constructivist theory; objective and subjective. For an identity to be produced, it is necessary to meet objective interests, whereas subjective interest *lies in the beliefs of actors about how to meet their identity needs.* (Wendt 1999, 234) Subjective interests are preferences over outcomes, not preferences over strategies, because action is caused not only by the desire but also by what is possible to attain, and preferences cannot be inferred from the actions.(Wendt 1999, 232, Jackson and Sørensen 2006, 165) In the absence of interests, however, identities lack "motivational force" and cannot explain actions which results from a combination of "desire" and "belief." (Wendt 1999, 231)

For understanding the EU "Identity" and "interests "and then realizing the "Self" and "Other" relationship, the EU smart sanctions, which is adopted in the framework of common foreign and security policy, was studied closely. The EU common foreign and security policy is guided by the "the EU Values, democracy, peace, rule of law, human rights, international law, preventing conflict and strengthening international security". (Union 2014a, 1) On smart sanctions, the

official discourses of EU which includes regulations, factsheets and decisions formulates a definition of jurisdiction bounding only those belonging to its member states and third countries are separately referred as "Other". (Union 2014a, Union 2014b)

The jurisdiction of the EU sanctions is defined as:

- within EU territory (which includes its airspace)
- to EU nationals, whether they are in the EU or not
- to companies and organizations incorporated under the law of a member state
- to any business done within the European Union (in part or completely)

The collective identity and interests of the EU also applies to the smart sanctions, that comes to force by the Regulations of Restrictive Measures based on Article 215 TFEU, which provides a legal basis for constraining the Union's economic and financial relations with the third countries (in part or completely) and decisions adopted in the framework of the Common Foreign and Security Policy. (Union 2014a, 1)These are adopted, where such measures are necessary to achieve the objectives of the Common Foreign and Security Policy (CFSP). In European Union law, regulations on restrictive measures are directly applicable in all EU Member States and they have *general application and are binding in their entirety*. (Union 2014a, 1) The decisions on the sanctions in EU are collectively decided by its "actors" and adopted by the following steps:

- A joint proposal which contains the details on the precise scope of the restrictive measures, is made by the High Representative of the Union for Foreign Affairs and Security Policy and the European Commission, thereafter presented for a Council regulation.
- The decision on sanctions comes after thorough discussion in the European Council and there is a collective decision by unanimity or qualified majority if required.
- The European Council then informs the European Parliament of the adoption of the Council regulation.

The EU Council's decisions (2014/145/CFSP,17th March, and 2014/512/CFSP, 31st July) as well as the Regulation (EU) No 833/2014 of 31 July 2014 condemned Russian Federation's actions undermining or threatening the territorial integrity, sovereignty and independence of Ukraine and European Council collectively decided to impose significant restrictive measures on Russia by mentioning the Russian act as illegal, and unprovoked violation of Ukrainian sovereignty and territorial integrity. On 8th September 2014, the European Council amended the decision (2014/512/CFSP) concerning restrictive measures, condemning the increase in inflows of fighters and weapons from Russian into Eastern Ukraine. European Council collectively decided to put additional restrictions on access to the capital market, particularly certain Russian financial and defense institutions, for the reason of increasing the cost of smart sanctions imposed on Russia. (Union 2014d) The desired implication of this potentially leads to stricter access to capital market of the EU, for the Russian financial and defense institutions; by limiting the foreign intermediate inputs for their operations. With limited foreign intermediate inputs, the cost of operations increases, thus leading to lower profitability. (Ahn and Ludema 2017, 3) The details of the EU restrictive measures with timeline is given below.

The EU Restrictive Measures		
Prohibition of issuance or trade in bonds, equity or similar financial instruments		
Date of announcement	Period when the financial instrument was issued	Maturity of the prohibited instruments
March 17, 2014	Before 12th September 2014	Longer than 90 days maturity for all financial, defence and energy sectors of Russian economy
July 31, 2014	On or after September 12, 2014	Longer than 30 days maturity for financial and defence institutions on the SSI list

Table 4 The EU restrictive measures
Source:(Union 2014b, d)

Similarly, the restrictive measures of the US on smart sanctions imposed on Russia are tightened with extra restrictive measures for Russian financial institutions, since the initial measures of March 2014, where maturity periods of financial

instruments are shortened. (Register 2014c) Here, table 5 gives a comparative of restrictive measures on Russian financial institutions by the EU and the US.

Prohibition of issuance or trade in bonds, equity or similar financial instruments with Russian financial institutions

US Restrictive Measures		The EU Restrictive Measures	
Period when the financial instrument was issued	Maturity of the prohibited instruments	Period when the financial instrument was issued	Maturity of the prohibited instruments
On or after July 16, 2014 and before September 12, 2014	Longer than 90 days maturity	On or after August 1, 2014 and before September 12, 2014	Longer than 90 days maturity
On or after September 12, 2014 and before November 28, 2017	Longer than 30 days maturity	On or after September 12, 2014	Longer than 30 days maturity
On or after November 28, 2017	Longer than 14 days maturity		

Table 5 Restrictive measures by the EU and US on Russian financial institutions
Source:(Register 2014c),(Union 2014b, d)

2.5   Empirical analysis of smart sanctions imposed on Russia

In case of smart sanctions imposed on Russia, most empirical studies are macro level analysis while others estimate the impact of smart sanctions against specific targets. Researchers attempting to empirically estimate the impact of smart sanctions on Russia face the challenge of extricating the impact of smart sanctions from the dramatic drop in oil prices and uncertainty of global hydrocarbon market prices, which coincides with the Russian sanctions period. (Ahn and Ludema 2017, Crozet and Hinz 2016, Fritz Oliver 2017) Russia, being a net exporter of natural gas, was affected by the deterioration of the situation in the global hydrocarbon market (significant decrease of natural gas price in 2014) during the sanctions period; which led to the ruble depreciation, growing inflation and dropped business confidence. (Russia 2015, 12,13)

Kholodilin and NetŠunajev used a structural vector auto regression method (SVAR) to evaluate consequences of smart sanctions to identify the sanctions shock and trace the reaction of the Russian and European economies to the shock. (Kholodilin and Netsunajev 2016) They used SVAR method because it allows to (1) assess the responsiveness of macro economies to smart sanctions dynamically; (2) understand contribution of smart sanctions shocks to the variability of the macroeconomic indicators; (3) obtain a counterfactual data series under the assumption of the absence of smart sanctions. They assess the responsiveness of macro economies, (i.e. Russia and Euro Area) to smart sanctions and assess the contribution of smart sanctions shocks to the variability of key macroeconomic variables like gross domestic product growth, exchange rate. They chose Euro Area because euro area economies, have significant impact on the aggregate growth of the European Union and these economies share the same currency and monetary policy. Their findings reflect that smart sanctions directly affect Russian GDP, but not the GDP of euro area as they found much larger variations in the GDP growth of Russia than of the Euro Area given the smart sanctions shock.

Estimating the impact of Russian sanctions, Moret, Giumelli and Bastiat-Jarosz mentiones that sanctions on Russia have had a targeted or "smart" impact, rather than imposing costs on the entire Russian economy.(Moret, Giumelli, and Bastiat-Jarosz 2017) They adopted a general comparative analysis method with trade and investment data, both at country and sectoral level. Analysing macro trade and investment data between the US, the EU and Russia, they found that economic costs incurred have been substantially larger for the EU than for the US. This is because, the EU had significantly larger volume in terms of trade in goods and trade in services with Russia compared to that of the US.

Crozet and Hinz studies the firm-level effects of the smart sanctions regime between Russia and Western countries, where they use French firm-level data and ordinary least square method (OLS) to explain if the French firms' exports were affected with respect to margins of trade i.e. the individual firm's participation on the Russian market (extensive margin) as well as the export value of those firms that stayed in the Russian market (intensive margin) after smart sanctions imposed on Russia. (Crozet and Hinz 2016) Their regression results show that the smart sanctions

significantly reduced both firm export participation and the value exported by the export firms. For example, in agri-food products, about one fourth of the firms that had previously present in the market were active after the sanctions imposed and those stayed in the market exported 89 % less than before.(Crozet and Hinz 2016)

Ahn and Ludema uses detailed firm-level data for all the sectors of the Russian economy with regression analyses to study the impact of smart sanctions imposed on Russia, where they constructed sanctions as a dummy variable. Their main finding is that sanctioned Russian companies or those associated with sanctioned individuals are significantly affected by smart sanctions compared with non-sanctioned companies *in terms of losing operating revenue, asset value and number of employees*. (Ahn and Ludema 2017)

2.6   Bank profitability and determinants of bank profitability

The empirical analyses of this paper focus on the Russian financial institutions and the impact of smart sanctions on their profitability. To better understand the impact of smart sanctions on the Russian financial institutions, it is crucial to first understand what bank profitability is and the determinants of bank profitability. The below section examines the existing literatures on bank profitability and the determinants of bank profitability and these papers don't examine sanctions. The aim of this section is to give a comprehensive overview of important findings of other studies. Furthermore, relevant studies and used empirical models are discussed on which this paper can build the regression model.

The bank profitability variable is represented by two measures in the literature: the ratio of profits to total assets, i.e. the return on assets (ROA) and the profits to total equity ratio, i.e. the return on equity (ROE). (Kohlscheen, Pabón, and Contreras 2018, Staikouras and Wood 2004) In principle, ROA reflects *the ability of a bank's management to generate profits from the bank's assets* (Claessens, Coleman, and Donnelly 2017) while ROE indicates *the return to shareholders on their equity*. (Athanasoglou Panayiotis 2005, Kohlscheen, Pabón, and Contreras 2018)

Most of the literature categorizes the determinants of banks' profitability into two parts, namely bank-specific characteristics, and external macroeconomic characteristics, while others use industry specific characteristics, additionally. Internal factors are those within the control of the bank and are mainly influenced by the bank's management decisions and policy objectives, while the external determinants like industry specific or macroeconomic are beyond the control of the bank's management. (Athanasoglou Panayiotis 2005) Several explanatory variables have been proposed for the above categories, according to the nature and purpose of each study, which are described separately for each paper below.

Athanasoglou et al. follows ROA and ROE as alternative dependent variables in their empirical model while capital adequacy (measured as equity to asset ratio), credit risk (measured as loan loss provisions to total loans), size (log value of assets), productivity (measured by real gross total revenue over the number of employees) and expenses management (operating expenses to assets ratio) are taken as bank specific characteristics. (Athanasoglou Panayiotis 2005) Additionally, "concentration"as an industry specific characteristic has been taken using the 'Herfindahl-Hirschman (H-H) index, calculated by *squaring the market share of each firm competing in a market, and then summing the total numbers*. Furthermore, inflation and cyclical output represents the macroeconomic determinants of bank profitability in their model. They used a dynamic panel data with a GMM technique estimation procedure. The empirical results suggest that bank specific determinants credit risk, size, significantly affect bank profitability while the industry variables are not significant in explaining bank profitability.

Staikouras and Wood quantifies how internal determinants and external factors (GDP growth and Inflation) contribute to the profitability of banks. They used a regression model where they employ four variables to account for bank-specific characteristics namely loan to asset ratio, equity to asset ratio, provision of loan losses and bank size.(Staikouras and Wood 2004) Their estimation results shows that banks with greater levels of equity are relatively more profitable and the loans to assets ratio and provision of loan losses are inversely related to banks return on assets. However, they used both the Herfindahl index,the industry specific variables and firm specific market share as independent variables and the results are not significant for both the

variables in explaining profitability. Furthermore, their results suggests that profitability of European banks is not only influenced by the bank specific factors, but also by the macroeconomic factors as they found a positive effect of level of interest rates on bank profitability.(Staikouras and Wood 2004)

Claessens et al. examines the relationship between bank profitability and interest rates through a cross country empirical analysis. The empirical analysis follows ROA as the bank profitability while deposits over total liabilities, total equity capital over total assets, and total securities over total assets as bank level controls and GDP growth as macro economic control. They used a regression model with bank fixed effects and time fixed effects and their results finds a negative effect of low interest rates on bank profitability and capital adequacy has a positive relationship with profitability. (Claessens, Coleman, and Donnelly 2017)

Kohlscheen et al. analyses key determinants of bank profitability, where both ROA and ROE are taken as measures of profitability. (Kohlscheen, Pabón, and Contreras 2018) For the empirical analysis, loan growth, capital, liquidity provision, consumer deposits, efficiency are taken as bank related variables while GDP growth, short- and long-term interest rates are taken as macro-economic variables. They used a regression model for empirical analyses and finds that profitability is significantly affected by capital adequacy measured as equity to assets ratio, size measured as log value of total assets and expenses measured as operating expenses to assets ratio. (Kohlscheen, Pabón, and Contreras 2018)

Bikker et al. used a dynamic model with lagged dependent variable to investigate the impact of the low interest rates on profitability of US banking sector. (Bikker and Vervliet 2018) They used size (log value of total assets), capital adequacy (ratio of equity to assets), credit risk (loan loss provisions), liquidity risk (ratio of total loans over total assets), diversification (ratio of non-interest income over total income) as the bank specific variables. Furthermore, macroeconomic variables are taken with real GDP growth and inflation in their paper. In their findings, all the bank specific variables are significant in explaining profitability while inflation, as the only macroeconomic variable explains profitability. (Bikker and Vervliet 2018)

Most of the literature used linear models with annual data frequency to estimate the impact of various factors that may be important in explaining profitability while Athanasoglou et al. and Bikker et al. adopted dynamic models by including a lagged dependent variable among the regressors. (Athanasoglou Panayiotis 2005, Bikker and Vervliet 2018) Mostly, the literature essentially considers determinants of profitability at the bank and/or industry level followed by macroeconomic determinants.

Bank specific determinants capital adequacy, credit risk, liquidity risk and operating expenses appear to be an important determinant of profitability in most of the literature. Additionally, Athanasoglou et al. used productivity as an important bank specific determinant and found productivity has significant positive relationship with profitability.

There are two hypotheses on the industry specific and bank market share variable, (1)The structure conduct performance hypothesis, which argues that banks are able to extract monopolistic rents in concentrated markets by offering lower deposit rates and charge higher loan rates, (2) The relative market power hypothesis which argues that firms with large market shares and well differentiated products are able to exercise market power and earn more profits. (Athanasoglou Panayiotis 2005) Supporting the structure conduct performance hypothesis, Athanasoglou et al. used HH index as a proxy of concentration while Staikouras and Wood (2004) used market share of individual banks to examine whether market share is important in explaining profitability, supporting the market power hypothesis. In both cases, not only the structure conduct performance hypothesis, but also the relative market power hypothesis is not important in explaining profitability.

Finally, most of the literatures used GDP and inflation as the macroeconomic variables to isolate their influence from that of bank structure so the impact of macroeconomic factors on profitability may be more clearly understood. However, the relationship between the macroeconomic variables and profitability is ambiguous in most of the literature.

CHAPTER III   METHODOLOGY

This section describes the methodologies used for the study, the data and description of variables as well which includes the specification and explanation of the used econometrical model.

3.1   Process tracing

For the research question on the EU's collective identity and its influence on smart sanctions imposed on Russian financial institutions, the methodology of "Process Tracing" is used, which is well suited to testing theories to identify the intervening casual process and multiple interaction effects. The process tracing research method attempts to identify the casual chain and casual mechanism *"between an independent variable (variables) and the outcome of the dependent variable."* (George and Bennett 2005, 206) It's a two- stage deductive process where the researcher first *clarifies the theoretical argument and then empirically verifies the theoretically predicted intermediate steps and the goal is to get sufficient explanation of the outcome*.(Beach and Pedersen 2013, 10) By process tracing, analysts can better understand the processes that constitute the interests of actors. (Klotz and Lynch 2014, 95) Furthermore, this is an appropriate method for a detailed study of diffusion and decision making by describing the sequence of key decisions as it focuses on *unfolding the events or situation over time*. (Collier 2010, 2) Process tracing research method is getting increased attention for researchers focusing on constructivist approaches to international security studies. (Checkel 2017, 14) To conclude, use of this methodology is well suited for this thesis as the aim of the first research question is to provide a constructivist interpretation to the actions of the EU actors on imposing smart sanctions on Russia and extending extra restrictive measures on Russian financial institutions.

Official documents of the EU, which includes the Factsheet of EU's restrictive measures, council of the European Union's decisions and regulations are selected for the research because they comprise the official EU decisions for the imposition of economic sanctions against Russia. Official discourse provides better evidence *for*

articulation of interests because it reveals normative rationales for policy.(Klotz and Lynch 2014, 95) Since the research question is on the decisions taken within the framework of the EU, it is necessary to assess the documents at the EU level and studied further to reflect a constructivist field of analysis.

For explaining the results of process tracing, the model of identity and interest formation proposed by Wendt will be used where Russian identity and interests are excluded; which is beyond the scope of this paper. The reproduced model is shown in figure 2 below.
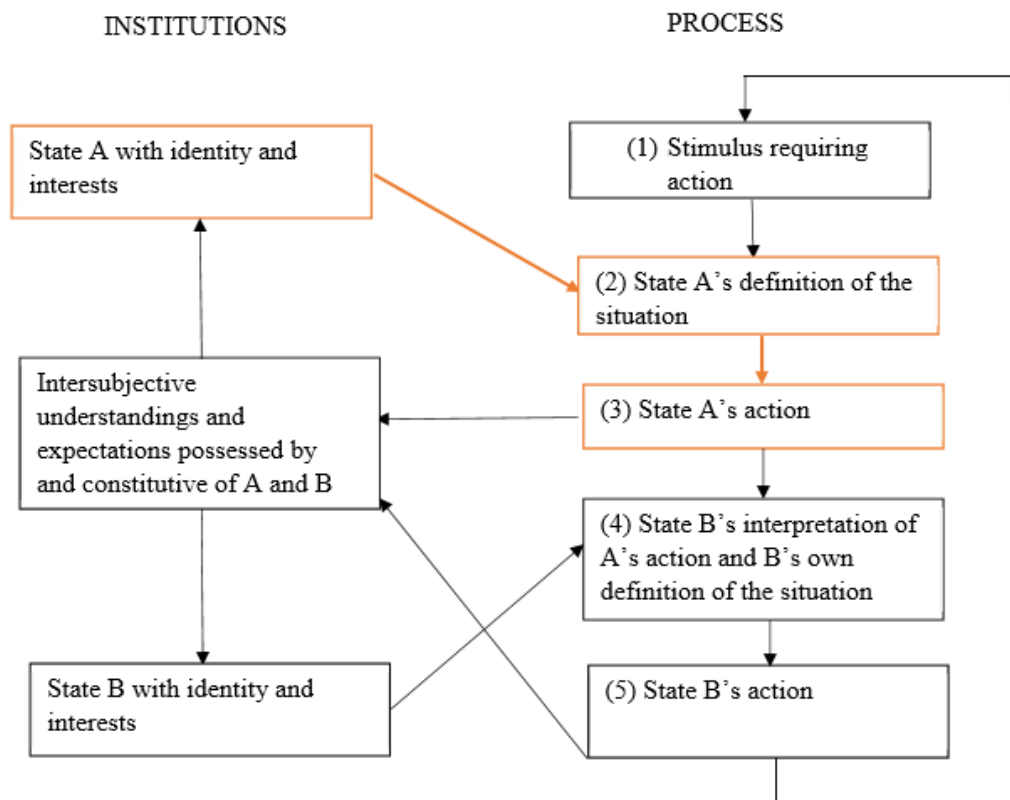
Figure 2 The codetermination of institutions and process

Source: (Wendt 1992, 406)

The constructive interpretation will be explained in three steps:

Step 1: The EU with "Collective Identity", its "objective interests" and "subjective interests".

Step 2: The EU's "definition" of the situation.

Step 3: The EU's "actions" on smart sanctions imposed on Russian financial institutions.

3.2   Econometric analysis

For firm level research, regression analyses are done to examine the profitability of sanctioned banks and banks associated with sanctioned individuals compared with the non-sanctioned banks.

3.2.1   Data collection and analysis

Here, the data that form a balanced panel data set covers a period of 5 years (2012-2016) including two years (2012 and 2013) without sanctions. Overall, the data consists of 37 selected Banks (6 sanctioned and 31 non-sanctioned) and those are listed on MOEX as of 31st Dec 2017. Collection of balance sheets and income statement data are done from the official websites of respective banks at an annual frequency. Sanctioned banks are identified after examining both the SDNs/Restrictive measures lists and SSI lists of the EU and the US. 10 sanctioned banks are identified based on two criteria, (1) if, it is listed on the sectoral sanctions or entities list, (2) if a sanctioned individual is associated with the bank as a shareholder with more than 5% share. This is because substantial shareholders are classified by a minimum shareholding percentage, which is usually fixed at 5%. (OECD 2017) However, data of only 6 sanctioned banks could be gathered for the empirical research because of unavailability of information on Sobin Bank, Russia National Commercial Bank and SMP Bank, while Bank Moscow has been merged with VTB Bank. The sampled sanctioned banks cumulatively share about 61% market share in terms of assets in the Russian banking sector, while the sampled non-sanctioned banks share about 18% of market share in terms of assets as of 31st Dec 2016. The market share information of individual sampled banks is given in appendices section. The findings on sanctioned

banks from both the SDNs/Restrictive measures lists and SSI lists of the EU and the US has been given separately in two tables, where table 6 contains the information of the banks based on the first criteria while table 7 is followed by the second criteria as mentioned above.

Sl No.	Russian Banks listed on SSI Lists	Listed on MOEX	Included in the Sample
1	Bank Moscow	Yes	No
2	Bank Russia	Yes	Yes
3	Gazprom Bank	Yes	Yes
4	Rosselkhoz Bank	Yes	Yes
5	Russian National Commercial Bank	Yes	No
6	Sber Bank	Yes	Yes
7	SMP Bank	Yes	No
8	Sobin Bank	Yes	No
9	Vneshekonom Bank	Yes	Yes
10	VTB Bank	Yes	Yes

Table 6 Findings of SSI lists of the EU and the US
Source: (Author)

Sl No	Name of the SDNs/DPs listed on the EU and the US lists	Associated Bank	Share in the Bank (In %)	Listed on MOEX	Included in the Sample
1	Arkady Romanovich	SMP Bank	49.25	Yes	No
2	Boris Romanovich	SMP Bank	38.05	Yes	No
3	Gennady Timchenko	Bank Russia	9	Yes	Yes
4	Nikolay Shamalov	Bank Russia	12.5	Yes	Yes
5	Yuri Valentinovich	Bank Russia	38	Yes	Yes

Table 7 Findings of SDNs/DPs lists of the EU and US
Source: (Author)

To examine the relationship between the profitability of the banks and explanatory variables, a regression model is used. The Hausman test was conducted by fitting each model (RE and FE) and its results after each regression is shown in appendix-7. Here, the null hypothesis cannot be rejected which means that the random effects estimator is consistent. Prior to the estimation process of determinants equation, all the variable concerned have been tested for stationary process using panel unit root test (Levin, Lin and Chu test) for the whole period and the results are given in appendix-8. All the potential outliers are investigated individually, and the accompanying graphical representation is presented in appendix-10. There is no multicollinearity problem between the control variables taken in this paper. Results for the correlation test are provided in appendix-11.

In this paper, the regression model of Staikouras and Wood has been adopted sanctions (dummy variable) as an independent variable has been added . (Staikouras and Wood 2004) All the bank specific variables taken by them are included in this paper except the size variable. They used both Herfindahl index and firm specific market share to capture for both the traditional concentration-performance relationship and the efficient hypothesis. However, Herfindahl index has been excluded because of multicollinearity issues and firm specific market share has been used in this paper. Similarly, the macroeconomic variables gross personal income and level of interest rates are excluded. Macroeconomic variable GDPt (measured as real gross domestic product growth) has been included in this model following Athanasoglou et al. and Kohlscheen et al. (Athanasoglou Panayiotis 2005, Kohlscheen, Pabón, and Contreras 2018)

The general view of the model used in this paper is as follows

$$ROA_{it} = \beta_0 + \beta_1 EA_{it} + \beta_2 CR_{it} + \beta_3 LR_{it} + \beta_4 MSH_{it} + \beta_5 GDP_t + \beta_6 SANC_{it} + \varepsilon_{it}$$

3.2.2   Description of variables

In this paper, return on assets (ROA_{it}) is used as a measure of bank profitability, which is the dependent variable. Here, return on assets is defined as the net annual income of the bank after tax divided by total assets and is expressed as a

percentage. (Athanasoglou Panayiotis 2005, Claessens, Coleman, and Donnelly 2017, Staikouras and Wood 2004)

Here, two categories of independent variables that are used for the analyses of bank profitability. First category is the bank-specific or internal determinants including the firm specific market share which relates to market power and the second category is macroeconomic determinants. This paper uses four independent variables as bank specific determinants of profitability, and one external macroeconomic factor. Due to multi collinearity issues the industry specific determinant Herfindahl index and macroeconomic determinants oil price and inflation has been excluded in the analysis. The description of these independent variables are as follows:

As a proxy of capital adequacy, first difference of equity to assets ratio (EAit) is used because the variable equity to assets ratio is not stationary or got unit root at level. Equity to assets ratio is taken as a proxy of capital adequacy in literature which is measured as the ratio of equity over total assets and expressed as a percentage. (Athanasoglou Panayiotis 2005, Claessens, Coleman, and Donnelly 2017, Staikouras and Wood 2004) Generally, capital adequacy is referred to the capital that the bank keeps aside to absorb any shocks that it may experience in future. In the literature, the results for most studies indicate a positive relationship between capital adequacy and bank profitability. However, a negative coefficient estimate for equity to assets indicates an inefficient management of bank's capital structure. (Staikouras and Wood 2004) Thus, the relationship between capital adequacy and profitability is not conclusive.

Loan loss provisions over total assets (CRit) is a proxy for credit risk. A high credit risk ratio might be evident if the banking personnel lacks expertise to control its lending activities. (Staikouras and Wood 2004) For this reason, a negative relationship is expected between loan loss provisions ratio and profitability.

The ratio of total loan to total deposits (LRit) is used as a measure of liquidity risk. (Athanasoglou Panayiotis 2005) Based on the risk-return hypothesis, more liquidity risk is associated with higher expected returns. Thus, a positive relationship is expected between this variable and profitability.

Firm-specific market share (MSHit) has been taken as a proxy of the industry specific variable, which is defined as the bank's assets divided by total value of assets

of all banks in banking sector of a given country. (Staikouras and Wood 2004) The relationship between firm specific market share and profitability is ambiguous because of two hypotheses (structure conduct performance hypothesis and relative market power hypothesis). However, a positive relationship between MSHit and profitability would support the relative market power hypothesis.

The real gross domestic product growth (GDPt) is taken as a proxy of GDP in this paper and the correlation between GDP and profitability is ambiguous. The growth of GDP means, with the growth of the economy the demand for lending will increase. This demand of lending permits the banks in some cases to charge higher loan rates and thus the profitability improves.(Athanasoglou Panayiotis 2005) On the contrary when the economy is in downturn and the GDP decreases, the asset quality of banks deteriorates as they likely to face more default loans resulting in decline of their profitability.(Staikouras and Wood 2004)

The following table aims at explaining how the dependent and independent variables has been constructed for the study. The data for the calculations of internal factors were obtained from respective bank's website and the details are provided in the appendices section for both sanctioned and non-sanctioned banks, while the data for external factors were obtained from World Bank website. Additionally, total value of assets of Russian banking sector was obtained from the banking supervision report of Central Bank of Russia and the firm specific market share has been calculated.

Variable	Proxy	Measurement	Expected Sign	Source
Dependent Variable	Profitability (**ROAit**)	Measured as a percentage of operating profit of the bank to that of the total assets		(Athanasoglou Panayiotis 2005, Claessens, Coleman, and Donnelly 2017, Staikouras and Wood 2004)
Independent Variable	Sanctions (**SANCit**)	Dummy Variable, which denotes 1 if a Bank is under sanction at time t and 0, if not.	(−)	(Ahn and Ludema 2017)
Control Variables	Capital Adequacy (**EAit**)	Measured as the first difference of equity to assets ratio	+/(−)	(Athanasoglou Panayiotis 2005, Claessens, Coleman, and Donnelly 2017, Staikouras and Wood 2004)
	Credit Risk (**CRit**)	Measured as the percentage of loan loss provision to total assets	(−)	(Athanasoglou Panayiotis 2005, Bikker and Vervliet 2018, Staikouras and Wood 2004)
	Liquidity Risk (**LRit**)	Measured as a percentage of loans of the bank to that of the total amount of deposits.	+	(Staikouras and Wood 2004)

	Market Share **(MSHit)**	Measured as the bank's assets divided by total value of assets of all banks in Russian banking sector and expressed in percentage	+/(−)	(Staikouras and Wood 2004) www.cbr.ru
	GDP **(GDPt)**	Measured as real gross domestic product growth rate of Russia	+/(−)	(Athanasoglou Panayiotis 2005, Kohlscheen, Pabón, and Contreras 2018)

Table 8 Explanation of variables, proxies, measurement and source

3.3   Content analysis

The paper proceeds further with the aim of comparing the empirical finding of regression analyses with relevant literature. This will be achieved with content analysis method. Content analysis is a qualitative research tool used to *determine the presence and meaning of concepts, terms, or words in one or more pieces of recorded communication*. (Stan 2010, 225) This method allows for *compressing many words of text into fewer content categories based on explicit rules of coding* to make inferences about the individuals, groups, firms. To construct the categories, words with similar meanings and connotations are organized in *mutually exclusive and exhaustive categories*. (Stan 2010, 227)

Recorded communication in the form of annual reports of sanctioned banks were collected for the period 2014-2016 and analyzed. This would help in comparing the empirical findings of the regression analyses with the literature. The literature review, involved using descriptive categorization of the collected annual reports of the sanctioned banks. Before analyzing the reports, extracted lines which fit to the topic of Russian sanctions were chosen and saved as a separate word document and further analyzed carefully. The findings were categorized those shared similarities and are relevant for this paper, threading them into three groups, namely (a) smart sanctions, (b) smart sanctions and banking sector and (c) profitability. This, logically and intuitively fits together as per the scope of the paper. With these groups, appropriate information would be searched that will lead to deeper understanding of language that reflects: smart sanctions, smart sanctions and Russian banking sector and finally, profitability. The tabular summary of annual reports is given in the appendices section, separately for each category used in content analysis.

CHAPTER IV RESULTS

In this chapter, this paper reports the findings of process tracing (section 4.1), econometric analysis (section 4.2) and content analysis as well (section 4.3). These sections outline the interpretation of findings and includes discussion.

4.1   Results and discussion of process tracing

The analysis of this section leads us to answer the first research question, where the constructivist concepts of "collective identity", "interests" are explored at first. Then, these two concepts are analyzed in relation to the EU common foreign and security policy and smart sanctions. Finally, these concepts are connected to the "action", i.e. the collective decision of the EU actors on targeting certain sectors of the Russian economy and extending extra restrictive measures on Russian financial institutions. The aim is to find a constructivist interpretation, that the collective identity of the EU stipulated the objective interests and subjective interests to its actors and influenced the "actions" of smart sanctions imposed on Russian financial institutions.

The European Union is founded on the values of "respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities" and these values are common to the Member States. (Article 2 TEU) The Union's aim is to promote peace and its values (Article 3 TEU) which means the Union retains these shared values while promoting its common foreign and security objectives. Thus, The EU identity within the context of CFSP denotes constructive elements of collective identity and satisfy the theoretically informed perquisites of the "Collective Identity" of the EU as it clearly defines the "Self-Other" concept. This is because collective identity involves shared characteristics, means shared values, norms and in the case of the EU, these are internalized by the member states; which denotes "identification" element of constructivism. The discourses of the EU reflect the language that defines the "Self" which includes the member states and defines the targeted third countries as "Other." (Union 2014a, 3) While imposing the smart sanctions on Russia, EU defines Russia as the "Other" while definition of "Self" doesn't separate the member states and the

EU.(Union 2014a, Union 2014b) Thus, the EU including its member states can be described as "Self" while Russia as "Other".

On decisions of sanctions, the sources of interest for the EU actors comes from the article 215 of the TEFU[1] and the introductory statement of the decisions on smart sanctions imposed on Russia reflect the language "having regard to the Treaty on European Union". (Union 2014c, b, d) This means the primary sources of interests on imposing sanctions are from within the institutional structure as the treaty gives a legal basis for constraining the Union's economic and financial relations with third countries. The EU, as an institutional structure employs economic sanctions to promote its Common Foreign and Security Policy (CFSP) objectives and defines them as "peace, democracy and respect for the rule of law, human rights and international law". As Wendt mentions, these objective interests are not only normative guidelines for action, but causal powers that predispose states or institutions to act in certain ways to achieve the security needs. (Wendt 1999, 234) If the sources of interests of the EU are from interaction with other states or diffusing through norms of international organizations like UN, those essentially need to be aligned with the EU's objective interests. (Union 2014a, 1)This is because, the EU clearly defines its objective interests on sanctions within the framework of common foreign and security policy and retains its shared values, ideas and norms, i.e. the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. (Article 2 TEU)

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[1] *Article 215 TEFU:*

- *Where a decision, adopted in accordance with Chapter 2 of Title V of the Treaty on European Union, provides for the interruption or reduction, in part or completely, of economic and financial relations with one or more third countries, the Council, acting by a qualified majority on a joint proposal from the High Representative of the Union for Foreign Affairs and Security Policy and the Commission, shall adopt the necessary measures. It shall inform the European Parliament thereof.*
- *Where a decision adopted in accordance with Chapter 2 of Title V of the Treaty on European Union so provides, the Council may adopt restrictive measures under the procedure referred to in paragraph 1 against natural or legal persons and groups or non-State entities.*
- *The acts referred to in this Article shall include necessary provisions on legal safeguards.*

As a tool of foreign and security policy, historically, the imposition of sanctions was gravitated towards comprehensive sanctions until the alternative of smart sanctions are emerged in the late 90's. Comprehensive sanctions were imposed on the entire target economy to create pressure and bring compliance. On the other hand, the aim of smart sanctions is that they would focus in targeting the individuals or entities responsible for violation of international law or human rights violation and/or targeting certain sectors of the economy to create pressure on the target, with a desire to avoid any negative impact on civilian populations. Thus, smart sanctions are the preferences over outcomes that desires to impact specific individuals, entities and sectors, rather than the entire economy of the target. Constructivists call this preferences over outcomes, not preferences over strategies because the actors' belief on what is possible to attain is equally important as desire for actions.(Wendt 1999, 231) Given the preferences over outcomes and its actors' beliefs about what is possible to attain, a state or international organization can prioritize between comprehensive and smart sanctions. While imposing sanctions, the notion of sanctions lies in the desire of changing the target's behavior and bring to compliance where the sender holds the belief that the target's compliance is attainable. This, can be summed up by the intentional equation (desire + belief = action) where subjective interests belong to the desire side. (Wendt 1999) Thus, it can be concluded that comprehensive and smart sanctions are subjective interests of the senders" employed to fulfil the foreign policy and security needs.

Let's analyze the EU's smart sanctions imposed on Russia to better understand the nexus between preference over outcomes and smart sanctions. In March 2014, condemning Russia's involvement in Crimean referendum, the EU imposed travel bans and asset freezes on several individuals and entities from Russia and Ukraine. The initial measures were implemented through Council Decision (2014/145/CFSP) and Council Regulation (No 269/2014). Here, the European Council desired to impact the individuals and entities (involved in violation of Ukraine's territorial integrity) with the belief that it would create pressure and Russia will immediately withdraw its armed forces to the areas of their permanent stationing in Ukraine. This desire and belief lead to the actions, i.e. travel restrictions and asset freezes. However, in July

2014, the situations deteriorated further and following Russian aggression in eastern Ukraine, the EU imposed trade sanctions on certain products and technology intended for military and dual use and some equipment for the oil industry and financial sanctions on financial, defense and energy sectors of Russian economy. The restrictions were enacted through Council Decision 2014/512/CFSP and Council Regulation (EU) No 833/2014. This is because, the Council desired to increase the cost of smart sanctions imposed on Russia with the belief that this could create additional pressure on Russia and help in achieving tangible results in deescalating the situation in eastern Ukraine. Thus, the preferences over outcomes shifted from the desire of impacting the individuals and entities at the former stage of smart sanctions to the desire of impacting certain sectors of Russian economy in the later stage. Here, the EU only changed the options on preferences over outcomes, which doesn't mean that the norms are changed because the measures are targeted towards the state-owned institutions or the institutions owned by the elites and those responsible for the violation of Ukraine's territorial integrity, thus avoiding the adverse consequences for the civilian population or for legitimate activities.

From the above analysis it can be concluded that smart sanctions are the subjective interests of the EU and the smart sanctions imposed on Russia is not excluded from the objective and subjective interests of the EU. This could be violated if, the interests of the member states outweigh the objective interests of the EU, especially when the EU actors decides about the imposition of sanctions. However, the way EU transfers these objective interests within the institutional framework, it seems unlikely that there is an inherent bias for the interests of the member states. This is because the EU actor's decision making and actions regarding sanctions signifies collective interest, where the binding measures taken for the sanctions are adopted in a context of collective action; unanimity and qualified majority voting.(Union 2014a, 2) This corresponds to the theoretical prerequisites of fulfilling the necessity of actions in reproducing the collective identity of the EU.

The European Council, as "actors" of the EU, defines the Russian involvement in conducting referendum and annexing Crimea as illegal and unprovoked violation of Ukrainian sovereignty and territorial integrity. (Union 2014c, b, d) This definition of the situation cautiously established and justified the actions related to imposing smart sanctions on certain sectors of Russian economy and extending extra restrictive measures on Russian financial and defense institutions and these are inspired by the Treaty on European Union. This is due to the fact, the EU institutional framework allows the EU actors to decide on applying stricter and additional measures, where the EU deems it necessary, autonomously or reinforcing UN sanctions. (Union 2014a, 1)

Analyzing the actions by the EU actors on smart sanctions imposed on Russia and extending extra restrictive measures for Russian financial institutions can be explained in two phases. At first, in view of the gravity of the situation, European Council collectively decided to impose smart sanctions against specific sectors of the Russian economy, which includes financial, defense and energy sector and the Council considers it "appropriate" in response to Russia's actions. (Union 2014c, b) However, the Council amended the previous decision on smart sanctions in response to the increase in inflow of fighters and weapons from the Russian territory into Eastern Ukraine and aggression of Russian armed forces. They collectively decided to take significant extra restrictive measures with a view to increasing the costs of Russia's actions, which were targeted towards Russian financial and defense institutions. (Union 2014d) The below figure summarizes the identity and interest formation process of the EU on smart sanctions imposed on Russia and how the collective identity influenced the actions on smart sanctions in targeting Russian financial institutions.

The EU with **"Collective Identity"** with **"Objective Interests"** in promoting "peace, democracy and respect for the rule of law, human rights and international law" and with **"Subjective Interests"** in smart sanctions

The EU's definition of the situation: Russian involvement the situation of carrying out referendum in Crimea and Russian aggression in eastern Ukraine as illegal, unprovoked violation of Ukrainian sovereignty and territorial integrity

The EU's actions: (1) Prohibition of issuance or trade in bonds, equity or similar financial instruments within the EU; with maturity exceeding 90 days for energy, defense and financial sectors of the Russian economy (2) Extending extra restrictive measures for Russian financial institutions by lowering the maturity of financial instruments to 30 days

Figure 3 Identity and interest formation of the EU
Source: (Author)

Resulting from the above analysis, the relation between "collective identity" of the EU and "actions" on imposing smart sanctions on Russia and extending extra restrictive measures on Russian financial institutions, allows for a constructive interpretation that *"The EU's "collective identity" stipulated the "objective interests" and "subjective interests" to its actors and influenced the "actions" of smart sanctions on the Russian financial institutions."*

4.2   Results and discussion of econometric analysis

In the following section, the paper reports the findings of econometric analysis and outlines their interpretation.

The descriptive statistics of the dependent variable and all control variables are presented in appendix-9. Hierarchical regression has been done with four regressions for the relationship of bank profitability and determinants of bank profitability. Firstly, regression analysis was performed with the bank specific controlled variables (EAit, CRit and LRit) serving as independent variables. A second regression was done with the industry specific variable (MSHit) as an independent variable together with the first step independent variables. The third multiple regression was done adding the macroeconomic variable (GDPt) as an independent variable to the previously taken bank specific and industry specific independent variables. The fact that the paper aims at investigating the influence of smart sanctions on the profitability of Russian Banks. Finally, the fourth multiple regression was done by adding the sanctions dummy variable (SANCit) which is the independent variable while all other variables are control variables. The regression outputs for all the models are as follows:

Variable	(1) ROA	(2) ROA	(3) ROA	(4) ROA
EA	0.0380**	0.0384**	0.0463**	0.0437**
	(0.0126)	(0.0126)	(0.0150)	(0.0144)
CR	0.1712***	0.1705***	0.1665***	0.1686***
	(0.0204)	(0.0204)	(0.0193)	(0.0191)
LR	-0.0017	-0.0017	-0.0009	-0.0009
	(0.0009)	(0.0009)	(0.0011)	(0.0010)
MSH		-0.0142	-0.0117	0.0334
		(0.0245)	(0.0337)	(0.0357)
GDP			0.0007	6.87E-05
			(0.0008)	(0.0008)
SANC				-0.0233**
				(0.0083)
Constant	0.0101**	0.0107***	0.0088**	0.0101**
	(0.0026)	(0.0028)	(0.0003)	(0.0035)
R-squared	0.3306	0.3318	0.3286	0.3573

Observations	184	184	184	184

Notes: Standard errors are in parentheses

Significance levels: *** $p<0.001$, ** $p<0.01$, * $p<0.05$

Table 9 Regression Output
Source: (Author)

Table 9 exhibits the results of the regression analyses for the entire period (2012-2016) and for all the four models of regression. In all the cases, with all the variables selected for the model, around 30% of the ROAit variation is explained by the determinants considering 184 observations. Control variables that prove to be significant factors when explaining bank profitability are EAit, a proxy of capital adequacy and CRit, a proxy of credit risk and both have positive relationship. The positive relationship between capital adequacy and profitability is in line with the literature (Athanasoglou Panayiotis 2005, Claessens, Coleman, and Donnelly 2017, Staikouras and Wood 2004) and suggests that banks with greater equity are relatively more profitable. The positive relationship between credit risk and profitability doesn't support the findings of most of the literature (Athanasoglou Panayiotis 2005, Staikouras and Wood 2004) while this is in line with the findings of Bikker et al. as they found positive relationship between credit risk and profitability. (Bikker and Vervliet 2018) They suggest that, as credit risk increases, the extent of loan loss provisioning is raised that results in a higher lending rate, which in turn enhances the net interest margin.

The bank specific determinants liquidity risk (LRit) measured as a percentage of loans of the bank to that of the total amount of deposits is not significant which is not supporting the findings of literature as Athanasoglou et al. and Kohlsheen et al. found positive relationship between liquidity risk and bank profitability. (Athanasoglou Panayiotis 2005, Kohlscheen, Pabón, and Contreras 2018, Staikouras and Wood 2004) The findings on bank market share variable (MSHit) is in line with the findings of Staikouras and Wood (2004) as the relative market power hypothesis cannot be supported. Furthermore, the real gross domestic product growth (GDPt) is not a significant factor in explaining profitability which is in contrary to the literature

as Staikouras and Wood (2004) finds that gross domestic product growth has significant negative effect on profitability while Kohlscheen, Pabón and Contreras (2018) finds a positive effect of gross domestic product growth on profitability.

The result of regression analysis shows that SANCit dummy variable significantly influences the profitability, where sanctioned banks have lower profitability than non-sanctioned banks. The regression results suggest that after facing smart sanctions, the return on assets corresponding to the sanctioned banks or banks associated with sanctioned individuals is around 2.3 percentage points lower compared with non-sanctioned banks. This, allows to conclude the second hypothesis as: "*Sanctioned banks have lower profitability than non-sanctioned banks controlling for other factors.*"

Although the regression results show the impact of sanctions on profitability of sanctioned banks, these results should be interpreted cautiously. This is because, the effect of sanctions doesn't apply uniformly to all sanctioned banks. The effect on each financial institution may vary according to firm specific characteristics and, the type of smart sanctions the firm faces, like sectoral sanctions or specially designated nationals.

4.3   Results and discussions of content analysis

Impact of smart sanctions was given nearly equal emphasis in all the annual reports. Here, the language reflected impact of smart sanctions in general, impact of smart sanctions on banking sector and impact on profitability as well. The focus on the impact of smart sanctions emphasized: (a) difficult circumstances because of the imposition of smart sanctions against Russia, (b) the smart sanctions regime caused a slowdown of economic growth and deterioration of the financial position, and (c) the subsequent introduction of smart sanctions against certain sectors of Russian economy.

Similarly, the description on smart sanctions and banking sector emphasized: (a) restricted access to western capital markets, (b) due to smart sanctions, the banking sector was the most exposed segment of the economy, (c) the limitations in the banks' funding mechanisms resulted from the imposed smart sanctions. Due to the smart sanctions imposed by the EU and the US against Russian financial institutions,

the Bank of Russia carried out several temporary measures to maintain stability in the Russian banking sector as well.

These annual reports emphasized bank profitability, albeit less frequently. In 2014 and 2015 they mention about significant increase in provisions of loan impairment, which led to a reduction of net profit. While in 2016, the Russian banking sector witnessed its margins gradually recover after two difficult years. At the same time, the banks also continued implementing conservative risk management policies and paid special attention to cost management.

In summary, the annual reports reflect smart sanctions and impact of smart sanctions, and particularly emphasized the vulnerability of banking sector towards smart sanctions which curbed the financial position of Russian Banks. Hence, "smart sanctions" was reconfirmed as one of the important dimensions of external factor that hit the banking sector from the banks' perspective. Together, the results of regression analyses and the literature review of above section indicate that the smart sanctions imposed on Russia appears to be "smart" in targeting the Russian financial institutions.

4.4   Limitations

Before concluding the findings, it is important to clarify the limitations of the methods used and acknowledge the contribution of this paper to the existing literature. As the smart sanctions on Russia led by the US happened during the same time as the EU smart sanctions, it's difficult to separate the US contribution on the impact of smart sanctions on Russian financial institutions. Furthermore, the annual data frequency limited the number of observations and the regressions have shown relative low R squared values because of that. There is an inherent problem of the Russian sanctions topic, since the period in which Russian sanctions occurred coincided with other external shocks on Russia like decline in oil prices and rouble exchange rate. The average oil price has been dropped from 96.29 dollars/barrel (in 2014) to 40.68 dollars/barrel in 2016, which has significant negative impact on Russian economy by affecting the rouble exchange rate. (Russia 2015, 12) As the correlation between the oil price and real gross domestic product growth was found very high (83%), this

paper excluded the oil price variable during the analysis and the paper considers real gross domestic product growth as the macroeconomic variable. Thus, a lot of the impact on Russian banks is unexplained by the common factors used, which limits the explanatory power of the analyses in this paper.

Furthermore, the issue of language and availability of data on Russian banks are added to the above limitations. As the data are collected using different sources such as websites, official documents, financial statements, it's difficult to obtain and interpret the data, because most of them are either unavailable or dominated by Russian language.

4.5   Future Research

In case of smart sanctions imposed on Russia, this paper is one of the few attempts of firm-level analysis and so far, first paper to empirically examine the impact of smart sanctions on Russian financial institutions. Future research should consider the limitations of this thesis when replicating the empirical analysis. Besides, there are several other recommendations for future research to mention. As Russia retaliated with counter sanctions, further research on Russian "identity" and "interests" could give deeper insights on codetermination process between the EU and Russia, in the case of smart sanctions imposed on Russia. As the EU and US both led the smart sanctions on Russia, another interesting prospective would be to understand whether "Corporate Identity" or "Collective identity" of the US influenced the actions of smart sanctions on Russia. The restrictive measures on Russian financial institutions has been strengthened by the EU and the US in September 2014, extending the initial measures imposed in March 2014. Additionally, the US tightened the restrictions on Russian financial institutions by shortening the maturity further in October 2017. Because of the changes, the directive prohibits the issuance or trade in financial instruments issued on or after 28th November 2017 with a maturity of greater than 14 days, rather than 30 days. With data frequency like monthly or quarterly and sufficient number of observations, further research could be done separating the periods with equal magnitude of restrictive measures and compare them to understand the magnitude of impact in a more detailed manner.

CHAPTER V CONCLUSION

By utilizing theoretical elements of constructivism with process tracing method, this thesis examines the influence of the EU's collective identity on smart sanctions imposed on Russia. The analysis of the purpose and process of the smart sanctions, their relationship with the international law and the decision making of the EU actors in targeting the Russian financial institutions, resulted in an interpretation that can be satisfactory under the constructivist approach. Because of its specific collective identity, the EU has a preference order, in which "smart sanctions" are generally preferred over "comprehensive sanctions". The is because, the value of "human rights" as an integral part of the EU's collective identity can be better served with "smart sanctions", because "comprehensive sanctions" are more likely to contain unintended effects harming the simple population of the target state. Based on the process tracing analysis, an identity and interest formation model were created which explains the influence of the EU's collective identity on smart sanctions imposed on Russia. The process tracing analysis finds that the EU's "collective identity" stipulated the "objective interests" and "subjective interests" to its actors and influenced the "actions" of smart sanctions by extending extra restrictive measures for Russian financial institutions to increase the cost of smart sanctions imposed on Russia.

Thus, the paper then examines the impact of smart sanctions on Russian financial institutions. This was done through regression analyses with a dataset that covers 6 sanctioned and 31 non-sanctioned Russian banks. Sanctioned banks are identified by examining the EU's and the US's sectoral sanctions lists and those associated with individuals on the EU's restrictive measures lists and the specially designated nationals lists of the US. The paper considered the list of Russian banks and banks associated with individuals having more than 5% share, those explicitly targeted by the EU and U.S. from March 17, 2014 to 31st December 2016. In the regression model, explanatory variables include bank-specific determinants, firm specific market share and real gross domestic product growth, and a dummy variable for sanctions (SANCit) was created, as this paper intended to estimate the impact of smart sanctions on Russian financial institutions.

Control variables that prove to be significant factors when explaining bank profitability are EAit, a proxy of capital adequacy and CRit, a proxy of credit risk and both have positive relationship. The positive relationship between capital adequacy and profitability is in line with the literature and suggests that banks with greater levels of equity are relatively more profitable. The positive relationship between credit risk and profitability doesn't support the findings in most of the literature while this is in line with the findings of Bikker et al. as they found positive relationship between credit risk and profitability. (Bikker and Vervliet 2018) The bank specific determinants liquidity risk (LRit) measured as a percentage of loans of the bank to that of the total amount of deposits is not significant in explaining the profitability. The findings on bank market share variable (MSHit) is in line with the findings of literature as the relative market power hypothesis cannot be supported. Furthermore, the real gross domestic product growth (GDPt) is not a significant factor in explaining profitability.

The regression results show that sanctions dummy variable have a statistically significant negative impact on the profitability of sanctioned banks compared to non-sanctioned banks, controlling for other factors. The regression results suggest that after facing smart sanctions, the return on assets corresponding to the sanctioned banks or banks associated with sanctioned individuals is around 2.3 percentage points lower compared with non-sanctioned banks. Furthermore, the literature review of annual reports of sanctioned banks also emphasized the vulnerability of banking sector towards smart sanctions which curbed the financial position of Russian Banks.

Finally, the findings in this paper have important implications for policy makers as both theoretically and empirically this paper documents how senders strategically employ smart sanctions instead of comprehensive sanctions to avoid negative impact on the civilian population. From the findings of this paper, smart sanctions appear to be "smart" in targeting the Russian financial institutions.

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APPENDIX

Appendix-1 List of sanctioned banks sampled

Sl No.	Bank Name	Data Source	Market Share in % (as of 31st Dec 2016)
1	Bank Rossiya	https://www.cbr.ru	36.1891
2	Gazoprom Bank	https://www.gazprombank.ru	6.0943
3	Sber Bank	https://www.sberbank.ru	31.6863
4	VEB Bank	www.veb.ru	4.4632
5	VTB Bank	https://www.vtb.com	15.7195
6	Rosselkhoz Bank	https://www.rshb.ru	3.0757

Appendix-2 List of non-sanctioned banks sampled

Sl No.	Name of the Bank	Data Source	Market Share in % (as of 31st Dec 2016)
1	Absolute Bank	www.absolutbank.com	0.3759
2	AK Bars Group	http://www.abh.ru	0.5038
3	ALFA Bank	https://alfabank.com	3.1925
4	Bank Okritie	https://www.open.ru	3.3758
5	Bank Saint Petesburg	https://www.bspb.ru	0.7248
6	BIN Bank	https://eng.binbank.ru	1.3774
7	Center Invest Bank	https://www.centrinvest.ru	0.0836
8	Centro CREDIT Bank	https://www.ccb.ru	0.1206
9	CHELIND Bank	https://www.chelindbank.ru	0.0569
10	Credit Bank of Moscow	https://mkb.ru	1.9584
11	Deniz Bank	www.denizbank.ru	0.0205
12	Exim Bank	eximbank.ru	0.0829
13	EXPO Bank	https://expobank.ru	0.0823
14	HSBC Russia	www.about.hsbc.ru	0.0929
15	INTERSTATE Bank	www.isbnk.org	0.0090
16	LOCKO Bank	www.lockobank.ru	0.0994
17	MIZUHO Bank	https://www.mizuhobank.com	0.0537
18	Moscommers Bank	www.moskb.ru	0.0279
19	Natixis Bank	www.natixis.ru	0.0234
20	Nordea Bank	https://www.nordea.ru	0.2973

21	OTP Bank	https://www.otpbank.ru	0.1500
22	POMSVYAZ Bank	https://www.psbank.ru	0.0007
23	PRO Commerce Bank	www.procombank.ru	1.5291
24	ROS Bank	https://www.rosbank.ru	1.1000
25	ROSDOR Bank	en.rdb.ru	0.0183
26	RUSSO Bank	russobank.ru	0.0050
27	Russia Commercial Bank	www.rcbcy.com	0.8039
28	SDM Bank	www.sdm.ru	0.0679
29	SOVCOM Bank	sovcombank.com	0.7061
30	Transkapital bank	www.tkbbank.com	0.3111
31	Unicredit Bank	https://www.unicreditbank.ru	1.4642
	Total share in %		18.7153

Appendix-3 Herfindahl-Hirschman index data (Russian banking sector)

Data Source: Bank of Russia						
https://www.cbr.ru/						
Country Name	Indicator Name	2012	2013	2014	2015	2016
Russian Federation	Herfindahl-Hirschman Index (Asset)	0.101	0.107	0.108	0.107	0.111
Note:	The Central Bank of the Russian Federation calculates the Herfindahl-Hirschman Index as the sum of the squared unit weights of credit institutions in the total volume of the Russian banking sector. It shows the degree of concentration on a scale ranging from 0 to 1. The zero value corresponds to the minimum concentration; a value of less than 0.10 indicates a low level of concentration; a value between 0.10 and 0.18 represents a medium level of concentration, and a value of more than 0.18 corresponds to a high level of concentration.					

Appendix-4 Real GDP growth (annual rate %) of Russian federation

Data Source: World Development Indicators							
Last Update Date: 3/1/2018							
Country Name	Country Code	Indicator Name	2012	2013	2014	2015	2016
Russian Federation	RUS	Real GDP growth (annual %)	3.6559	1.7853	0.7386	-2.8282	-0.225

Appendix-5 Inflation (annual rate %) of Russian federation

Data Source: World Development Indicators							
Last Update Date: 3/1/2018							
Country Name	Country Code	Indicator Name	2012	2013	2014	2015	2016
Russian Federation	RUS	Inflation (annual %)	9.08593	5.4093	7.54	8.1509	3.6103

Appendix-6 Oil price (2012-2016)

Average annual OPEC crude oil price
source: www.opec.org

Year	Average price in U.S. dollars per barrel
2016	40.68
2015	49.49
2014	96.29
2013	105.87
2012	109.45

Appendix-7 Hausman test for appropriateness of FE

Correlated Random Effects - Hausman Test			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section	7.14417	6	0.308
Cross-section random effects test comparisons			
Variable	Fixed	Random	Var(Diff.)	Prob.
EAit	0.06821	0.043745	0.000285	0.147
CRit	0.16584	0.168666	0.000044	0.669
LRit	0.0006	-0.000992	0.000001	0.106
MSHit	0.18626	0.033486	0.105275	0.638
GDPt	0.00028	0.000069	0.00000	0.231

Appendix-8 Panel unit root test summary

Levin, Lin & Chu unit root test: Summary		
Variable	Statistics	Probability
ROAit	-3.1088	0.0009
EAit	-1.34195	0.0898
CRit	-1.95887	0.0251
LRit	-3.19765	0.0007
MSHit	-6.87368	0.0000
GDPt	-13.6305	0.0000

Appendix- 9 Descriptive statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis	Jarque-Bera	Probability
ROAit	185	0.0112	0.0331	-0.1572	0.3007	3.2352	39.0961	10366.14	0.0000
EAit	184	-0.000376	0.160502	-0.564293	0.544723	-0.261362	5.422669	47.09302	0.0000
CRit	185	0.0236	0.0990	-0.0085	1.3141	12.1114	157.7321	189075.8	0.0000
LRit	185	1.6962	2.0511	0.0025	19.8358	5.1114	39.1847	10898.34	0.00000
MSHit	185	0.0316	0.0829	0.0000	0.4236	3.5151	14.6688	1430.549	0.0000
GDPt	5	0.6253	2.1596	-2.8282	3.6559	-0.2484	2.1281	7.763019	0.0206

Appendix-10 Graph indicating outliers
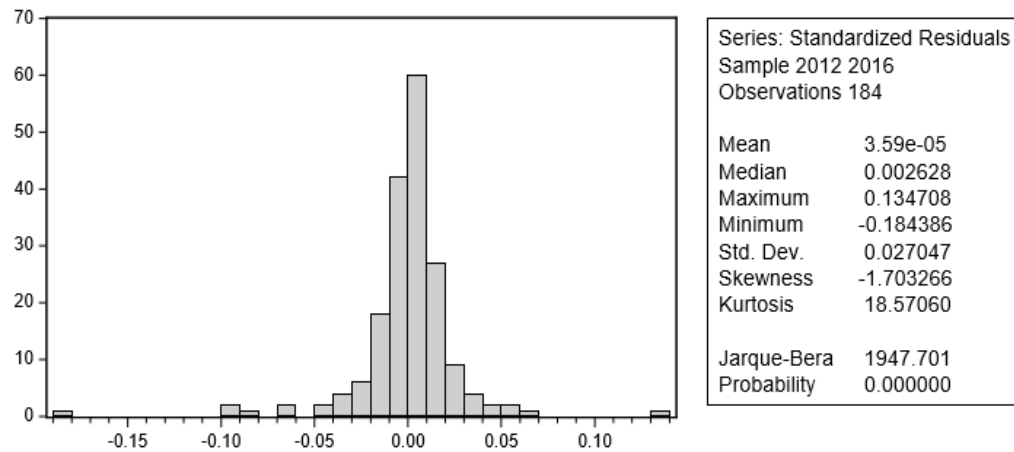
Appendix-11 Correlation test results

Variables	EAit	CRit	LRit	SIZEit	MSHit	HHt	GDPt	INFLt	OILt	Variance Inflation Factors Coefficient Variance	Centered VIF
EAit	1									0.0002	1.05
CRit	0.082	1								0.0004	1.05
LRit	0.013	-0.06	1							0.0000	1.04
SIZEit	-0.207	-0.02	-0.03	1						0.0000	1.08
MSHit	0.051	-0.05	-0.10	-0.18	1					0.0006	1.05
HHt	-0.001	0.06	-0.09	0.00	0.00	1				3.7602	9.79
GDPt	0.000	-0.03	-0.01	0.00	-0.01	-0.61	1			0.0000	8.56
INFLt	0.002	0.03	0.12	-0.01	0.01	-0.80	0.16	1		0.0000	5.17
OILt	0.001	0.02	0.05	-0.01	-0.01	-0.67	0.83	0.44	1	0.0000	7.71

Appendix-12 Textual data on smart sanctions

Page	Line Number	Textual Data	Category (Code)	Date	Source
1	1	In 2014, the Bank of Russia operated under difficult circumstances because of the imposition of economic sanctions against Russia	Smart sanctions	20-Jun-18	https://www.cbr.ru
1	16	the subsequent introduction of sectoral sanctions against Russia.	Smart sanctions	20-Jun-18	https://www.cbr.ru
1	19	For all the external challenges posed by the so-called sectoral sanctions against Russia	Smart sanctions	20-Jun-18	https://www.sberbank.ru
1	23	Rising geopolitical tensions and the introduction of economic sanctions on Russia limited major credit organizations' ability to attract finance	Smart sanctions	20-Jun-18	https://www.vtb.com
2	1	In 2015, the Russian economy continued to experience the negative effects of ongoing sanctions	Smart sanctions	20-Jun-18	https://www.cbr.ru
2	5	the sanctions regime caused a slowdown of economic growth and deterioration of the financial position	Smart sanctions	20-Jun-18	https://www.gazprombank.ru
2	15	adverse factors such as EU and US sanctions against Russia and the consequential restriction of			www.veb.ru

Page	Line	Textual Data	Category	Date	Source
		trade and economic relations with foreign countries	Smart sanctions	20-Jun-18	
3	6	Restrictions imposed on Russia by a number of foreign countries as well as Russian countersanctions continued to persist.	Smart sanctions	20-Jun-18	https://www.cbr.ru
3	14	As the US, the EU and some other countries continued to uphold their economic sanctions in 2016	Smart sanctions	20-Jun-18	https://www.rshb.ru
3	17	Russian economy finds its way back to growth again in the fourth quarter of 2016 after two difficult years.	Smart sanctions	20-Jun-18	https://www.sberbank.ru

Appendix-13 Textual data on smart sanctions and banking sector

Page	Line Number	Textual Data	Category (Code)	Date	Source
1	3	Due to the sanctions imposed by the EU and the US against Russian major credit institutions and non-financial organizations, the Bank of Russia carried out a number of temporary measures to maintain stability in the Russian banking sector	Smart sanctions and Banking sector	20-Jun-18	https://www.cbr.ru
1	8	Restricted access to Western capital markets forced down the amount of foreign debt owed	Smart sanctions and	20-Jun-18	https://www.ga

			Banking sector		zpromb ank.ru
1	12	Due to the lack of access to long-term funding on international capital markets, the banking sector was the most exposed segment of the economy	Smart sanctions and Banking sector	20-Jun-18	https://www.rs hb.ru
2	2	Vnesheconom bank together with several major national financial institutions has been cut off from the traditionally large and liquid debt capital market for an indefinite term of time	Smart sanctions and Banking sector	20-Jun-18	www.ve b.ru
2	8	sanctions imposed by the United States, the European Union, and a few other countries on Russian state-owned banks	Smart sanctions and Banking sector	20-Jun-18	https://www.vt b.com
2	10	Access to international long-term financing has been closed for Russian Agricultural Bank.	Smart sanctions and Banking sector	20-Jun-18	https://www.rs hb.ru
3	20	the limitations in the Bank's funding mechanisms resulting from the imposed sanctions.	Smart sanctions and Banking sector	20-Jun-18	www.ve b.ru

Appendix-14 Textual data on profitability

Page	Line Number	Textual Data	Category (Code)	Date	Source
1	27	We faced a significant increase in provisions for loan impairment, which led to a reduction in the Group's net profit	Profitability	20-Jun-18	https://www.vtb.com
3	8	The banking sector recovered its profitability and accumulated sufficient capital to step up lending to the economy.	Profitability	20-Jun-18	https://www.sberbank.ru
3	13	The Russian banking sector saw its margins gradually recover.	Profitability	20-Jun-18	https://www.rshb.ru
3	23	continuing to implement conservative risk management policies and paying special attention to cost management.	Profitability	20-Jun-18	https://www.vtb.com

VITA

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