For sanctions compliance, the relaxation of sanctions offers no time to relax

by Jonathan H. Burke

The United States Government has taken several steps recently to ease sanctions related to Cuba and Iran in support of US foreign policy objectives. In addition to a diplomatic thaw with Cuba, the US agreed to a deal with Iran, along with the “P5+1” (permanent members of the UN Security Council plus Germany), to ease sanctions in exchange for Iranian action to roll-back its nuclear program. With this change in posture on US and international sanctions, businesses around the world are now lining up at the doors of Cuba and Iran to take advantage of new commercial opportunities. US financial institutions, however, may find sanctions compliance even more challenging as an easing of sanctions creates more caveats, nuances and complications in a sanctions framework that, in reality for the US, remains largely intact.

To understand how sanctions compliance may become more difficult in an era of easing sanctions, it is important to explore how sanctions became complex, what the relaxation measures actually do and how financial institutions can enhance their sanctions compliance programs to address these challenges in a manner that also offers the agility to adapt to a future sanctions landscape that can change rapidly.

The rise of sanctions

Sanctions compliance has grown more challenging over the past decade as sanctions programs have expanded in scope and complexity. Broad-based country programs within the US, such as the embargoes on Cuba and Iran, have been compounded by targeted financial measures against individuals and entities located throughout the world on the basis of specified behavior (e.g., proliferation, terrorism, human rights). In 2010, the US Congress introduced the concept of “secondary sanctions,” which provides for prohibitions on the US correspondent access of non-US financial institutions in response to business conducted with certain Iranian entities, even when that business does not involve the US financial system or a US person abroad. This measure
required that non-US financial institutions located outside of the US recognize activity that does not involve the US but could be subject to secondary sanctions. As a result, most non-US financial institutions ceased any business with Iranian entities sanctioned by the US. This concept was further expanded against Iran through both legislation and executive action and is also a currently unexercised option in the US sanctions against Russia.

A new era of sanctions

Just as the increasing of sanctions has created additional layers, the easing of sanctions is similarly complex. For both Cuba and Iran, the US embargo remains in place with no current indication of relief, and sanctions on Iran related to issues such as terrorism and human rights that were not part of the agreement with Iran regarding its nuclear program will also remain. However, as it relates to Cuba, the US Government expanded permitted activity largely through new general licenses, and for Iran, the US Administration has agreed to lift or waive the threat of most “secondary sanctions” on non-US financial institutions that do business with Iran, including those related to oil. Secondary sanctions related to business with entities designated for terrorism or related to the Islamic Revolutionary Guard Corps (IRGC) will remain in effect. While financial and trade restrictions for US persons with Iran remain unchanged, US banks may face increased exposure through non-US financial institutions now permitted by their own governments to do more business with Iran that is also free from the threat of secondary sanctions in the US.

The sanctions that snap back

The agreement with Iran for the easing of international sanctions also includes a new concept for the re-application of sanctions: the so-called snap back provision that reapplies sanctions in the event that allegations of Iranian nonperformance of the agreement are not resolved. However, not all sanctions would snap back, as this provision applies to sanctions previously imposed by the UN Security Council and not those imposed individually by various countries, which may be more restrictive. The autonomous sanctions on Iran by several governments, including the US, EU, Canada, Norway, Australia and Japan were deliberately aligned, but the agreement with Iran does not envision that these measures would be reapplied automatically. As these autonomous sanctions are lifted and the US maintains its restrictions, any reapplication of sanctions by individual jurisdictions as a result of the snap back may increase the disparity between country-specific sanctions.

Another key point behind the snap back provision is its very intention to reapply a sanctions program with immediate effect, signaling the policy value of a rapid shift in the application of sanctions. In order to operationalize such a shift, including a shift with inherent disparities, financial institutions must have a sanctions compliance program that can quickly identify and adjust to the changes reapplied. The Office of Foreign Assets Control (OFAC), which administers US sanctions, has made it clear that any business ventures with Iran made prior to a “snap-back” of sanctions will not be exempt from any sanctions enforcement should the sanctions be reapplied.

Adapting to the new sanctions environment

For financial institutions, sanctions compliance would be a lot easier if it was “all or nothing.” Being able to engage in some but not all business related to sanctioned countries, particularly when the restrictions vary across sanctions programs, increases the burden on institutions to figure out what they can, can’t, and are willing to do. In addition, as the US and other governments continue to adjust sanctions expectations, as is proposed within the agreement with Iran, US institutions may need to evaluate their risk to Iran vis-à-vis their relationships with financial institutions outside of the US that may have very few restrictions on business with Iran. This raises numerous operational challenges to creating an effective and efficient sanctions compliance program.

First, how can sanctions screening accurately identify a prohibited party or transaction in the context of added complexity? The traditional approach of screening customer names and parties in a transaction may not capture those hiding behind evasion tactics, and what is prohibited may not purely be a function of the name on the list. The multiple layers of sanctions and related parties, combined with the relaxation of sanctions related to certain activity means that identifying and understanding the nature of the activity subject to sanctions is critical to applying effective screening controls. OFAC guidance, most recently a July 2015 advisory on sanctions evasion, notes the importance of additional due diligence on customers and transactions where necessary to understand if, and exactly how, sanctioned entities may be involved.

• Consider a payment involving Cuba:
  ▶ Is it related to the purpose for which the general OFAC licenses apply?
  ▶ Is the Cuban national normally resident outside of Cuba?

• Consider a payment related to Iran (following the proposed sanctions easing):
  ▶ Is a Government of Iran entity involved?
  ▶ Do you need to block or reject it?
  ▶ Is it related to trade with Iran; is that trade prohibited; and is a prohibited party involved in permissible trade? (The proposed Iran deal would license the importation to the United States of Iranian-origin carpets and foodstuffs but not when a designated entity is involved.)

• Consider a customer or transaction counterparty in a foreign jurisdiction:
  ▶ Does the customer or counterparty have increased exposure to Iran due to the relaxation of sanctions within its jurisdiction?
  ▶ What additional due diligence, on the customer or transaction, may be required?

• Consider a payment related to Cuba or Iran through a foreign subsidiary of your institution:
  ▶ Is it permissible under the revised sanctions regulations?
  ▶ Do you need a license?
  ▶ Are there conflicts of laws?
Second, how can sanctions controls be implemented with greater efficiency in a way that is adaptable to future changes? Many financial institutions have begun a process to increase their understanding of the specific sanctions risks and the processes currently in place to control them in order to determine inconsistencies, redundancies and controls that do not align to the risks. These issues can create unnecessary “noise” within sanctions screening that can lead to missing true risks and increasing costs. For example:

- When screening global transactions, are they routed through different screening engines? Are those screening engines tuned the same and do they use the same lists?
- Are all classes of transactions screened? Do they need to be? Screening every piece of information available without appreciation of the risk may contribute to unnecessary alerts, which increase the burden on the compliance cost to address those alerts.
- Where and how are sanctions alerts investigated? Is there consistent understanding of what the different sanctions programs target and are there consistent standards for investigations?
- Are sanctions alert investigators knowledgeable about the current sanctions programs so they can identify potential issues of concern and more effectively eliminate false positives?

By identifying these issues within the sanctions compliance program, institutions of all sizes can begin to tailor their controls to areas of particular risk, achieve more meaningful alerts, improve the dissemination of information and implement systemic control enhancements in an organized way.

**Living with sanctions**

The recent examples of easing US sanctions do not suggest that sanctions are a thing of the past. On the contrary, the Iran deal suggests that sanctions were of high value in the portfolio of US Government policy tools and will continue to offer appealing options to support future foreign policy objectives. However, the use of sanctions has clearly moved away from the blunt application of country embargoes to more targeted and complex restrictions within an equally complex international financial system. To adapt to this evolving application of sanctions in a way that can manage the costs of compliance in the long-term, financial institutions must invest in “smart compliance.” This is not a matter of “checking the box” of the standard operational elements of a sanctions compliance program, but rather developing and maintaining a thorough understanding of what the sanctions do, where the risks are in the context of your business, and targeting controls to account for that risk. This must be an ongoing process, as well as a constantly innovative and perpetually manageable one.

There are several things that financial institutions can do to manage their sanctions risk in the context of ongoing compliance program enhancements:

- First, developing a robust risk assessment that is specific to sanctions and addresses the unique and dynamic risk factors associated with sanctions is a foundation to many other program activities.
- Second, institutions might assess operational roles and processes to identify potential gaps, needs for targeted and tailored training, and opportunities for greater efficiency.
- Third, given the environment of changing risks, adaptive industry capabilities, and the rise of analytics, institutions could evaluate their own technology relative to their needs and operational processes to identify stale, inefficient, or potentially ineffective systems and processes.

Underscoring much of these programmatic areas is the benefit of continued dialogue with representatives of relevant government agencies as well as industry practitioners to share common challenges and work collaboratively to find new solutions. After all, protecting financial institutions from the risks associated with sanctioned parties is a shared interest, not a competitive one.
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