Establishing a Direct Financial Channel between the United States and Iran

Executive Summary

In the wake of a nuclear deal, the White House should establish a direct financial channel between the United States and Iran. This would serve three purposes:

1. Help facilitate transactions with Iran that the White House has authorized and thus regards as being in U.S. foreign policy interests. On several recent occasions, the Obama administration has generally authorized a host of activities with Iran, including the sale of personal communications technologies. Without a clear means to conduct transactions related to these activities, however, U.S. and Iranian parties are barred from engaging in them. A direct financial channel would resolve this issue.
2. Incentivize Iran to adhere to its nuclear non-proliferation obligations by ensuring Iran receives the benefit of its bargain under a nuclear deal. Sanctions are easier to turn on than off, and the White House will have difficulties providing Iran practical value from sanctions relief. Establishing a direct financial channel remedies this problem by sending a clear signal to banks that the risk of doing business in Iran is diminishing.
3. Realize the potential for a broader opening to Iran. The United States has long believed that commercial ties moderate otherwise recalcitrant regimes. Iran should no longer be the exception. By authorizing a broader range of commercial activities with Iran and establishing a direct financial channel so that U.S. companies can make and receive payments, the White House could utilize the private sector to realize its foreign-policy objectives vis-à-vis Iran.

By establishing a direct financial channel, the White House would help secure and sustain the viability of a nuclear deal over the long-term, while also testing the unique opportunity to set U.S.-Iran relations on a different course.

Introduction

On the eve of a potential settlement to the Iranian nuclear dispute, the United States must be prepared to provide Iran the sanctions relief pledged it under a nuclear deal. Unwinding the sanctions will be crucial to ensuring that Iran upholds its commitments under a final deal and remains compliant with its nuclear non-proliferation obligations, while also setting the stage for the White House to pursue a broader opening to Iran.

To accomplish this, the United States should establish a direct financial channel between the United States and Iran. This channel would be used both to facilitate authorized transactions with Iran and to send an unmistakable signal to Iran and the rest of the world of the U.S.'s own commitment to a nuclear deal and its interest in turning the page in relations with Tehran.

In the absence of a direct financial channel, conducting otherwise licensed or exempted transactions with Iran has proven difficult, if not near impossible. This has undermined U.S. interests. In the wake of a nuclear deal, this problem will become even more acute as the United States will need to ensure Iran receives substantive relief in order to warrant Iran's compliance with the agreement and demonstrate to international actors that the U.S. is indeed de-escalating the sanctions pressure. Failure to do so threatens to undermine the practical value of sanctions relief to Iran and thus the long-term viability of a nuclear deal that imposes strict limits to Iran's nuclear program.

Moreover, failing a direct channel, the U.S. will find it difficult to utilize commercial ties as a way to facilitate a broader opening with Iran. This would be unfortunate. The United States has long believed that commercial relations tend to moderate otherwise recalcitrant regimes. Iran should not be the exception. By tailoring sanctions relief so as to permit the limited entry of U.S. companies into Iran, the Obama administration can use the influence of the private sector to appeal to Iran's population and tempt Iran's leadership to reciprocate American good-faith with that of its own.

By creating a financial channel between the U.S. and Iran, the U.S. stands prepared to accomplish these twin goals. Below, we discuss further why there is a clear need for a direct financial channel between the United States and Iran; what that channel could look like; and why creating such a channel will serve important U.S. foreign policy interests.

The Need for a Direct Financial Channel

Difficulties Conducting Legal Transactions

Since the advent of financial sanctions on Iran, conducting authorized transactions has proven difficult.[1] While the U.S. trade ban with Iran prohibits most transactions between the two countries, there is a growing class of activities

[1] This issue has especially affected Iranian Americans. Banks have not only refused to process authorized transactions with Iran, but have also taken the additional step of closing down the accounts of persons engaged in such transactions. See Barbara Slavin, "Banks Remain Fearful of U.S.-Approved Transfers to Iran," *Al-Monitor*, October 2, 2014.

that are either authorized or exempted from these prohibitions.[2] This includes, for instance, the provision of humanitarian goods or services, the sale of agricultural commodities, and personal remittances to Iran. However, in order to conduct transactions related to these activities, U.S. and Iranian parties must route funds through third-country financial institutions since there is no direct financial channel between the U.S. and Iran.[3] Due to U.S. financial sanctions, however, most third-country banks are unwilling to process such transactions.[4] This leaves U.S. and Iranian parties without a clear means to effectuate transactions related to legitimate activities.

This also undermines U.S. foreign policy interests. For example, where the United States authorized the sale or provision of personal communications technologies or software to Iran as a way to help Iranians circumvent the government crackdown on Internet and communication technologies, this authorization has proven of limited value in the absence of a clear means for Iranians to pay for such goods.[5]

The United States itself acknowledged this problem when it agreed to the Joint Plan of Action with Iran last November. Under the JPOA, the United States and its P5+1 partners agreed to establish a financial channel for Iran to use oil revenues tied up in overseas accounts for the purchase of humanitarian goods.[6] Less noticed was that these same transactions were already exempted from U.S. sanctions.[7] The fact that the U.S. agreed with Iran that there was a need for such a humanitarian channel spoke to the deficiencies in the present sanctions regime. These same deficiencies persist for the broader set of transactions authorized or exempted under the Iranian Transactions and Sanctions Regulations. Such deficiencies must be adequately addressed.

Sending a Clear Signal to Financial Institutions

In the wake of a nuclear deal with Iran, the United States will need to send a clear signal that it is starting to de-escalate the sanctions and to relieve the pressure on Iran in order to ensure that Iran receives tangible benefits from the sanctions relief and is adequately incentivized to adhere to its reciprocal obligations under a nuclear deal. Establishing a direct financial

[2] See 31 C.F.R. § 560.210 for exempted transactions and 31 C.F.R. § 560 Subpart E for authorizations.
[3] 31 C.F.R. § 560.516.
[4] A U.S. Treasury official acknowledged that "there are banks out there that are reluctant to facilitate these transfers for a variety of reasons – they are risk averse when it comes to dealing with Iran." Jonathan Saul & Parisa Hafezi, "Collateral Damage: How Iran Sanctions Fears Hurt Humanitarian Trade," *Reuters*, August 1, 2014. A Western intelligence source confirmed this, saying, "Large European banks are to a large extent making it a matter of policy to manage risk and operate more cautiously than is actually required by regulations in order to avoid prohibited activity." Jonathan Saul & Parisa Hafezi, "Iran Seeks to Resolve HSBC Freeze on Some Trade Financing," *Reuters*, June 24, 2014.
[5] See, e.g., Jack Linshi, "Why U.S. Sanctions Mean Some Countries Don't Get Any iPhones," *TIME*, October 16, 2014.
[6] Joint Plan of Action (November 24, 2013).
[7] Section 1245 of the National Defense Authorization Act for Fiscal Year 2012.

channel between the U.S. and Iran for authorized transactions would accomplish this.

U.S. financial sanctions proved a reputation-killer for Iran's banking sector. Most European and Asian banks severed all ties with Iranian financial institutions starting in 2010, refusing to conduct even permissible funds transfers with Iran.[8] To hear banking executives talk about it, the risk is high and the reward much too little to be seen doing business with Iran.[9]

While banks' 'de-risking' has, in some respects, worked in the U.S.'s favor when the United States was accelerating the sanctions pressure on Iran, it now stands to undermine U.S. sanctions relief and, in so doing, risks damaging U.S. credibility to Iran, its people, and the wider international community. The United States will need to send a strong signal that it is committed to provide Iran the sanctions relief promised it under a nuclear deal. That will involve measures that have not just practical benefit, but also symbolic value. Establishing a direct financial channel between the U.S. and Iran would carry both the practical and symbolic worth necessary to sustain a nuclear deal with Iran.

Pursuing a Potential Opening with Iran

Whether a nuclear deal between the U.S. and Iran gives rise to a broader opening between the two countries remains unclear. Nonetheless, despite serious differences between the two states, the year-long nuclear negotiations have facilitated direct contacts between the U.S. and Iran for the first time in more than three decades. This sets the stage for both parties to pursue the opportunity for broader ties.

Pursuing such, the United States might well authorize a more expansive class of activities with Iran than permitted at present. U.S. tech firms, for instance, are itching to enter Iran and capture some of the market share that has been handed over to Asian tech companies like LG and Samsung. Insofar as U.S. tech giants like Apple represent the best of the American brand, their entry into Iran could inure to the ultimate benefit of the United States, moderating Iran's regime by appealing to its population.

However, absent a clear means to process transactions, U.S. companies will be hesitant to

[8] This followed the passage of the Comprehensive Iran Sanctions Accountability and Divestment Act ("CISADA") in July 2010, and the accompanying high-profile three-week tour of top-level Treasury officials to foreign jurisdictions. As Undersecretary of the Treasury David Cohen said in 2012, "With [CISADA] in place, Treasury embarked on a global outreach campaign to engage with governments and financial institutions around the world to warn them off business" with Iran. See Remarks of Under Secretary for Terrorism and Financial Intelligence David Cohen at the Foundation for Defense of Democracies Washington Forum, December 6, 2012.

[9] As a 'banking source' noted, "[Banks] are increasingly worried about falling foul of any sanctions oversights. It's just not worth the risks, especially in this climate." See Jonathan Saul & Parisa Hafezi, "Iran Seeks to Resolve HSBC Freeze on Some Trade Financing," *Reuters*, June 24, 2014. One former U.S. official echoed this, saying, "Financial institutions are seeing the business, even though it is permissible, as too risky from an anti-money laundering perspective and not profitable enough to outweigh the potential penalties and additional compliance costs." Jonathan Saul & Parisa Hafezi, "Collateral Damage: How Iran Sanctions Fears Hurt Humanitarian Trade," *Reuters*, August 1, 2014.

move into Iran. Already, according to reports, Apple and others are in conversation with the Treasury Department's Office of Foreign Assets Control discussing some of these impediments.[10] The White House should consult closely with U.S. companies interested in doing business in Iran to figure out how to tailor sanctions relief to permit their entry. Setting up a direct financial channel will resolve a major barrier and set the stage for the private sector to act for the benefit of U.S. foreign policy interests.

Mechanisms for a Direct Financial Channel

Past Precedents

Various mechanisms exist for the United States to establish a direct financial channel between the U.S. and Iran. Some of these have a clear precedent. For instance, under the Burmese Sanctions Program, the Office of Foreign Assets Control ("OFAC") issued General License authorization for U.S. depository institutions to engage in financial transactions with Burmese financial institutions that remained designated under OFAC sanctions programs.[11] A similar arrangement was made in the case of the Zimbabwe Sanctions Regulations as well.[12]

These two models can be replicated in the context of Iran: OFAC could issue general license authorization for a U.S. financial institution(s) to establish and maintain a correspondent banking relationship with an Iranian financial institution for the purpose of effectuating funds transfers authorized under the Iranian Transactions and Sanctions Regulations. The Burma and Zimbabwe examples should mitigate fears that establishing a financial channel with Iran would itself be precedential. Instead, policymakers can legitimately claim that, by responding to a clear need and helping facilitate authorized transactions with Iran, OFAC is instituting a policy that it has successfully implemented under other U.S. sanctions programs.

The Best Option: The Federal Reserve

What is most critical in designing a direct financial channel, however, is to mitigate the risk that financial institutions will refuse to process authorized transactions for fear of running afoul of U.S. sanctions. That is why the most credible option for the United States might well be controlling and overseeing the channel itself – via the Federal Reserve. Doing so would ensure a number of things: first, that the United States has complete discretion and oversight over the financial channel itself; second, that it is sending the clearest and strongest signal to financial institutions that the U.S. is interested in de-escalating the sanctions pressure on Iran; and lastly, that legitimate transactions are, in fact, effectuated through the financial channel and not delayed or denied by the 'conservative compliance' of U.S., European, and Asian financial institutions.

As discussed above, the financial channel must have both practical and symbolic value. If

[10] Benoit Faucon, "Apple in Talks to Sell iPhone in Iran," *Wall Street Journal*, October 29, 2014.
[11] General License No. 19 (February 22, 2013). This General License authorization has since been codified under the Burmese Sanctions Regulations. See 31 C.F.R. § 537.531.
[12] 31 C.F.R. § 541.510.

a channel is created and legal transactions remain under stress, the practical value will be nil and the symbolic worth will be negative. While any kind of financial channel would be a significant improvement over the current regime, only by shouldering the burden of creating and overseeing the channel itself can the White House ensure that its ultimate policy goals vis-à-vis the financial channel are met. Leaving this in the hands of private U.S. depository institutions may be too big a risk for a matter as serious as sustaining a nuclear deal with Iran.

U.S. Foreign Policy Interests At Stake

The United States has important foreign policy and national security interests at stake in the creation of a direct financial channel with Iran. First, a direct financial channel would help sustain a nuclear deal with Iran by ensuring that Iran receives the sanctions relief the United States pledged it at the negotiating table. Second, such a channel would help U.S. and Iranian parties effectuate funds transfers related to legitimate activities in each of the two countries – activities which the United States has generally authorized (and, hopefully, broadened following a nuclear deal) and which thus serve important U.S. foreign policy interests. Third, a direct financial channel would strengthen anti-money laundering controls, as the U.S. would have oversight over authorized transactions that it does not at present. Taken together, these considerations underline the important benefits of establishing a financial channel.

Under a nuclear deal, the United States will trade sanctions relief for verifiable limits to Iran's nuclear program. In order to sustain a long-term nuclear agreement, the U.S. will need to ensure that sanctions relief has practical value, leading to material benefits for Iran and its population. Formalistic approaches to sanctions relief – such as waiving sanctions or licensing otherwise prohibited activities – will not be adequate. Instead, creative solutions will need to be embraced to start to reverse the real damage that sanctions have done to Iran's financial reputation in the world. One of those creative solutions is a direct financial channel.

Second, by authorizing or exempting a series of activities from the Iranian Transactions and Sanctions Regulations, the United States has determined that certain kinds of engagement with Iran serve important U.S. interests. The fact, then, that U.S. and Iranian parties have immense difficulties engaging in these activities undermines those same U.S. foreign policy interests. Establishing a direct financial channel would ensure that banking restrictions pose no barrier to the achievement of U.S. foreign policy goals.

Just as important, a direct financial channel would provide the United States a level of oversight over authorized transactions with Iran that it does not have at present. By forcing U.S. and Iranian parties to route funds transfers through third-country financial institutions, the United States loses all means of supervision over the funds itself. However, if the Federal Reserve or U.S. depository institutions were to serve as the conduit for legitimate transactions to or from Iran, the United States would be able to track both the sender and the recipient of the funds and be confident that the funds, in fact, reached their intended recipient. Following a nuclear deal with Iran, the U.S. will still have important concerns over money-laundering in Iran's financial sector. The best means of assuaging these concerns, however, is to exercise a level of discretion and control over the funds that the U.S. does not otherwise possess at present. Only a direct financial channel to Iran can accomplish this goal.

Conclusion

As part of a nuclear deal, the United States should establish a direct financial channel between the U.S. and Iran for the purpose of authorizing permissible transactions under the Iranian Transactions and Sanctions Regulations. Doing so would serve important U.S. foreign policy interests, including the U.S. interest in seeing a nuclear deal with Iran sustained over the long-term.