Draining the Financial Swamp

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The value of a robust financial front in the War on Terror has not been lost on the Bush administration and key members of the U.S. Congress. Through a variety of Executive Orders and legislative initiatives, the Treasury Department and U.S. law enforcement agencies are now empowered with greater authority than ever before to seize terrorist-related funds and blacklist individuals and organizations with terrorist connections.

Over the past five years, using new regulatory mechanisms, the U.S. has sought to discipline an international financial system all too easily exploited by terrorist groups and their sympathizers. To this end, the Bush administration has forged a tripartite financial strategy aimed at simultaneously crippling the financial resources of existing terrorist organizations by seizing assets and freezing bank accounts, exploiting the necessity of terrorist networks to raise and move money to learn the identities of key players and track their activities, and increasing the difficulty for terrorists to raise funds.

Only in recent months, however, has the U.S. government truly begun to target the most dangerous terrorist benefactors: state sponsors. Through their reliance on foreign investment and inefficient state-run economies, these states are perhaps the most vulnerable of all terrorist supporters to carefully crafted economic and financial penalties. In its final two years, it is incumbent on the White House to match the creativity and aggressiveness of its earlier moves on the finan-

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cial front of the War on Terror—taking advantage of new opportunities to stem support for terrorists from these rogue governments.

Shifting focus

Early Bush administration initiatives properly focused on the immediate task at hand: freezing the accounts of known terrorists; establishing money trails to identify previously unknown terrorists; and, stopping the movement of terrorist money through formal and informal financial networks. The USA Patriot Act of 2001, renewed in 2006, extended unprecedented anti-money laundering powers to catch suspect transactions as they make their way through the financial system. Time and effort has also been spent encouraging other countries to enact similarly aggressive regulations. Increased resources were also applied for the purposes of identifying and naming terrorists and their organizations, front companies and supporters in order to provide such lists internationally to decrease the number of funding safe havens and unregulated financial channels.

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The Administration also has made several bureaucratic innovations, including the establishment of an Office of Terrorism and Financial Intelligence at the Treasury Department (consisting, for the first time in U.S. history, of an intelligence analysis unit at Treasury) and the creation of special provisions in the USA Patriot Act that empower Treasury to seize the assets held in U.S. correspondent accounts by foreign banks in response to overseas violations of U.S. money laundering laws. These initiatives have yielded some successes, despite the challenges posed by the wide variety of funding sources available to terrorist organizations—a list that includes individual donors, global Islamic charities, criminal enterprises, and others.

Over the past year, however, the Administration has turned its attention to a new target: state sponsors. This constitutes a signal development; the steps taken above are all important initiatives, but the threat of terrorism is two-pronged. The urgency the U.S. and its allies accord to fighting international terrorism stems in part from the possibility that terrorist groups will one day acquire chemical, biological or even nuclear weapons, and merge their murderous intentions with weapons of mass destruction (WMD). But, in order to be considered complete, the financial front of the War on Terror also must include the governments that facilitate these activities. And so far, little progress has been made in isolating these bad faith actors, or impacting their ability to contribute to terrorist organizations.

All of that is beginning to change. New Administration initiatives progressively have begun to put the financial squeeze on two of the world's leading state sponsors of terrorism: Iran and North Korea.

Blacklisting

In September 2006 and again in January 2007, the Treasury Department announced that two of Iran's leading banks, Bank Saderat and Bank Sepah, were being cut off

completely from the U.S. financial system.[1] That Iranian banks have to this point been allowed at all to benefit from the U.S. financial system is somewhat surprising. Nevertheless, existing sanctions had permitted U.S. banks—including U.S. branches of foreign-owned banks—to process certain fund transfers involving Iranian businesses. Up until then, sanctions guidelines had allowed certain exempted business transactions to be processed in the U.S. and, even more importantly, made possible so-called "U-turn" transactions—transfers where a U.S. bank processes dollar payments for Iran-related business, but where none of the parties directly receiving or delivering funds to the U.S. are Iranian entities.

The rationale for Treasury's tightening of the belt was the revelation that Bank Saderat had been involved in the transfer of hundreds of millions of dollars to Hezbollah and other terrorist organizations, and that Bank Sepah had facilitated Iran's missile procurement network. The measure, in turn, immediately reverberated throughout the business world, impacting the practices of many companies involved in Iranian trade via these banks.

These financial sanctions do not represent isolated incidents. A year earlier, the Treasury Department had demonstrated the utility of Section 311 of the USA Patriot Act when it formally designated Banco Delta Asia (BDA) as a "primary money laundering concern" for serving as a "willing pawn for the North Korean government to engage in corrupt financial activities."[2] The ensuing bank run on BDA, and the threat of formally shutting off the bank's correspondent accounts in the U.S., crippled BDA and had a ripple effect of scaring off other banks with ties to Pyongyang.

Divestment

Even more impressive have been the moves made by Treasury's Office of Terrorism and Financial Intelligence to explain to a number of foreign banks with extensive ties to Iran the full magnitude of the reputational risk that they assume by continuing their business relationships there. For years, this market risk has gone unnoticed and unmitigated by some of the world's leading companies. Yet today, a variety of European and Asian financial institutions and companies are being highlighted in the U.S. press for their ties to Iran. Further, there is a rising chorus of U.S. investors that are forswearing any investment of stock in these companies as a show of displeasure with their business operations in terrorist-sponsoring states. Companies are being divested by institutional and individual investors that are increasingly educated about the scope and implications of corporate ties to state-sponsors of terrorism.

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This trend has only been accelerated by Iranian President Mahmoud Ahmadinejad's outrageous statements regarding Israel and the Holocaust, which have prompted Americans to try and better understand the nuances of America's relationship with Iran, and to identify the Iranian regime's sources of support. The connecting lines—being drawn, in part, by the press at local levels and by national cable news—are leading back to non-U.S. companies doing

business in Iran. The result is a very real market risk associated with business ties to such countries, one that is reflected in the reputation of these companies in the U.S. and in their share value internationally. Some U.S. companies are going even further, adding "terror-free" mutual funds—free of companies with ties to any terrorist-sponsoring states—to the 401k plans that they offer to employees.

These grassroots actions are being taken for both ethical and financial reasons. Corporate ties to terrorist-sponsoring states expose the reputations and share values of those companies to risk. It has taken a number of years, but these facts are finally being delivered to foreign capitals and foreign corporations by senior U.S. officials. The result has been striking; a number of prominent banks, including UBS, Credit Suisse, ABN Amro and Commerzbank, have committed either to closing their business ties to Iran completely or at least to curbing their willingness to engage in dollar transactions there. These moves have had a material impact on Iran's international trade.

Tightening the noose

The above initiatives, for the first time, have begun to leverage market-based risk factors to encourage corporations to be responsive to security concerns. But, although the Treasury Department is showing encouraging signs of broadening its financial strategy, U.S. efforts are not as yet comprehensive. Nor are they adequately aggressive. Greater action is needed to increase the transaction costs associated with those corporations, and their respective governments, that choose to carry out problematic business with rogue regimes.

In its final two years in office, the Bush administration has the ability to take the financial offensive in the War on Terror. It can do so in three specific ways. The first is to expand the Treasury Department's dialogue with banks and companies concerning reputational risk with respect to all terrorist-sponsoring states (not just Iran and North Korea). Second, it can expand the use of Section 311 of the USA Patriot Act and the application of "U-turn sanctions" to all financial institutions involved in money laundering or other means of handling terrorist accounts. Finally, it has the ability to adopt more project-by-project diplomacy with foreign governments to ensure that a deal abandoned by one country's company is not picked up and executed by that of another.

Self-policing

For corporations, especially those with exposure to the U.S., it increasingly is good business to self-police their activities to ensure that they are not exposed to undue "global security risk." At a minimum, those that choose to continue to do so might put in place a new layer of safeguards and corporate governance policies.

For example, companies should be aware that it is in their best interests to ensure—for reputational and share value, as well as legal, reasons—that their business does not involve the provision of dual-use equipment or technology to, or partnering with, front companies associated with the Iranian nuclear or other weapons programs. Such prudence may seem obvious to an outside observer, but many companies act without this kind of security-related due diligence. More often than not, corporate actions are driven exclusively by what is deemed legal by their respective governments.

The Bush administration has started to tap into market forces and educate non-U.S. companies of these risks. These efforts should be increased substantially to include companies outside of the financial sector (i.e., the energy, telecommunications and even metals and mining sectors that form the economic backbone of foreign countries). If the reaction of a number of major financial institutions so far is any indication, European and Asian companies are clearly ready to hear this message.

Expanding application of the Patriot Act

The success of U.S. financial action against Banco Delta Asia took many, even at senior levels of the U.S. government, by surprise. It also likely was quite a shock to officials in Pyongyang to discover that their regime was so vulnerable to this new form of financial pressure. The power of Section 311 lies in its threat to cut off correspondent banking accounts with the U.S.—accounts that are fundamental to the ability of banks to carry out business on behalf of their clients with the United States. Without this capability, the attractiveness of a bank diminishes substantially.

The initial announcement of the sanction against Banco Delta Asia only included the possibility that correspondent banking accounts would be shut down. That alone not only caused the bank to freeze its North Korean accounts, but also resulted in a run on the bank and brought about the resignation of the bank's board. A number of other banks then terminated their relationships with Pyongyang and prompted Macao to make progress in the implementation of money laundering regulations. Clearly, this is a powerful tool, even when used sparingly.

Expand sanctions on U-turn transactions

Bank Saderat was sanctioned because it "facilitates Iran's transfer of hundreds of millions of dollars to Hezbollah and other terrorist organizations each year," and Bank Sepah because it "is the financial linchpin of Iran's missile procurement network and has actively assisted Iran's pursuit of missiles capable of carrying weapons of mass destruction."[3] But this is just the beginning; the predominately state-controlled economies in Iran, Syria, Sudan and North Korea are likely home to dozens more banks handling accounts and making transfers involving terrorist organizations or front companies. Iran's Islamic Revolutionary Guard Corps (IRGC), for example, controls significant segments of the Iranian economy and runs front companies that are directly involved in both military and civilian activities. It is unlikely that Bank Saderat and Bank Sepah are the lone Iranian banks with ties to such entities, nor is it likely that the Administration will stop there. Additional steps may be only a matter of time.

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Iran has at least four other prominent, state-run banks and Syria's mostly state-run financial sector so far has escaped such pressure completely. Moreover, which European and Asian banks are inadvertently processing transactions for IRGC front companies or, for that matter,

even semi-legitimate IRGC-controlled businesses? No doubt this question has been a key factor in the decisions of a number of financial institutions to reexamine their ties to Iran. Others still doing business there risk unwittingly, if not knowingly, engaging in business with these entities and placing themselves in the crosshairs of now existing U.S. anti-money laundering tools. Such banks should be targeted more often to demonstrate the seriousness with which the U.S. views these relationships.

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Project-by-project diplomacy

For years, the U.S. has followed a principled policy of sanctioning certain countries, including Iran, to deny them the economic rewards associated with U.S. trade, finance investment and technology. Often, however, as is the case with Iran, the U.S. has been alone in such decisions. With U.S. companies—except for those that have circumvented sanctions by using foreign subsidiaries—essentially blocked from these markets, foreign competitors have divvied up the spoils amongst themselves with the luxury of not having to compete with some of the strongest players in a variety of industries, notably energy.

With developments in Iran reaching crisis proportions, we are finally seeing some U.S. allies consider the idea that certain of Iran's most lucrative or specialized projects should be withheld due to the regime's intransigence. Yet a key factor impeding such moves toward the economic isolation of Iran is fear that restraint will simply lead to another foreign entity's taking over their contracts.

The case study for such concerns is Iran's mammoth Azadegan oil field. Initially, the contract for the field's development was awarded to Japan's INPEX Corporation, which was to hold a 75 percent ownership stake in the project.[4] With estimated reserves at some 26 billion barrels, Azadegan stood to serve as an important source of oil imports for Japan, a nation heavily dependent on such imports and highly sensitive to the need to ensure long-term supply. For Tokyo, Azadegan was a rare find.[5]

As important as the project was to Japan, it was at least as important to Iran. In fact, Azadegan was the largest oil field discovered in Iran in 30 years. The field, however, is reportedly geologically complex and requires advanced technology and expertise to mine successfully. The $2 billion project has the potential to generate some 250,000 barrels per day of crude oil by 2014 to 2015[6]—at today's prices, that equates to some $5.5 billion per year in state revenues.

Azadegan's importance to Iran was, of course, not lost on the Bush administration, which exerted significant pressure on the Japanese government to forgo the deal, citing Tehran's continued breach of its obligations under the 1968 Nuclear Non-Proliferation Treaty. In an effort to retain Azadegan as a strategic asset, Japan and INPEX stalled for months in order not to commence development work against the wishes of the U.S. government. Their hope was that

the nuclear standoff would resolve itself prior to Tehran's losing patience with that company and canceling the contract. Alternatively, Iran hoped for international cover for its inaction via some form of multilateral—ideally, UN-administered—sanctions.

The worst-case scenario for Tokyo was that it lose the Azadegan contract for it merely to be picked up by another willing player. This, however, appears to be exactly what is taking place. In a welcome display of principled trade policy and a courageous show of sensitivity to U.S. security concerns, Japan refused Iranian ultimatums to begin development of Azadegan. Its reward? The slashing of its stake in the project from 75 percent to 10 percent and ongoing negotiations now taking place between the Iranian regime and unnamed foreign investors.

Azadegan is the example that proves the rule. The U.S. cannot continue to convince foreign partners to show the type of restraint displayed by energy-hungry Japan if there is no action taken to stem other foreign players from simply stepping in to take their place. If we expect the likes of Japan and other partners to stand with us on such matters, there must be some persuasive penalties for those that step in where other responsible parties have pulled out. Fortunately, there are a variety of means to do just that. An international working group within the framework of existing UN Security Council discussions could be convened to single out projects or oil fields as "off limits" until Iran complies with its UN obligations. Should this fail, the U.S. would be empowered to consider extraterritorial sanctions and other measures that target specific projects, rather than entire countries or industries.

Raising the costs

The final two years of the Bush administration will no doubt see the Treasury Department and intelligence agencies continue to work together to track down and freeze terrorist assets—and to urge international partners to do the same. Beyond that time frame, however, we will also likely see the security challenges represented by Iran, Syria, North Korea and Sudan become even more grave. It is high time to leverage the vulnerabilities of the economic and financial situations and inherent market risk exposures of these countries into a more sophisticated strategy—one designed to increase greatly the transactional and economic costs that are associated with their malevolent behavior.

1. News release, "Treasury Cuts Iran's Bank Saderat Off from U.S. Financial System," U.S. Department of the Treasury, Office of Terrorism and Financial Intelligence, September 8, 2006; News release, "Iran's Bank Sepah Designated by Treasury, Sepah Facilitating Iran's Weapons Program," U.S. Department of the Treasury, Office of Terrorism and Financial Intelligence, January 9, 2007.
2. News release, "Treasury Designates Banco Delta Asia as Primary Money Laundering Concern under USA PATRIOT Act," U.S. Department of the Treasury, Office of Terrorism and Financial Intelligence, September 15, 2005.
3. "Treasury Cuts Iran's Bank Saderat Off From U.S. Financial System," and "Iran's Bank Sepah Designated by Treasury, Sepah Facilitating Iran's Weapons Program."
4. "Japan Consortium Seeks European Partners," *Financial Times*, February 20, 2004.
5. U.S. Department of Energy, Energy Information Administration, "Country Analysis Brief: Iran," August 2006, http://www.eia.doe.gov/emeu/cabs/Iran/Background.html.
6. Ibid.