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Protecting Europe-Iran Trade to Prevent War:

A Provisional Assessment of INSTEX

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About the Authors

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Protecting Europe-Iran Trade to Prevent War: A Provisional Assessment of INSTEX

Executive Summary

The uncertainty over the future of the JCPOA threatens progress made by France, Germany, and United Kingdom to establish INSTEX, a state-owned entity that will help facilitate Europe-Iran trade in the face of US secondary sanctions.

INSTEX is a limited solution for a specific problem. The mechanism is intended to alleviate restrictions on sanctions-exempt trade, stemming from the reluctance of European banks to conduct cross-border transactions with Iran.

INSTEX cannot directly counteract the Trump administration's "maximum pressure" campaign nor can it fully deliver on the JCPOA's economic promises. Given its focus on humanitarian trade, INSTEX can help Iranian people by reducing the inflationary impact of increases in the price of imported goods.

The strength of INSTEX is in its declared humanitarian focus, which shields it from US pressure and also maximizes the likelihood that European companies will engage the currently untested mechanism. The officials working to operationalize INSTEX are doing so in accordance with four workstreams:

- Workstream 1: Operations and Trade Mechanism
- Workstream 2: Compliance Framework
- Workstream 3: Integration with Iranian Corresponding Entity
- Workstream 4: Expansion to "Like-Minded Countries"

Progress is being made in each workstream. However, significant challenges remain that will likely mean that in 2019 the scale of INSTEX commercial operations will be limited. The critical question facing policymakers in Europe and Iran is whether the first transactions can take place in the next few weeks in order to be part of Europe's considered response to Iran's escalation on the JCPOA.

Introduction

Over the past year, the European Leadership Network (ELN) and Bourse & Bazaar have convened policymakers and business leaders to examine the sanctions-related impediments to Europe-Iran trade and investment. These meetings culminated in two public reports. The first diagnosed the breakdown of Europe-Iran banking channels in the face of US sanctions pressures.[1] The second proposed the creation of a state-owned special purpose vehicle (SPV) in order to help facilitate humanitarian trade between Europe and Iran.[2]

Having first committed to establishing an SPV in September 2018, the E3 governments of France, Germany, and the United Kingdom worked closely with the European Union to formally establish such a mechanism—the Instrument in Support of Trade Exchanges (INSTEX)—in January 2019.

1 https://www.europeanleadershipnetwork.org/report/europe-iran-and-economic-sovereignty-a-new-banking-architecture-in-response-to-us-sanctions/

2 https://www.europeanleadershipnetwork.org/policy-brief/mitigating-us-sanctions-on-iran-the-case-for-a-humanitarian-special-purpose-vehicle/

The political effort necessary to take these steps should not be underestimated. European leaders should be commended for harnessing their institutional capacities to pursue an unprecedented project in the name of economic sovereignty.

> ***INSTEX—working in tandem with its Iranian corresponding entity, the Special Trade and Finance Instrument (STFI)—aims to defend Iranian people from medicine and food shortages, challenging the Trump administration's "maximum pressure" campaign and stated intention to stand with the Iranian people.***

This report offers a partial assessment of progress in the operationalization of INSTEX and proposes areas for further work.

Recent Developments

In May, Iran announced that it was taking measured steps that could see it end its compliance with the Joint Comprehensive Plan of Action (JCPOA). Such a change in the Iranian strategy could be viewed as a response to what it perceives as failure among Europe, Russia, and China—the remaining parties to the JCPOA—to meet their commitments under the deal in the aftermath of President Donald Trump's withdrawal in May 2018. Iran has indicated a 60-day deadline for substantive action to be taken to preserve the JCPOA, after which it will further reduce compliance with its non-proliferation commitments, potentially by breaching enrichment caps. This 60-day deadline is largely directed at Europe, which Iran considers to have fallen short in counteracting the US sanctions that have not just hurt Iran's economy and people, but also forced many European companies to forgo lucrative bilateral trade.

The continued uncertainty over the future of the JCPOA threatens the progress made by France, Germany, and United Kingdom to establish INSTEX, a state-owned entity that intends to ease Europe-Iran trade in the face of US secondary sanctions. To be clear, INSTEX is a limited solution for a specific problem. The mechanism aims to alleviate restrictions on sanctions-exempt trade which stems from the reluctance of European banks to conduct cross-border transactions with Iran. INSTEX cannot directly counteract the Trump administration's "maximum pressure" campaign nor can it fully deliver on the JCPOA's eco-

German Foreign Minister Heiko Maas and Iranian President Hassan Rouhani in Tehran in June 2019

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nomic promises. However, given its focus on humanitarian trade, INSTEX can play an important role in securing Iran and the Iranian people a basic resilience in the face of what Iran sees as a US-led "economic war," particularly by reducing the inflationary impact of increases in the price of imported goods. The International Monetary Fund estimates that Iran's year-on-year inflation could reach 50 percent, undercutting the purchasing power of ordinary Iranians and reflecting sharp price increases in essential goods such as basic foods and medicine.[3]

INSTEX remains the most concrete step Europe has taken to increase Iranian confidence in the basic quid-pro-quo which underpins the JCPOA.

In turn, it is a natural place for Europe to redouble efforts as part of its response to Iran's reduced compliance with the JCPOA at this critical juncture. Encouragingly, the EU/E3 statement in response to the US revocation of key oil and nuclear waivers declared that Europe remains "committed to significantly increasing their financial contributions to INSTEX's operational budget" as part of efforts to "enable the continuation of legitimate trade with Iran."[4]

However, Europe must be wary about setting expectations too high as it seeks to operationalize INSTEX. Following a recent meeting of the European Union Foreign Affairs Council, EU High Representative Federica Mogherini announced in mid-May her intention that INSTEX would undertake its first transaction within the following few weeks. The same day, the governor of the Central Bank of Iran, Abdolnaser Hemmati, criticized European leaders for their "procrastination" over the implementation of INSTEX, pointing specifically to the tendency to make statements with little evidence of technical implementation.[5]

Iranian officials should refrain from unreasonable demands regarding INSTEX's operationalization. One such demand is that INSTEX facilitate Iran's continued oil exports. This is unfeasible due to the reticence of traders and refiners to handle Iranian petroleum products in the absence of a US waiver. The strength of INSTEX is in its humanitarian focus, which shields it from US pressure and maximizes the likelihood that European companies will engage with the currently untested mechanism. Recent comments from US officials suggest a limited ability to directly target INSTEX in its humanitarian guise.[6]

Against this complex political backdrop, the team working to operationalize INSTEX is doing so in accordance with four workstreams, which can be entitled as follows:

- 1: Operations and Trade Mechanism
- 2: Compliance Framework
- 3: Integration with Iranian Corresponding Entity
- 4: Expansion to "Like-Minded Countries"

Progress is being made in each of these areas. However, significant challenges remain that will likely mean that in 2019 the scale of INSTEX commercial operations will be limited. The critical question facing policymakers in Europe and Iran is whether the first transactions can take place in the next few weeks in order to be part of Europe's considered response to Iran's escalation on the JCPOA.

3 https://www.bourseandbazaar.com/news-1/2019/4/29/imf-sees-risk-of-50-iran-inflation-on-more-us-sanctions

4 https://eeas.europa.eu/headquarters/headquarters-homepage/61840/statement-jcpoa-high-representative-european-union-and-foreign-ministers-france-germany-and_en

5 http://www.irna.ir/en/News/83314563

6 https://www.nytimes.com/2019/05/08/world/europe/eu-iran-nuclear-sanctions.html

Workstream 1: Operations and Trade Mechanism

INSTEX has made progress in hiring staff, a priority as the company develops its international protocols and expands its outreach to the European business and banking communities. To support these hires and other overheads, additional startup capital has been secured from the founding E3 shareholders.

The netting mechanism at the heart of INSTEX has been sense-checked with companies in both Europe and Iran. The mechanism, which seeks to avoid the need for cross-border transactions, is familiar to companies that have maintained commercial operations in Iran during the sanctions period. Absent reliable banking channels, many companies devised their own netting arrangements to move money in and out of Iran. As such, the netting mechanism is considered a feasible basis for INSTEX's operations. Several companies have expressed serious interest in utilizing INSTEX and supporting its operationalization by offering their input in the test phases.

Despite reports that INSTEX would be mostly attractive to small and medium-sized enterprises that have little exposure to US markets, the best candidates for early adoption of INSTEX are major European multinationals which maintain significant operations in Iran and as a result possess the internal treasury management and compliance knowhow that is necessary to engage the mechanism in its early stages of development. The ideal scenario would be for several companies to engage INSTEX together, helping to provide safety in numbers and ensure the developed mechanisms are widely compatible with business operations.

Setting aside the question of whether European companies will be inclined to use the mechanism, doubts about the successful operationalisation of INSTEX focus on Iran's trade deficit with Europe in the absence of oil exports. Many have observed that the netting mechanism at the heart of INSTEX will be constrained by the limited volume of Iranian exports to Europe. This limits the credits available for netting against liabilities among Iran's European trading partners. INSTEX management are aware of this and continue to explore funding arrangements that would enable INSTEX to offset the deficit with trade finance.

Prior to the reimposition of sanctions, numerous European export credit agencies sought to support European trade with Iran. However, a failure to secure banking services hindered these efforts. Should INSTEX prove successful in eliminating the need for cross-border transactions between Europe and Iran, it is possible to imagine that new trade finance schemes could be devised. In the meantime, INSTEX can increase trade volumes in a stepwise fashion. Iranian commercial actors are confident that a sufficient volume of European exports to Iran can be directed through the INSTEX/STFI channel such that INSTEX can achieve a meaningful scale in its netting activities. A brief examination of Europe-Iran bilateral trade provides a basis for this confidence.

Bilateral trade between Europe and Iran has been significantly impacted by the reimposition of US secondary sanctions.

As of February 2019, monthly total European Union exports to Iran are down to EUR 341 million while imports are down to EUR 87 million, a fall of 55 percent and 93 percent year-on-year respectively.[7] The sharp deterioration in this trade helps demonstrate why INSTEX can be useful in resuscitating bilateral trade from its new low base.
In 2018, Iranian annual total exports to Germany, France and the United Kingdom amounted to EUR 288 million, EUR 51 million, and EUR 34 million respectively. The vast majority of this trade constitutes goods which are candidates for trade through the INSTEX mechanism. Examples include vegetables and fruits, pharmaceutical products, and textiles. On this basis, there appears to be no reason to believe that INSTEX could not scale its volume of trade to levels that would make a meaningful percentage point difference in the overall volume of trade between Europe and Iran. Aside from any impact on the overall

7 https://www.wsj.com/articles/europe-rejects-irans-ultimatum-on-nuclear-deal-11557394228

volume on trade, there are secondary benefits to funneling bilateral trade through INSTEX in the area of Iran's foreign exchange needs. For example, if Iranian importers are able to pay for EUR 10 million of pharmaceutical exports from Europe through the netting mechanism on offer from INSTEX, this will free EUR 10 million in foreign exchange which the Central Bank of Iran can allocate elsewhere, helping to reduce the devaluation pressures stemming from Iran's now constrained supply of foreign exchange revenue.

Workstream 2: Compliance Framework

In recent comments, Sigal Mandelker, the US Treasury Under Secretary for Terrorism and Financial Intelligence, suggested that INSTEX is unlikely to meet anti-money laundering norms, pointing to the role of the Islamic Revolutionary Guard Corp (IRGC) in Iran's economy.[8] These comments reflect an effort on the part of American policymakers to sow doubt about INSTEX and its successful operationalisation. But the tight focus of INSTEX on sanctions exempt trade, and especially trade in food and pharmaceuticals, means that the mechanism will be utilized by companies with a demonstrated capacity to conduct the necessary due diligence in order to remain in compliance not just with EU sanctions, but crucially with US sanctions as well.

As European banks grew more reticent to facilitate Iran-related transactions, European capitals discussed whether it would be possible to issue a kind of "whitelist" of pre-screened companies in which European governments had a high degree of confidence about the ultimate compliance of their trade with Iran. However, several issues prevented such a list from being devised. European policymakers did not wish to accommodate US secondary sanctions by judging the compliance of companies in accordance with those sanctions as banks would have wanted. The European Union and member states also lack the institutional capacity to evaluate and continually monitor compliance in the manner that the US Treasury Office of Foreign Assets Control (OFAC) does with its licensing program.

However, as European policymakers work with business leaders to shape INSTEX's compliance program, the mechanism presents a valuable opportunity to approximate such a whitelist. INSTEX will conduct aggressive due diligence to ensure that it's trade mechanisms are used to support only what the European Union considers legitimate trade. As such, companies which use INSTEX will be able to point to their participation in the scheme backed by European governments as an indicator of their robust approach to Iran sanctions compliance. In this way, INSTEX can help Europe counteract the efforts of US officials to spread fear among European market actors about the risks of doing business with Iran. In short, while INSTEX will not itself act as a licensing or enforcement institution in the manner of OFAC, companies conducting trade via the INSTEX mechanism will be able to point to their participation in the scheme as a sign of their high standards of compliance.

Challenges

However, INSTEX still faces three key challenges in establishing its compliance framework. First, INSTEX must establish a single compliance standard will be applied across all of the companies using the mechanism. Such a standard will delineate the know-your-customer and know-your-transaction related documentation required to substantiate that a proposed transaction is consistent with the purposes of the INSTEX mechanism.

Second, the compliance framework established by INSTEX must be matched by a similarly rigorous framework in the Iranian counterpart, STFI. This is especially pertinent since the US administration is considering targeting STFI.[9] Given that the greatest compliance risks facing INSTEX will be the possible utilization of the INSTEX/STFI mechanism by designated companies, it is vital that the managers of the Iranian corresponding entity apply a strict compliance framework.

8 https://uk.reuters.com/article/uk-usa-iran-sanctions-interview/eu-iran-trade-vehicle-unlikely-to-meet-anti-money-laundering-norms-u-s-idUKKCN1SD23Y

9 https://www.bloomberg.com/news/articles/2019-06-10/u-s-weighs-more-iran-sanctions-over-potential-trade-with-europe

As elaborated below, the shareholding structure of STFI, centered on Iran's private sector banks, should help in this regard. For the sake of preserving their own non-designated status and to preserve precarious correspondent banking links, Iran's private sector banks have developed protocols to prevent facilitating the activities of companies on the US Treasury's Specially Designated Nationals (SDN) list.

Finally, even if both INSTEX and STFI are able to establish mutually satisfactory compliance frameworks that also meet the standards of candidate companies, it remains possible that most European banks will refuse to accept funds coordinated through INSTEX, even though by the very nature of the mechanism those funds did not originate in Iran. On this basis, the continuing concerns over Iran's progress in meeting the requirements of the Financial Action Task Force (FATF) action plan will have a bearing on whether INSTEX can secure and maintain basic banking services required for its operation and the number of financial institutions providing such services.

Nonetheless, European officials have made clear that operationalization of INSTEX is not directly dependent on Iran's completion of the FATF action plan.

European executives note that in its early days INSTEX will necessarily focus on supporting longstanding business relationships where the counterparties are well-known to one another and where a long transaction history provides confidence as to the end-users of the goods in question and the ultimate beneficiaries of the transactions. For example, European pharmaceutical companies will be selling products to their exclusive agents or even wholly-owned subsidiaries in Iran. The compliance officers of INSTEX and STFI can have a high degree of confidence in such transactions.

Workstream 3: Integration with the Iranian Corresponding Entity

As they work to operationalize INSTEX, European officials have expressed satisfaction with Iran's progress in operationalizing its corresponding entity, STFI (known in Iran by its Persian acronym SATMA). Formally incorporated in April of 2019, STFI is backed by several of Iran's leading financial institutions, including Bank Pasargad, Refah Kargaran Bank, Bank Keshavarzi, and Fardis Gostar Kish Informatics Services Company, a financial technology company partly owned by the Central Bank of Iran.[10]

That STFI was structured with the ownership of private sector banks and not as an outright state enterprise reflects a commendable effort on the part of the Iranian authorities to both limit compliance risks by limiting the direct role of the Iranian government while also leveraging the well-tested compliance standards of Iran's private sector banks. In addition, these banks play a central role in Iran's humanitarian trade and maintain working relationships with the key European and Iranian companies which might wish to avail themselves of the INSTEX/STFI mechanism.

However, the presence of these banks also introduces certain vulnerabilities. In October 2018, Parsian Bank, among Iran's largest private sector banks and an institution which has played a central role in humanitarian trade between Europe and Iran, was sanctioned by the US Treasury, with what many in the Iranian banking community considered limited cause.[11] STFI's shareholders could be targeted in a similar manner. As such, INSTEX and STFI ought to develop a clear protocol for the US sanctions designation of shareholder which may involve the transfer of shares to other shareholders or the placement of the affected shares in a trust.

The ability of the INSTEX/STFI mechanism to increase Iran's access to crucial imports is of critical important to addressing economic hardship. Iran's current economic downturn is

10 http://en.otaghiranonline.ir/news/21948

11 https://www.bourseandbazaar.com/articles/2018/10/21/parsian-bank-ceo-us-treasury-made-mistake-in-iran-sanctions-designation

principally related to supply-side disruptions. Should Iran prove able to increase the volume of critical imports and reduce the need for foreign exchange to make these imports, there will likely be a positive impact on inflation, especially in key categories like healthcare where European imports constitute a significant portion of typical expenditures.

In this sense, it may behove Iran to adopt a more centralized approach to its side of the INSTEX/STFI mechanism. One potential model would see the STFI mechanism paired with a state-owned international trade intermediary. For example, the General Trading Corporation (GTC) of Iran, the state-owned entity responsible for the country's purchase of essential foodstuffs on international markets, could have its mandate expanded to extend to the facilitation of Iranian exports. In such a scheme, GTC would effectively purchase goods from Iranian manufacturers and then sell these goods on to European buyers. GTC could play a similar centralizing role on Iran's imports, though it would not be strictly necessary. Concentrating Iranian trade with Europe through a single trade intermediary, and connecting that trade intermediary to the STFI netting mechanism would also make it easier for Iran to provide trade finance to offset Iran's trade deficit with Europe. It may also prove beneficial in helping companies, especially Iranian small and medium-sized enterprises (SMEs), meet the compliance requirements of the INSTEX/STFI mechanism. In this way, GTC or a similar company could come to fulfill the broad trade mandate exemplified by Japanese general trading companies, known as "sogo shosha."

Workstream 4: Expansion to "Like-Minded Countries"

INSTEX's founding shareholders have expressed their desire to see the mechanisms ownership and operations expanded to other countries that are supportive of Iran's continued compliance with the JCPOA and wish to maintain economic relations with Iran in the face of US unilateral sanctions. JCPOA parties Russia and China have expressed interest in joining the mechanism, as have Turkey and India, which count among Iran's major trading partners.[12]

INSTEX's present shareholders should extend ownership and operation of the mechanism to other EU member states. Officials report that there is interest for participation in INSTEX among a number of European countries with strong bilateral trading relationships with Iran. By adding these countries as shareholders, INSTEX will be able to access a wider pool of working capital, access technical expertise in a wider range of ministries, and also increase efforts to draw European importers and exporters into the mechanism.

However, at this early stage, it would be a mistake to expand INSTEX's scope to non-European shareholders. The integrity of the INSTEX mechanism depends in large part on the uniform application of its compliance framework across all companies using the mechanism. The introduction of non-European companies into the mechanism would likely deter the participation of many European firms wary about the weaker compliance standards typically found in non-European markets. A case-by-case assessment can be made for companies from third-party countries that are able to engage with INSTEX through their European subsidiaries.

Politically speaking, Europe should leverage its demonstrable progress in establishing INSTEX in order to demand commensurate efforts are taken by Russia and China as JCPOA parties. Russia and China ought to establish their own SPVs in order to support bilateral trade with Iran. India and Turkey can do the same. The mechanisms established in these countries may have meaningful structural and operational differences with INSTEX and may be able to leverage the greater degree of state-control over strategic enterprises and financial institutions.

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12 https://www.ecfr.eu/article/commentary_trading_with_iran_special_purpose_vehicle_how_it_can_work

Conclusion

INSTEX has largely been defined by its own contradictions. On one hand, it is an undertaking of remarkable political ambition, reflecting Europe's nascent reckoning with the extraterritorial power of US sanctions. On the other hand, the vehicle's economic operations are intended to remain limited in scope, focused on addressing specific restrictions on humanitarian trade between Europe and Iran. Pushing past these contradictions, commercial actors who have had the opportunity to learn more about INSTEX's proposed operations generally agree that the mechanism is feasible. They are also encouraged by the seriousness and diligence of the officials involved in the establishment of the special purpose vehicle. INSTEX cannot save the JCPOA on its own, but the cooperative work of operationalizing the mechanism remains the best way for Europe and Iran to demonstrate their continued commitment to economic diplomacy under the nuclear deal.

Recommendations

- Europeans should explore funding arrangements that would enable INSTEX to offset the deficit with trade finance, either through European governments or the use of Iranian foreign reserves already within Europe.
- Both sides should grow trade volumes in a stepwise fashion to achieve a meaningful scale in netting activities, funnelling bilateral trade through INSTEX in the area of Iran's foreign exchange needs. This would help to reduce the devaluation pressures stemming from Iran's now constrained supply of foreign exchange revenue.
- INSTEX should establish a single compliance standard will be applied across all of the companies using the mechanism, and it must be matched by a similarly rigorous framework in the Iranian counterpart, STFI.
- Iran's progress in meeting the requirements of the Financial Action Task Force (FATF) action plan will have a bearing on whether INSTEX can secure and maintain basic banking services required for its operation and the number of financial institutions providing such services.
- INSTEX and STFI ought to develop a clear protocol if the US is to designate one of the Iranian shareholders which may involve the transfer of shares to other shareholders or the placement of the affected shares in a trust.
- Iran should adopt a more centralized approach to its side of the INSTEX/STFI mechanism. One potential model would see the STFI mechanism paired with a state-owned international trade intermediary, perhaps through the expansion of the mandate of the General Trading Corporation (GTC) of Iran.
- Europe's present shareholders (the E3) should extend ownership and operation of the mechanism to other EU member states. A case-by-case assessment should be made for companies from third-party countries that are able to engage with INSTEX through their European subsidiaries.

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