

# Potential U.S. Clarification of Financial Sanctions Regulations

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## ABOUT THE AUTHORS



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Brief Analysis

## Proposals for clarifying or relaxing certain U.S. financial restrictions would be a cumbersome way for Iranian trading partners to access U.S. dollars, but would give Iran modest, unreciprocated benefits.

**O**n April 1, President Obama responded to reports that the United States was considering new sanctions concessions for Iran in the wake of Iranian complaints about the difficulty of reestablishing banking relationships since sanctions relief took effect in January. After noting that Washington and others would "provide clarity to businesses about what transactions are, in fact, allowed," he added, "It is not necessary that we take the approach of them going through dollar-denominated transactions." What are the implications of his clarification about access to the U.S. dollar?

## BACKGROUND

**U.**S. banks were prohibited from dealing directly with Iranian banks starting in 1995. Yet a "U-turn" exemption allowed U.S. banks to process dollar-denominated transactions on Iran's behalf as long as the payments were initiated offshore by a non-Iranian foreign bank and only passed through the U.S. financial system en route to another non-Iranian foreign bank. This exemption -- revoked in 2008 -- allowed Iran to receive dollar-denominated payments for oil sales in foreign banks, which are generally not able to make large dollar-denominated interbank transfers without drawing on their own dollar accounts with U.S. banks.

Yet even before the U-turn revocation, Iran had found it difficult to transact in U.S. dollars because of U.S. sanctions on a number of its largest banks (e.g., Bank Sepah, Bank Melli, and Bank Saderat), as well as the growing consensus that such institutions had acted deceptively to evade sanctions. By 2008, the Financial Action Task Force, the intergovernmental standard-setting body for anti-money laundering and counter-terrorist financing, had issued

several warnings about the risks posed by deficiencies in Iran's AML/CFT regime. UN Security Council Resolution 1803 of March 3, 2008, also called for vigilance in dealing with Iranian banks. Despite those 2008 actions which blocked Iran from legal access to U.S. dollars for settling oil payments through banks, Tehran was able to keep on selling oil, suggesting that dollar access was not as vital as sometimes implied. It was not until 2012, when the United States and EU adopted sanctions on Iran's energy sector, that its oil sales fell precipitously, dropping by 47 percent from the Iranian fiscal year 2011/12 to 2012/13.

## **ACTIONS UNDER CONSIDERATION**

In a March 30 speech at the Carnegie Endowment for International Peace, Treasury Secretary Jacob Lew stated that the United States would comply with both the "letter and the spirit" of its commitments to provide sanctions relief under the nuclear deal, which some read as implying more Iranian access to the dollar. Yet administration officials testified last summer that Iran would not be allowed direct or indirect access to the U.S. financial system to dollarize payments, and they have reiterated that contention in recent weeks. This has been broadly understood to mean that reinstatement of the U-turn license remains off limits. What appears to be under discussion is permitting foreign banks -- not Iran -- to access U.S. dollars for foreign currency conversions in support of legitimate trade with Iran. Under this proposal, such transactions could not involve Iranian rials, start or end with U.S. dollars, or involve a sanctioned entity. An important distinction between this proposal and reinstatement of the U-turn is that Iran would not accrue dollar balances as a result -- it would have no "pot of dollars" to use as it sees fit.

The proposal would also address ambiguity in how U.S. sanctions apply to foreign currency conversions. Clarification is not required under the terms of the Joint Comprehensive Plan of Action (JCPOA), and leaving the rules ambiguous has served to deter risk-averse banks. Clarifying that such transactions are allowable -- whether through new guidance or a general license issued by the Treasury Department's Office of Foreign Assets Control -- would facilitate international trade with Iran. The benefits for Iran would be real but modest; the authorized procedure would be complicated, and it is not clear how many banks would provide such a service or how much they would charge.

## **HOW THE NEW MECHANISM MIGHT WORK**

One way the new mechanism could work would be through the Asian Clearing Union (ACU). Last month the Indian government announced that it was looking to resume settling trade with Iran through the ACU. Established by regional central banks in 1974 and headquartered in Tehran, the ACU helps to facilitate intraregional trade and conserve foreign exchange resources, especially for members with capital controls that restrict access to hard currency -- these include India, an important customer for Iranian oil. Local commercial banks provide "ACU dollars" on exchange for U.S. dollars, and trade is settled through netting to reduce transaction costs. So while the activity occurs offshore, there is a related dollar-denominated transaction that touches the U.S. financial system.

In 2009, following revocation of the U-turn exemption, India and Iran directed their companies to use the ACU to settle trade payments. Iran's Fars News Agency announced that these companies "no longer need to fret over the U.S. embargo on all dollar transactions involving Iranian banks and Iranian companies." Under pressure from the United States, however, the Reserve Bank of India (RBI), the country's central bank, stopped processing ACU oil payments to Iran after roughly two years. According to press reports, Washington had raised concerns that the ACU's netting function obscured counterparties and put Indian banks at risk of doing business on behalf of Iranian bad actors.

Another way the new mechanism could work is if banks make payments "on their books," so to speak. "Book transfers" are those made from one account to another within the same financial institution. This procedure could be used to make a payment to or for an Iranian beneficiary, as well as to conduct a foreign currency conversion. Such

activity has at times been a grey area in the sanctions regime; however, a number of enforcement actions and substantial fines have targeted foreign banks seeking to clear dollars deceptively on behalf of sanctioned countries through unwitting U.S. banks. For example, as part of the 2014 BNP Paribas settlement -- which involved a nearly \$9 billion fine for violating U.S. sanctions on Iran, Cuba, and Sudan -- the bank admitted to using correspondent accounts at non-U.S. banks to conduct dollar-denominated book transfers involving Sudan. Besides the deceptive nature of the practice, the difference between what BNPP did and the proposal currently under consideration is that banks would be restricted from providing U.S. dollars to Iran. The Treasury could clarify that some book transfers would be allowable as long as the services provided by U.S. banks would benefit Asian or European trading partners, not Iran itself.

## CONCLUSION

Last week, Secretary Lew argued that the complexities of sanctions compliance risk pushing financial transactions away from the U.S. dollar, which could ultimately risk unseating it as the global reserve currency. This concern is not new and, fortunately, this is not a near-term risk -- as Iran's struggle to reintegrate into the international financial system indicates, there is no real alternative to the U.S. dollar. What makes the U.S. sanctions more effective is the shift that occurred in banks' perception of sanctions risks. In the wake of unprecedented enforcement actions, financial institutions are simultaneously reassessing their sanctions exposure and making significant investments in sanctions monitoring and compliance. These are multiyear endeavors, and in the interim, many banks are withdrawing from high-risk lines of business or jurisdictions as a whole.

This is not the only reason Tehran is struggling to reestablish banking relationships. When foreign institutions look at Iran, they see many risks beyond sanctions risks -- illicit finance, regulatory issues, reputational concerns -- and most of them are of Iran's own making (see [PolicyWatch 2600 \(http://www.washingtoninstitute.org/policy-analysis/view/iran-locks-itself-out-of-the-international-financial-system-while-blaming-w\)](http://www.washingtoninstitute.org/policy-analysis/view/iran-locks-itself-out-of-the-international-financial-system-while-blaming-w), "Iran Locks Itself Out of the International Financial System While Blaming Washington"). As such, additional clarity or new concessions from Washington may do little to change the economic dynamics.

At the same time, the political implications of clarifying or relaxing restrictions is that the United States is giving priority to additional sanctions relief. That could reinforce the widespread perception that sanctions are on the way out, perhaps because they will not be enforced with the same vigor as before. It will be hard to argue that the sanctions relief is coming in response to Iranian actions that go beyond the strict letter of the JCPOA, given that Iran continues to insist that it is free to test ballistic missiles, and several Iranian shipments of arms to the Houthis have been intercepted in recent months despite Security Council bans on such exports. The administration should therefore consider reminding Iran that if it continues to pursue a deliberately cramped reading of the JCPOA, Washington can reciprocate.

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