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Europe, Iran and Economic Sovereignty: A New Banking Architecture in Response to US Sanctions

GLOBAL SECURITY REPORT

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Executive Summary

On May 8, U.S. President Donald Trump announced that the United States would unilaterally withdraw from the 2015 international nuclear agreement with Iran, known as the Joint Comprehensive Plan of Action (JCPOA). The Trump administration is now set to pursue a "maximum pressure" campaign against Tehran. As part of this approach, all U.S. sanctions lifted pursuant to the JCPOA will be re-introduced, the few licenses enabling certain exemptions to U.S. sanctions will be revoked, and "additional economic penalties" will be devised.

From the Iranian perspective, the return of U.S. sanctions means a lost opportunity for growth and international engagement, but not an impending economic catastrophe. From a European perspective, sustaining economic exchange with Iran is not about advancing economic gains but rather about consolidating an agreement which is driven by pragmatic security concerns. The shared elements are clear—Iranian and European policymakers alike are principally motivated by a need to salvage the JCPOA and thereby protect their economic sovereignty and autonomy in international relations.

To support these ends, this paper presents a vision of a new banking architecture that must be at the heart of Europe's package to protect Europe-Iran economic ties. This banking architecture should be designed not to evade US sanctions, but to ensure that those companies that can operate in compliance with U.S. secondary sanctions have access to the necessary banking services.

The design of this architecture should be presented to Tehran not as a "turnkey" initiative that can simply be switched on, but rather as a part of a comprehensive "roadmap" for joint European and Iranian implementation, in pursuit of expanded economic relations.

The architecture should have two main elements:

- It should be centered on "gateway banks" - financial institutions which can serve as intermediaries between major Iranian and European commercial banks.
- It should be overseen by an "EU-OFAC," a regulatory authority modeled on the U.S. Treasury Office of Foreign Assets Control, but with a philosophy of operation geared towards facilitation of trade rather than restriction.

EU-OFAC would pursue measures in two domains:

- Compliance:
    - EU-OFAC would develop common standards, tools, and certification mechanisms for due diligence to enable European businesses and banks to have greater confidence about the compliance of their activities, thus addressing a longstanding issue with the interpretive guidance issued by the United States.

  - Drawing on a successful model developed in Germany, EU-OFAC would support collaborative efforts to increase the reliance on and reduce the costs of due diligence among the gateway banks.
  - EU-OFAC would also assist European companies in seeking waivers and exemptions from U.S. authorities and act as an interlocutor between European companies and U.S. authorities.

- Legal Protection:
  - EU-OFAC would strengthen EU legal protections for entities engaged in Iran trade and investment by developing guidelines related to a strengthened blocking regulation, creating linkages to laws that underpin the Single European Payments Area (SEPA) and to non-discrimination in the provision of banking services.

Introduction

On May 8, U.S. President Donald Trump announced that the United States would unilaterally withdraw from the 2015 international nuclear agreement with Iran, known as the Joint Comprehensive Plan of Action (JCPOA). Faced with a May 12 legal deadline on whether to continue to waive certain sanctions on Iran lifted pursuant to the deal, the President announced instead that he would reintroduce sanctions, thereby violating U.S. commitments under the agreement.

The President's decision did not come as a surprise. Criticism of the JCPOA—and, more broadly, of his predecessor's Iran policy—had been a core element of his foreign policy platform as a candidate. In his maiden address to the UN General Assembly, the President singled out the deal as "one of the worst and most one-sided transactions the United States has ever entered into."[1] In October last year, he refused to certify that remaining in the deal was in the U.S. national interest, and gave the U.S. Congress an opportunity to reinstate sanctions on Iran and tear up the deal—an offer which the congressional leadership declined (and declined again in both January and April, when the President again refused certification). Finally, the dual appointments of vocal critics of the deal to serve in key positions in his cabinet—John Bolton as National Security Advisor and Mike Pompeo as Secretary of State—signaled that the President was finally ready to pull the plug on the JCPOA.

However, the U.S. administration's position on the nuclear agreement was shared neither by its allies in Europe, who view it as a cornerstone of international security and non-proliferation, nor by the U.S. Congress, which despite deep skepticism of the Iranian regime proved mindful of the implications a withdrawal would have for transatlantic relations. As noted in an ELN policy brief published in April this year, there seemed to be some room for diplomatic talks to mitigate the impact on Europe in the event of a U.S. withdrawal—in particular with regards to secondary sanctions targeting non-U.S. entities conducting business with Iran.[2]

What was somewhat surprising, therefore, was the manner in which the United States orchestrated its withdrawal. Trump's announcement on May 8, and a subsequent speech by Secretary Pompeo, indicated that the administration will pursue a "maximum pressure" campaign against Tehran. As part of this approach, all U.S. sanctions lifted pursuant to the JCPOA will be re-introduced, the few licenses enabling certain exemptions to U.S. sanctions will be revoked, and "additional economic penalties" will be devised. Initial guidance from the U.S. Department of Treasury suggests maximal enforcement of these policies. As a result, the room for any sort of waivers or exemptions for U.S. allies with regards to investing in Iran has been all but eliminated.

> ***"The approach taken by the Trump administration has served as a wake-up call for Europe, opening political space for robust and transformative countermeasures."***

Responding to Trump's aggressive move, European leaders have reiterated their full support of the JCPOA and have made clear that they will continue to push for the agreement's full implementation despite the U.S. withdrawal. As High Representative Federica Mogherini noted in a swift reply to Trump's announcement, "The European Union is determined to act in accordance with its security interests and to protect its economic investments."[3] Accordingly, from a European perspective, attempts to salvage the JCPOA are not about "fighting the United States" nor "evading U.S. sanctions" but rather about creating the conditions that enable the EU to make good on its commitments under a deal which it considers to be crucial for international security.

The approach taken by the Trump administration has served as a wake-up call for Europe, opening political space for robust and transformative countermeasures. In addition to expert consultations on various levels focused on how to sustain European exchanges with Iran, some noteworthy measures being pursued by the EU include steps taken by the European Commission to update the so-called "blocking regulation" that prohibits European entities from complying with U.S. secondary sanctions, as well as trying to convince a reluctant European Investment Bank to finance projects in Iran.[4] Miguel Arias Cañete, the European Commissioner for Climate Action and Energy, visited Tehran in May to explore options for enabling continued European transfers to the Iranian Central Bank and thus sustaining Iran's ability to export oil and retrieve payments for those sales (abilities that are threatened by re-introduced U.S. secondary sanctions).

Against this backdrop, the frequency of formal and informal meetings that enable dialogue between policymakers and business leaders on matters pertaining to Europe-Iran trade and investment has reached unprecedented levels. The contents of this report are informed by several weeks of such consultations and convenings across Europe, though the recommendations principally draw on the dialogue which took place at the Iran Financial Future Summit (IFFS) on May 29 in Brussels, Belgium.[5]

Shared motivations for a robust response to U.S. actions

Protecting Europe-Iran economic ties, first and foremost by ensuring that Iran can sustain its current level of oil exports and oil payments in Euros, is essential to Iran sustaining at least modest economic growth in the near term. On this basis, many JCPOA opponents assert that the European interest in sustaining the Iran deal is primarily motivated by economic interests. According to this view, European leaders are motivated by access to a potential growth market and pressure from their national industrial groups.[6] But this is a misreading of the European position, which is above all motivated by security considerations. The past willingness of European leaders to accept economic costs in order to bring the Iranians to the negotiation table speaks to this. In only two years, between 2011 and 2013, the EU curtailed its imports of Iranian goods from EUR 17.3 billion to EUR 0.78 billion as it imposed stringent sanctions on Iran in coordination with the United States.[7] It was Europe, one ought to remember, which willingly took on the heaviest economic burden under the international sanctions regime on Iran, given its relatively substantial trade relationship with Iran prior to sanctions.

Given that the Rouhani administration has run an austerity budget for the last five years, the absence of foreign investment can be offset by public investment within Iran, and should oil revenues be sustained, Iran can achieve modest economic growth without significant trade or investment with Europe.[8] But the fact that there is only a weak economic incentive to protect trade and investment ties between Europe and Iran does not mean there is little resolve. On the contrary, recognizing that economic gain is a secondary consideration helps put the robustness of the European and Iranian political responses in sharper focus.

There are three shared goals for Europe and Iran which can be conceived of as concentric circles. At the core, the efforts to protect economic relations are about protecting the nuclear agreement and its attendant security benefits. European leaders understand, as did the other signatories of the JCPOA, that the agreement rested on a bargain: Iran would agree to verifiably scale back its nuclear program in exchange for putting an end to some of the economic penalties imposed on it by the international community. The JCPOA became a bulwark to possible proliferation not only in Iran, but also in the wider region, as frontlines multiply in Syria and Yemen. With Iranian hardliners now calling for Iran to openly drop out of the NPT in the case of the JCPOA's collapse, and with leaders in Saudi Arabia promising to seek a nuclear weapon should Iran go down the path of proliferation, the security stakes could not be higher.[9]

Second, there is a humanitarian imperative to maintain economic exchange. Reports from Iran already reflect rising fear and anxiety as Iranians face the prospect of increased economic hardship as a result of the renewed U.S. sanctions.The slide of the Iranian rial against the U.S. dollar in particular will reduce the purchasing power - and welfare - of ordinary Iranians, threatening public support for the JCPOA and the policies of international engagement ushered in by the Rouhani administration.

Third, both Europe and Iran are seeking to preserve their economic sovereignty, which can be defined in this context as the ability to engage in what is considered constructive and legitimate bilateral trade and investment irrespective of unilateral moves by the United States. This dimension is key to understanding the determination of European leaders to take affirmative action to sustain the deal. As an earlier ELN report noted, a key factor influencing the fallout from a U.S. withdrawal would be "the way that the Europeans choose to frame their differences with Washington over the JCPOA. A choice between the JCPOA and good relations with Washington is one thing; the ability of the EU to maintain its security, its autonomy and the values it thinks should define the international order is quite another."[10] Crucially, the political mood in Europe has gradually shifted following Trump's announcement. As Carl Bildt succinctly put it, "European economies can certainly survive without trade with Iran, but European sovereignty in foreign affairs can hardly survive passive compliance with the new dictates from the White House. Compliance would mean few would trust the E.U. as a sovereign actor in foreign and security policies."[11] This does not mean that the United States is no longer a crucial ally of Europe, but Europe has to stand up for and defend its interests. That advisors close to the Trump administration have called for an all-out "financial war" against Iran, including threats to sanction European central banks and the Brussels-based SWIFT network should these entities maintain ties to Iran, puts the matter of economic sovereignty in stark relief.[12]

> ***"The United States is still a crucial ally of Europe, but Europe has to stand up for and defend its interests."***

In short, the envisioned European effort to protect economic engagement with Iran is intended to mitigate the negative impact of the Trump administration's policy in these three areas. Europe is now seeking to build on the "nine-point plan" first sketched following consultations between Iranian foreign Minister Javad Zarif, EU High Representative Federica Mogherini and Yves Le Drian, Heiko Maas, and Boris Johnson, the foreign ministers of France, Germany and the United Kingdom respectively.[13] Four points in the plan are directly releveant to this paper: effective banking transactions with Iran, provision of export credit and special provisions in financial banking to facilitate economic and financial cooperation and trade and investment, the protection of European Union economic operators and ensuring legal certainty, and further development of a transparent, rules-based business environment in Iran.

In the effort to devise an economic package to keep Iran committed to the JCPOA, European leaders must recognize that this package does not need to be comprised of instantly implementable turnkey solutions. Political pressures in both Europe and Iran require that such a package emerges in the next few weeks. Many of the challenges facing trade and investment between Europe and Iran will take months and even years to fully address. But should the relevant stakeholders have a credible roadmap before them, it will remain possible to sustain the political will necessary to bring creative solutions to fruition. This report outlines one critical aspect of such a roadmap, focusing on the creation of a new architecture for Europe-Iran banking ties, leveraging existing legal authorities and regulated institutions.

New banking architecture, existing materials

Every few days a new headline proclaims the departure of a major multinational company from the Iranian market. But the “wind down” of commercial operations in Iran by multinationals such as France’s Total, Germany’s Siemens, or Italy’s Danieli is not due to their operations having necessarily become illegal. These companies had been required to eliminate any U.S. nexus and to avoid dealing with Iranian entities listed as Specially Designated Nationals (SDNs). Dealing with SDNs was prohibited under U.S. sanctions that remained in force after Implementation Day. Now many Iranian state-owned enterprises that had been removed from the SDN list as part of the nuclear deal are set to be re-listed, posing a significant challenge for some industrial joint-ventures. But many European companies had found joint venture partners or customers in Iran’s private sector, whose entities are not to be re-listed. For these companies, the decision to leave Iran is driven by operational considerations which stem from an inability to secure important third-party services, especially banking services.

European banks have struggled to avoid exposure to U.S. primary and secondary sanctions. On the one hand eliminating any U.S. nexus is exceedingly difficult given the primacy of the U.S. dollar and American institutions in the global financial system. On the other hand, banks have found it onerous to conduct the due diligence required to reliably avoid exposure to SDNs via customer transactions. There is nothing inherently more remunerative about servicing transactions to and from Iran than for any other market, and to whatever extent banks have sought to add a surcharge to transaction fees in order to account for the additional compliance costs, the assessments of reputational and legal risk have typically outweighed the expected value of the potential “Iran book” at nearly all European financial institutions.

As such, creating a European-Iranian banking solution is fundamentally about solving an operational, rather than legal, challenge for multinationals and SMEs that wish to maintain their business in Iran. The aim is not to facilitate trade and investment in contradiction or violation of U.S. law, but rather to ensure that operations can take place in a manner that such violations do not arise. This operational imperative means that a complete banking architecture is required, addressing the issue of compliance holistically. Importantly, rather than create this architecture from scratch, which would be a slow process likely resulting in a solution of limited enforceability, Europe should utilize existing legal frameworks and regulatory institutions as the “material” with which to devise the new banking architecture. Creating a robust banking architecture would also have positive effects for the provision of other financial services, such as insurance and payment services.

> ***“The aim is to ensure that operations can take place in a manner that violations of U.S. law do not arise.”***

Overall, the creation of a new banking architecture will entail addressing the operational challenges faced by European companies and their Iranian counterparts. This paper proposes one possible configuration for a banking architecture in the following sections. First, it describes the current regulatory environments in both Europe and Iran which complicate creating a banking architecture. Second, it outlines the central role of "gateway banks," those European financial institutions which serve as intermediaries between the Iranian and European financial systems. Third, it examines the significance of Iran's private sector banks for any such banking architecture. Next, the paper suggests the creation of a regulatory authority in the form of an "EU-OFAC," intended to counterbalance the adverse extraterritorial influence of the U.S. Treasury's Office of Foreign Assets Control (henceforth US-OFAC for clarity). Then, it details the role of EU-OFAC in supporting the banking architecture in two domains: the facilitation of bank transfers between Iran and Europe (a domain for compliance measures) and the movement of Iranian-origin funds within the European financial system (a domain for legal protection measures). Finally, the paper discusses the importance of actively resisting American pressure tactics while the banking architecture is under development.

The European regulatory environment

According to a July 2017 report by the Financial Stability Board, Iran lost 64 percent of its correspondent banking relationships in the period between 2011 to 2016. These losses were part of a larger global trend in which correspondent banking relationships have fallen, but hit high-risk jurisdictions such as Iran the hardest.[14] There are significant knock-on effects. Export credit agencies (ECAs) across Europe have struggled to operationalize their insurance and financing schemes because banks remain reluctant to engage. Italian ECA Invitalia and French ECA Bpifrance have earmarked EUR 5 billion and EUR 500 million respectively in credit lines for Iran, only to hit a wall when no banks subscribed to the financing schemes. Denmark's Danske Bank and Austria's Oberbank had also lined-up financing for Iran of EUR 500 million and EUR 1 billion respectively in schemes supported by their ECAs. Both agreements are now on hold.[15]

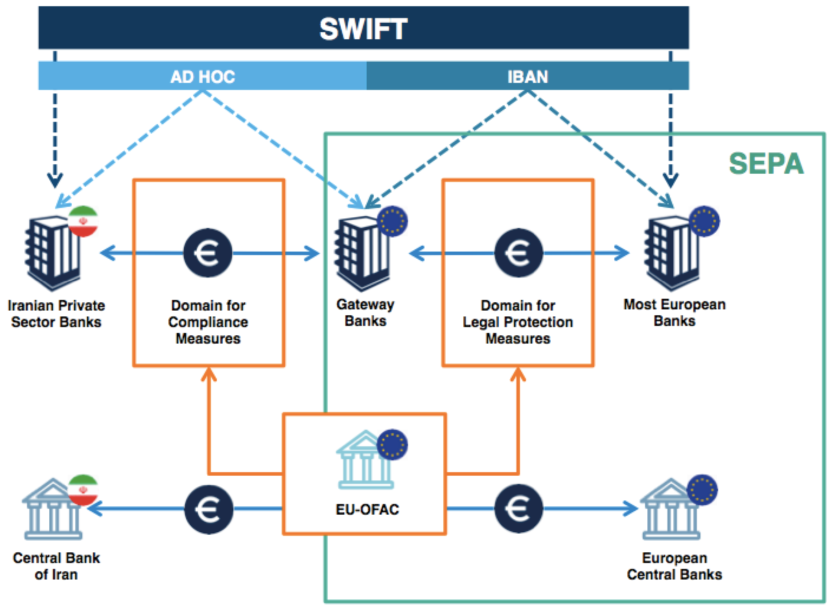
As it stands, the vast majority of European banks will not transact directly with Iranian banks. Therefore, a complete banking architecture would need to be devised in accordance with two principles: reachability, which ensures that funds from Iran can reach the European financial system and vice versa, and normalization, which ensures that funds that originated from Iran and the institutions which accept those funds enjoy normal, full, and unfettered access to the European financial system.

Reachability is a well-developed tenet of European financial regulations and is codified in EU Regulation No 260/2012, the law underpinning the Single European Payment Area (SEPA), the payment integration initiative of the European Union that harmonizes payments and direct debits between member states. In 2013, American authorities began to put pressure on Europe to close access to the European financial system, specifically by eliminating access to SWIFT and TARGET2, Europe's gross settlement system which operates at the heart of SEPA.[16] Following Implementation Day, Iranian banks were reconnected to SWIFT, and most European branches of Iranian banks were once again included in SEPA. On paper, reachability and normalization were assured for Iranian-origin funds. But in practice, significant improvements must still be made, especially in the face of renewed secondary sanctions risks.

The importance of Iranian banking reforms

Concurrently with European efforts to address banking logjams, it will be critically important that Iran remains committed to

FIGURE ONE: A NEW BANKING ARCHITECTURE



fulfilling its obligations under the action plan set by the Financial Action Task Force (FATF), an intergovernmental organization which develops policies to combat financial crime. One of the major justifications for the sanctioning of Iranian financial institutions has been Iran's weak anti-money laundering (AML) and counter terrorist financing (CTF) standards, which leave institutions susceptible to deliberate or inadvertent facilitation of illicit finance.

> ***"Successful implementation of the action plan would prove the most significant achievement for the Rouhani administration since the nuclear deal."***

Iran has recognized weaknesses in its financial crime controls and has made significant progress under this plan, in recognition of which FATF has suspended Iran's position on the so-called blacklist. However, Iran's suspended status will be reviewed at the next FATF plenary meeting at the end of this month and significant legislative work remains for Iran to satisfy the action plan directives.[17]

Encouragingly, however, a renewed political consensus has emerged in Iran around the importance of the FATF reforms in light of Trump's abrogation of the JCPOA. A new "high council for economic co-ordination," established to manage Iran's efforts to mitigate the impact of secondary sanctions, has identified the implementation of the FATF action plan as its first priority. Notably, the council includes figures from the executive, the judiciary, and parliament, reflecting a cross-section of the political spectrum.[18]

If Iran can successfully implement the action plan and earn its removal from the blacklist, it would prove the most significant political and technical achievement for the Rouhani administration since the nuclear deal. European governments must continue to support the implementation of the action plan, and advocate for a fair assessment of Iranian progress within the FATF plenary meeting. Offers of technical assistance should continue to be extended from European financial authorities to the Central Bank of Iran and Ministry of Economic Affairs and Finance, in addition to private sector enterprises and associations, especially given the emerging political consensus around the importance of FATF reforms. Demonstrable progress on these issues significantly strengthens the ability of European policy makers to encourage the European banking sector to service Iran transactions as part of a new banking architecture.

The central role of gateway banks

The ultimate success of any banking architecture will require that Iran's major commercial banks are able to transact with Europe's major commercial banks in order to facilitate the activities of multinational companies and SMEs alike. While direct transactions between major players remain untenable in the short-term, there is a special role to be played by a group of intermediary European financial institutions which can serve as the "gateway" between the Iranian and wider European financial system. These banks can also serve as intermediaries to international financial institutions from markets such as China and Russia which seek to work with Iran in tandem with European multinationals.

There are two categories of gateway banks. First, there are presently a small number of European banks that have opted to provide banking services to clients active in Iran. This category includes German landesbanks, a type of state-owned regional bank, Swiss private banks, and banks that have specialized in Iran trade finance. Chief among the latter group is the Europäisch-Iranische Handelsbank (EIH), a European bank established specifically to engage in trade finance with Iran.

Second, many Iranian financial institutions maintain branches in Europe. Though relatively underutilized and better suited to assisting Iranian companies to engage in the European market than assisting multinational clients seeking to transact with Iran, the institutions are unique given their direct links to the Iranian financial system and operation under European regulations.

A further third category of gateway banks can be envisioned, which would consist of special purpose vehicles established by European governments or as part of public-private partnerships in order to facilitate Iran trade and investment.

European authorities should seek to maintain, if not expand, the present number of gateway banks. Supporting efforts for European banks to open branches in Iran would also serve to strengthen the mutual integration of the new banking architecture.

Gateway banks could also play an important role by introducing a degree of redundancy in the bank messaging systems. The United States is poised to once again introduce "sanctions on the provision of specialized financial messaging services to the Central Bank of Iran and Iranian financial institutions."[19] Several gateway banks were able to maintain correspondent banking relationships with Iranian financial institutions using ad hoc messaging systems when Iranian banks were cut-off from Swift. These ad hoc solutions could be revived if necessary. This would ensure funds could move from Iran to SEPA. For subsequent transfers between the gateway banks and other European financial institutions, SEPA credit transfers (SCTs), which use the IBAN identification system, would be used. But the challenge facing the gateway banks is to ensure that they are neither cut-off from banking relationships with Iranian financial institutions, nor quarantined within the European financial system because they maintain financial links to Iran and process Iranian-origin funds.

Despite these looming uncertainties, the fact that there exists a patchwork of European financial institutions actively engaging with Iranian banks suggests that market forces did drive the reestablishment of banking ties between Europe and Iran following the lifting of sanctions in January 2016. The main characteristic among the two extant categories of gateway banks listed above was a limited exposure to the U.S. financial system, usually due to their small size or ownership structure. The absence of a U.S. nexus meant limited primary sanctions risk posed by servicing Iran-related transactions. Instead, the primary compliance burden for these institutions involved ensuring that facilitated transactions did not contravene secondary sanctions by directly or indirectly involving SDNs. Moreover, a range of non-sanctions regulatory requirements regarding anti-money laundering (AML) and counter-terrorist financing (CTF) measures also required compliance reviews.

“Gateaway banks could play an important role by introducing a degree of redundancy in the bank messaging systems.”

So while there exist European financial institutions that are structured in a manner that avoids primary sanctions risks, the willingness of these institutions to continue to facilitate Iran transactions is principally tied to the ability to manage increased regulatory scrutiny and the rising costs of maintaining compliance.

The role for Iranian private sector banks

Gateway banks work with a limited number of internationally-oriented Iranian financial institutions. These Iranian institutions play a similar gateway role for the Iranian financial system, though they differ from their European counterparts in that they tend to be among the larger Iranian banks by market capitalization. Generally speaking, it is Iran’s private sector banks which serve as the interface with European banks. Key institutions include Middle East Bank, Saman Bank, and Bank Pasargad. With respect to U.S. sanctions, this category of Iranian financial institutions is included as part of the Executive Order (E.O.) 13599 list, which sought to designate these institutions as SDNs as part of the effort to isolate Iran from the international financial system, but did so under designations for which secondary sanctions did not apply.[20] The secondary sanctions carveout was instrumental in ensuring that merchant banking services could be sustained for basic humanitarian trade in foodstuffs and pharmaceuticals during the sanctions period from 2006-2015.

There is some ambiguity as to whether the E.O. 13559 institutions will be subject to secondary sanctions after the end of the wind down period. The relevant guidance from the Trump administration notes that “beginning on November 5, 2018, activities with most persons moved from the E.O. 13599 List to the SDN List will be subject to secondary sanctions.”[21] The definition of “most persons” remains unclear, yet sanctions attorneys generally believe that the implementation of sanctions snapback will see Iranian private sector banks subject to the same secondary sanctions carveout as was in place under the Obama administration. However, European authorities will need to monitor this issue carefully, as in the event that Iran’s private sector banks do become subject to secondary sanctions, European gateway banks will themselves technically become exposed to being listed as SDNs.

The role for an EU-OFAC in the new banking architecture

In the days following Trump's withdrawal from the JCPOA, French economy minister Bruno Le Maire gave several interviews in which he underlined that European leaders would be asking themselves "What can we do to give Europe more financial tools allowing it to be independent from the United States?" Le Maire specifically pointed to the US-OFAC, which administers and enforces economic and trade sanctions. Le Maire postulated, "Why don't we create the same type of agency in Europe, capable of following the activities of foreign companies and checking if they are respecting European decisions?"[22]

The suggestion that France would lead the charge in creating an EU-OFAC in order to go after American companies was understandably seen more as an indicator of European ire rather than a concrete measure under consideration. But the notion of an EU-OFAC is far less outlandish when considering the important roles it could play prior to developing powers of sanctions enforcement. Such an agency could support the banking architecture necessary to facilitate Europe and Iran trade and investment. It could also support due diligence on transactions conducted between European central banks and the Central Bank of Iran.

Importantly, EU-OFAC could be developed in a manner that would reflect a European philosophy towards economic engagement with high-risk jurisdictions or markets under partial sanctions. The agency would augment the existing sanctions powers maintained by the European Commission and the member state governments, but also serve to better facilitate trade and investment in areas in which Europe wishes to maintain engagement.

The fact that US-OFAC sits within the U.S. Treasury belies the significant role of the agency in U.S. foreign policy. In the European Commission context, sanctions policy is organized within EEAS as a subset of security policy, and enacted by the Service for Foreign Policy Instruments (FPI). But this reflects a limited conception of sanctions as a coercive tool. European leaders should seek to avoid perpetuating such institutional disjunctures. Though it could develop into a standalone agency, EU-OFAC should initially be established as a new team within EEAS given the clear leadership on implementation issues pertaining to the JCPOA. Within the EEAS hierarchy, the issue of sanctions is so significant to European foreign policy and trade policy that it ought to eventually be led at the level of a Deputy Secretary General.

In its nascent phase, the EU-OFAC team would work to establish a new collaborative approach to sanctions oversight. EU-OFAC would serve as an interlocutor between US-OFAC and European companies. US-OFAC would be invited to raise compliance concerns with EU-OFAC, rather than pursuing companies directly. EU-OFAC can then seek to address concerns without raising undue alarm among executives, board members, and shareholders at the European company, blunting the effect of any pressure tactics.

Innovatively, EU-OFAC could also work directly with Iranian authorities to increase transparency in economic ties as part of the continued implementation of sanctions relief delivered as part of the JCPOA. Whereas US-OFAC imagines itself as the "world's economic policeman," in the words of Le Maire, the mandate for EU-OFAC would make economic coercion subservient to a more constructive mission of economic diplomacy. Protecting European and Iranian economic sovereignty, on the basis of a mutual commitment to financial integrity, would be the initial mission for the new agency. A host of responsibilities and activities can already be envisioned.

"That advisors close to the Trump administration have called for an all-out "financial war" against Iran, including threats to sanction European central banks and the Brussels-based SWIFT network should these entities maintain ties to Iran, puts the matter of economic sovereignty in stark relief."

EU-OFAC and the domain for compliance measures

Due diligence has proven the essential core competency for Iran trade and investment. In an environment pervaded by a "fear of the unknown", the ability to manage risk is about the reliability of information. Internal compliance teams and specialist advisors, including due diligence experts from the "Big Four" auditors and business intelligence firms, have developed significant capabilities in conducting "know-your-customer" (KYC) or "know-your-transaction" (KYT) due diligence. At this stage, many of the leading Iranian enterprises have been examined tens if not hundreds of times. However, while the veterans of the Iranian market are reasonably confident of the due diligence they have conducted, especially in instances where there is a long-standing commercial partnership in place, significant uncertainty remains as to how due diligence will be assessed by American authorities in the event of an inadvertent sanctions violation.

When OFAC issued Frequently Asked Questions (FAQs) guidance on Implementation Day, the guidance was frustratingly vague on the due diligence issue, making repeated reference to the expectation that due diligence conducted by European companies and financial institutions should both reflect "best practices of the particular industry at issue" and "conform to guidance and expectations of the non-U.S. person's home country regulators." Moreover, US-OFAC left it ambiguous whether banks need to repeat the due diligence conducted by their corporate customers on Iranian counterparties, stating that "While OFAC would consider it a best practice for a non-U.S. financial institution to perform due diligence on its own customers" repeating the due diligence would also be expected if "the non-U.S. financial institution has reason to believe that those processes are insufficient."[23]

During the Obama administration a loose understanding did emerge around these guidelines. Officials from the Treasury Department and State Department travelled to Europe to explain the intention of these guidelines and an expectation that companies would "do their homework" when it comes to due diligence. As long as that homework could be presented, these officials explained, US-OFAC would be understanding about an unintentional violation.[24]

> ***"Europe must develop its own tools, standards and certifications for due diligence."***

Such a pragmatic outlook is unlikely to be a characteristic of the Trump administration as it pursues its "financial war" on Iran. Any ambiguity in the implementation of secondary sanctions will prove all the more concerning for European businesses and banks. The new guidance issued by the Trump administration upon withdrawal from the JCPOA, extends this same ambiguity regarding due diligence in the context of wind down activities, explaining that companies ought to conduct "due diligence sufficient to ensure that it is not knowingly engaging in transactions with persons on the SDN List or in activities that would be sanctionable under authorities targeting Iran's malign activities."[25]

Overall, European commercial actors have been significantly hampered by the need to look to interpretative U.S. guidance in order to understand the parameters for acceptable due diligence. One of the few concrete pieces of guidance given by US-OFAC, to refer to local regulators, has itself been a source of frustration as European regulators have themselves never properly articulated what acceptable due diligence looks like.

In order to give confidence to European companies seeking to pursue business in

Iran in the face of sanctions snapback and what is likely to be a more militant stance from US-OFAC, Europe must develop its own tools, standards, and certifications for due diligence. To do so, greater cooperation between government and private sector is needed. Two existing models are instructive here which help outline how the private sector and governments can respectively create institutional frameworks to support the new banking architecture for Iran trade and investment.

First, looking to the private sector, a new institutional framework would help boost the due diligence capacities of the gateway banks and provide a focused interface for the envisioned EU-OFAC. In Germany, six credit unions have established the KompetenzCenter International, or International Competence Center, to assist them in matters related to international transactions. The center has developed specialized expertise for Iran transactions, centralizing resources for compliance and due diligence. Such a center helps these smaller banks, which are not accustomed to the particularities of international banking, perform the necessary due diligence functions more reliably and at a lower cost.

Notably, the banks associated with the center have expressed their willingness to continue working with Iran. In a recent interview, Patrizia Melfi, director of the competence center, indicated that the banks' supervisory board had given a "green light" to continue work with Iran despite the U.S. withdrawal from the JCPOA. In Melfi's assessment, the imperative is "to be well informed and conduct detailed checks of the companies' deals." If these steps are taken such that European entities "stick to the requirements and regulations of the current export controls of the EU and the US," Melfi explains, then "nothing can happen to them."[26]

The mere ability to persist with Iran business and to express such confidence regarding the legality of the Iran transactions demonstrates the potential impact of expanding the "competency center" model to all gateway banks in Europe, likely in the form of an industry association. The association would develop a "toolkit" of due diligence solutions that would increase the reliability of due diligence while also reducing costs, by concentrating expertise, assisting in the creation of industry-standards for compliance practices, and providing association-wide access to compliance monitoring software, among other measures.

> ***"The creation of an industry association would address the present fragmentation of the community of banks pursuing business in Iran."***

Additionally, the creation of such an association would benefit European governments by providing a single point of interface for dialogue on issues pertaining to the new banking infrastructure. Governmental support could also extend to financial assistance in the establishment of the association and subsidization of some of its compliance toolkit provisions, including joint public-private programs to provide training and technical assistance to the gateway banks and their Iranian counterparties. Overall, the creation of an industry association would address the present fragmentation of the community of banks pursuing business in Iran, which is inconsistent with the successful operation of the new banking architecture.

The second instructive model helps delineate a governmental institutional contribution, namely how the establishment of an EU-OFAC could serve to create greater regulatory clarity for the gateway banks and their corporate clients. Importantly, there exists an example where a stronger regulatory oversight by Europe was able to make a meaningful difference in the facilitation of Iran transactions under U.S. secondary sanctions.

During the sanctions period of 2006-2015, several European multinationals were able to maintain their commercial activities in Iran specifically because they sold products which were considered to be dual-use. As a result, sales were subject to additional oversight from the export control authorities of their home governments. This oversight, which required receiving a license from a European authority that served to certify the enhanced due diligence supporting the transaction, gave the banks servicing these multinational clients greater confidence about the associated risks.[27]

It stands to reason that EU-OFAC could play the same role currently played by export control authorities in EU member states, extending oversight across Europe and to a wider range of enterprises, including financial institutions. As part of this effort, EU-OFAC could also seek to foster cooperation with Iranian authorities in efforts to increase transparency in Europe-Iran economic relations. In recent consultations, Iranian authorities have expressed a willingness to support due diligence efforts, principally by improving the ease of access to company information maintained in the relevant registries in Iran.[28] This could take the form of a joint due diligence protocol whereby, EU-OFAC would be authoritatively able to verify information on Iranian companies, including their management, board members, and shareholders in accordance with a pre-agreed format and with the consent of the Iranian company. Iranian authorities would be permitted to request the same information on European companies from EU-OFAC. Such a protocol would help EU-OFAC move closer to providing certifications for due diligence by European companies and banks.

Taken together, these models help demonstrate that turning due diligence into a core competency of the European-Iranian banking architecture would significantly improve the defense of the architecture from U.S. interference. This is true not only because companies and banks will have greater confidence in the ultimate compliance of the transactions, particularly in regards to eliminating SDN-risks, but also because an effort focused on due diligence would see European political support converted into practical support. Yet while increasing due diligence competencies will protect transactions between the Iranian financial system and Europe's gateway banks, there exists a second challenge—ensuring that the gateway banks remain connected to the wider European financial system and that funds originating in Iran can move freely in Europe.

EU-OFAC and the domain for legal protection measures

One of the initial steps taken by European leaders to protect Iran trade and investment from secondary sanctions was to begin the process of reviving the Council Regulation No. 2271, the so-called Blocking Regulation, which is intended to protect companies against the "effects of the extra-territorial application of legislation adopted by a third country." The regulation does so by prohibiting EU entities and courts from complying with the listed foreign sanctions laws. Most legal experts and even policy makers agree that the regulation is largely symbolic as written, and offers little real legal recourse to blunt the blow of extraterritorial American sanctions. As such, European policymakers have been exploring how the regulation might be strengthened in some way to better protect Europe-Iran financial ties from U.S. secondary sanctions.[29]

The fundamental weakness of the regulation is its disconnection from both an enforcement power and from other better-established legal frameworks. Both of these weaknesses can be addressed within the proposed banking architecture. First, in the area of enforcement, the blocking regulation suffers from reliance on the authorities of member states. While this is consistent with most European Union law, it means that there is an effective mismatch between the regulatory unification of the European financial system and the means by which Europe manages the impact of financial sanctions on that unified system. An EU-OFAC would serve to rectify this imbalance by extending the executive power of the European Commission to better orchestrate the European response to extraterritorial sanctions.

> *"There is concern that larger European financial institutions could block credit transfers from the gateway banks on the basis that the funds may have originated in Iran."*

Second, in the area of broader legal frameworks, the blocking regulation could be strengthened so that it does not merely codify legal ramifications of European compliance with American sanctions, but also more clearly addresses European non-compliance with European law. European authorities plan to issue updated guidance regarding the workings of the blocking regulation when the updated regulation is expected to come into force in August.[30] This guidance should reflect the role of the blocking regulation within the context of a new banking architecture and could be issued through EU-OFAC.

Principally, this would see the blocking regulation used to ensure that institutions within the wider European banking system cannot arbitrarily deny services to gateway banks or European businesses, effectively quarantining them because of their sustained links to Iran in the new sanctions environment. The most concrete way in which this could be achieved is to ensure that the gateway banks which sustain commercial ties to Iran in the new sanctions environment are in no way disadvantaged within the Single European Payment Area. There is concern that larger European financial institutions could block credit transfers from the gateway banks on the basis that the funds may have originated in Iran. Under the SEPA credit transfer rulebook developed by the European Payments Council, beneficiary banks can reject a credit transfer from originator banks for "regulatory reasons."[31] These reasons are not clearly defined, indicating a degree of discretion on the part of the financial institutions related to their internal risk management protocols.

The principle of "reachability," under which "participants commit to making and receiving payments... according to the rules of [SEPA]" is considered a "key success factor" for the scheme.[32] European financial institutions should certainly retain the right to reject credit transfers should they feel that there may be a regulatory risk associated with processing the funds. But the importance of reachability to the banking architecture for processing financial transactions between Europe and Iran will require that any rejections are made with clear grounds. In the event that a gateway bank sees its credit transfer rejected in the period following the establishment of European standards around KYC/KYT due diligence, it would be possible to refer the beneficiary bank to EU-OFAC and require that bank to demonstrate the grounds for their rejection. Banks found to be obstructing reachability within SEPA on false regulatory grounds would be subject to penalties under the strengthened blocking regulation. The concept here is very simple—if a European authority believes that a group of assets have arrived within the European financial system legally and compliantly via the gateway banks, these assets should be able to move freely throughout the European financial system.

Relatedly, the blocking regulation should be strengthened to account for ways in which the fear of extraterritorial sanctions impacts individuals and entities in Europe. One of the most frustrating and damaging issues facing individuals and companies engaged in Iran trade and investment is the arbitrary closure of their accounts by European banks. This has been happening across Europe as banks decide that the costs of due diligence necessary to mitigate sanctions risks are not worth maintaining these clients.

In the assessment of some attorneys, these episodes reflect instances of discrimination by European banks and there have been lawsuits filed against banks for this reason.[33] The additional formalization of compliance measures represented by the creation of an EU-OFAC and the attendant reorganization of private sector actors such as the gateway banks would serve to remove the pretext for denial of service or the closure of accounts. The ramifications are most clear in the case of Iranian nationals in Europe. Presently, if challenged in accordance with non-discrimination laws, a bank would need to demonstrate that the treatment of the individual in question was not motivated by their nationality, but because of the legal obligation presented by sanctions regulation.[34] When EU sanctions on Iran were in place, the denial of service could have been construed as broadly consistent with a European regulatory requirement. But given that only U.S. secondary sanctions remain in effect, the denial would now at most reflect an adherence to an American regulatory requirement. On this basis, the blocking regulation could be updated with language that would offer protections for individuals and companies such that they cannot be denied services simply because they fit the profile of a person who may be exposed to U.S. secondary sanctions.

In these ways, the blocking regulation can be reshaped to not merely include protections against undue compliance with U.S. sanctions, but also specifically those instances in which European entities are giving precedence to precautionary compliance with U.S. sanctions over their duties under existing EU law.

Resisting American pressure tactics

The creation of a new banking architecture for Europe-Iran commercial ties will mean little if the architecture is not adequately defended from U.S. pressure. To this end, European governments ought to take two steps. First, European authorities need to give their businesses and banks greater confidence about protections in the worst-case scenario of direct U.S. enforcement action. In order to give greater confidence to European businesses, the blocking regulation could be strengthened to include an improved compensation scheme for possible U.S. penalties. Currently, the regulation includes a "clawback provision" that allows an EU company to sue in European courts to recover damages or expenses in the event an American entity or regulator takes legal action for business with an entity sanctioned by U.S. rather than EU law. But the provision is impractical given that it stipulates the "seizure and sale of assets" held by the American entity which launched the legal action. It is unclear how the clawback provision would protect a European company in the face of an OFAC penalty for ties to an SDN.

> ***"The creation of a new banking architecture for Europe-Iran commercial ties will mean little if it is not adequately defended from U.S. pressure."***

To be effective, compensation cannot be contingent on successful legal action in European courts. Rather, the compensation needs to be a protection available to European companies within the context of their negotiations or legal proceedings with American authorities, such that they can take a more robust posture in the face of possible enforcement action. Of course, European authorities will not wish to incentivize lax compliance standards with the promise that compensation is available in the event of a penalty. To avoid perverting incentives, EU-OFAC could play an important role. Qualification for the compensation scheme could be left to the discretion of the European regulator. For example, a European company facing a possible penalty from OFAC for an inadvertent violation of American sanctions, could qualify for compensation if the due diligence conducted in accordance with the relevant transactions was done to the approved standards of EU-OFAC. Such a scheme would also serve as a positive incentive for ensuring that European entities maximize the quality of their due diligence. Not only would such due diligence minimize the likelihood of a violation, and thereby an enforcement action from American authorities, but it would also enable access to a kind of "insurance policy" codified under the blocking regulation.

> ***"European authorities must insist of the effective unsanctionability of key institutions."***

French economy minister Bruno Le Maire has signalled interest in ensuring EU regulations can allow the bloc "to take charge of possible sanctions' prices paid by companies and that could be paid by the European Union."[35] German Chancellor Angela Merkel has struck a more cautious tone, noting that in terms of "compensating all businesses in a comprehensive way for such measures by the United States of America, I think we cannot and must not create illusions."[36] But it is important to note that the issue of compensation is not to provide financial relief for companies which can no longer pursue planned projects in Iran, but rather to offer aid to companies that may be penalized by U.S. authorities. The pool of funding for this application would necessarily need to be much smaller, especially if one considers that the average size of OFAC penalties is in the hundreds of thousands of dollars. The often cited billion-dollar penalties levied on the likes of BNP Paribas and HSBC were for very deliberate and knowing violations of U.S. primary sanctions that extended far beyond Iran violations. Such transgressions would not be subject to any European compensation scheme anyway. Funding for the compensation scheme could derive from taxes levied on some aspect of U.S.-Europe trade.

Second, aside from providing an added layer of protection for European companies and financial institutions, European authorities must insist on the effective unsanctionability of key institutions such as Swift and central banks. Close advisors to the Trump administration have unabashedly threatened that Trump could "use his executive powers to put on the sanctions list board members and senior officials at the ECB, European Investment Bank and national central banks."[37]

These threats present a valuable opportunity to test American resolve. For example, the decision to sanction an entity such as Swift would inhibit American financial institutions from using the world's most popular bank messaging system. Sanctioning European central banks would be similarly self-defeating. As such, there are two possible outcomes if these institutions proceed to work with Iran despite U.S. secondary sanctions. Either U.S. authorities fail to take enforcement action given the massive consequences for the operations and integrity of the American financial system, serving to "defang" the enforcement threats and reduce the risk of European self-sanctioning on the basis of fear, or U.S. authorities take such an enforcement action, a step that would only serve to accelerate European efforts to create a defensible banking architecture that goes beyond the Iran issue alone.

Conclusion

Developing the competencies of gateway banks, establishing an EU-OFAC, and strengthening the blocking regulation are steps that - when pursued in combination - can have a transformative effect on the ability for European businesses and banks to pursue opportunities in Iran. On the European side, creating this banking architecture will take considerable political effort and coordinated action among the European Commission, European Parliament, and governments of member states over the course of the next year. Yet the multitude of stakeholders involved also illustrates the substantial resources available to support these urgent processes. The story of Europe is a story of improbable coordinated action. The defense of the Iran deal will prove a compelling chapter.

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