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Iran's Long Road to Reintegrating With the World Financial System

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Brief Analysis

The recent warning by the Financial Action Task Force to banks about dealings with Iran shows that the end of nuclear sanctions was only the start of a long process.

In its first public statement on Iran since sanctions relief went into effect following implementation of the nuclear deal last month, the Financial Action Task Force (FATF), whose thirty-seven members include Russia and China, in mid-February urged member states to warn their banks about the risks of doing business with Iran. Coming only a month after Iran received nuclear-related sanctions relief from the United Nations, United States, and European Union, the statement underscores the risks for European and Asian banks in renewing financial ties with Iran.

BACKGROUND

Established in 1989 by the G-7 (Canada, France, Germany, Italy, Japan, Britain, and the United States), the FATF is the international standard-setting body for anti-money laundering and countering the financing of terrorism (AML/CFT). Members submit to peer reviews or "mutual evaluations" of their implementation of FATF standards, and jurisdictions that fail to address strategic AML/CFT deficiencies -- whether FATF members or not -- are publicly identified by the FATF in statements released following the group's plenary meetings in February, June, and October of each year. Iran has been the subject of such statements since 2008, when the FATF revised its processes for dealing with "high-risk and non-cooperative jurisdictions." However, despite the January lifting of U.S. and EU nuclear-related sanctions on Iran, the consensus-driven intergovernmental organization did not revise the statement it has issued three times a year since calling for member states to impose countermeasures on Iran in February 2009. The statement again urged Iran to "immediately and effectively address its AML/CFT deficiencies," noting that if Iran failed to do so, the FATF would consider calling on member states to strengthen countermeasures at its June 2016 meeting.

IMPLICATIONS FOR BANKS

For foreign financial institutions considering renewed ties with Iranian banks, the FATF's continuing designation of Iran as a high-risk jurisdiction and repeated call for countermeasures have real implications in terms of both illicit finance and regulatory risk. Relevant FATF standards, now being followed by member states in their fourth round of mutual evaluations, call on regulators to require banks to engage in enhanced due diligence when dealing with high-risk jurisdictions. These are time- and resource-intensive measures against which banks can be examined for compliance. Such measures can include obtaining additional information on the customer, beneficial owner, nature of the business relationship, and source or use of funds. Although designed to mitigate the risk to financial institutions of unwittingly processing illicit transactions, even such measures may not be sufficient for financial institutions when it comes to Iranian banks, which, according to the U.S. Department of Treasury, "willingly engage in deceptive practices to disguise illicit conduct."

FATF standards also provide a range of risk-mitigating countermeasures regulators can pursue beyond enhanced due diligence, such as imposing additional reporting requirements for banks working with high-risk jurisdictions, prohibiting financial institutions from relying on third parties located in the concerned country to conduct elements of customer due diligence, and even limiting business relationships or financial transactions with an identified country. In fact, the FATF call for countermeasures on Iran is referenced in the "findings" of Section 104 of the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA) -- the statutory basis for U.S. secondary sanctions on Iran. Although more than four hundred Iranian actors received relief from secondary sanctions as part of the nuclear deal through removal from U.S. sanctions lists, more than two hundred, including significant Iranian economic entities such as the Islamic Revolutionary Guard Corps (IRGC), remain listed and subject to secondary sanctions. The legislation, which first called for foreign financial institutions engaging in significant transactions with designated Iranian actors to be cut off from the U.S. financial system, cites the February 2010 meeting, at which the FATF urged member states to apply countermeasures to "protect the international financial system from the ongoing and substantial money laundering and terrorist financing risks emanating from Iran." That language remains in the current FATF statement, even after implementation of the Iran deal.

The new FATF statement -- which continued to press member states to "protect against correspondent relationships being used to bypass or evade counter-measures and risk-mitigation practices" -- came only days after the Society for Worldwide Interbank Financial Telecommunication (SWIFT) confirmed Iranian banks had been reconnected to the secure financial-messaging platform after having been cut off by EU sanctions in March 2012. Even with messaging services restored, however, the FATF's identification of Iran as a high-risk jurisdiction subject to FATF countermeasures will continue to complicate efforts by Iranian banks to reestablish ties upon which the majority of SWIFT messaging is predicated -- those with correspondents. Although Iran has been given access to roughly $100 billion of its previously restricted funds held overseas, Iranian banks -- in order to use these funds to make purchases and otherwise engage in international trade -- will have to reestablish correspondent relationships with banks in countries that are key trading partners. Banks' foreign correspondents hold deposits in foreign currencies and act as a nonresident bank's agent confirming letters of credit and completing other financial transactions on the correspondent's behalf. Beyond the enhanced due diligence discussed above, the FATF recommendation related to correspondent banking calls on regulators to require banks, at the least, to gather sufficient information to assess the quality of the correspondent institution's AML/CFT controls and the quality of its supervision -- an area where Iranian banks remain deficient.

NEXT STEPS

In its December 2015 Article IV report -- part of a running assessment of a country's economic and financial policies and developments -- the International Monetary Fund recommended to Iran that "bolstering the AML/CFT framework would facilitate re-integration of the domestic financial system into the global economy, lower transaction

costs, and reduce the size of the informal sector." Iranian officials, including Central Bank administrators and the country's executive director at the IMF, have acknowledged weaknesses in the Iranian banking system that could inhibit renewed foreign engagement and investment -- saying that Iranian banks are "outdated" and face a legacy of "weak risk management and inadequate supervision." Iranian regulators have taken limited steps over the past decade to improve their AML/CFT controls. In the FATF's October 2008 statement, it credited Iran for adopting an Anti-Money Laundering Law, which was approved by the Majlis in January 2008, but noted the "lack of corresponding effort on CFT." A 2012 draft CFT law that was approved by the parliament but remained pending with the Iranian judiciary did not meet international standards, according to the IMF. The IMF's December report specifically urged Iranian authorities to adopt a law that properly criminalized terrorist financing and contained mechanisms for implementation of UN terrorism sanctions.

Recent Iranian official statements have committed to bolstering the AML/CFT regime, including by joining the Eurasian Group, an effective FATF subentity based in Moscow, and requesting an IMF assessment of its AML/CFT regime against FATF standards. These are the correct first steps for Iran in working with the FATF to improve its AML/CFT status. But it will be a long process, and there is little indication real work has begun. Despite confirmation by the FATF's executive secretary to Agence France-Presse following the February plenary that Iran has "shown a willingness" to start cooperating, the recent statement did not acknowledge Iranian efforts to engage with the group as it has done in the past (February 2010).

What this all means is that sanctions relief and SWIFT readmission notwithstanding, significant impediments remain for those banks looking to reestablish financial ties with Iran. At a minimum, banks will continue to face illicit-finance and regulatory risks -- both conditions of Iran's own making.

Katherine Bauer is a senior fellow at The Washington Institute and a former official at the U.S. Treasury Department. ❖

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