# Iran's Banking Sector: Dark Days Loom

*Iran's banking crisis poses a bigger threat to the country's economy than the re-imposition of sanctions post-US withdrawal from the nuclear deal – though, of course, the two are not unrelated. Can Tehran deliver substantial reforms amid infighting and vested interests?*

After years of endemic corruption, government interference and economic mismanagement, Iran has accumulated tens of billions of dollars of bad debts. These debts are exerting unsustainable pressure on the balance sheets of the country's banking sector, which is dominated by state and state-linked institutions. Tehran had been struggling with the mammoth task of trying to reform the sector even before the US pulled out of the nuclear deal last month (MEES, 11 May). Already an uphill task, the job has now gotten a whole lot tougher.

Many of the country's 35 licensed financial institutions are desperately trying to repair their books after offering deposit rates as high as 22% back in 2014 before the oil price crashed later that year. (A substantial premium over inflation which was around 15%.)

Oil revenue collapsed from $57.3bn in 2014 to $27.3bn in 2015. But the real damage was done after the tightening of sanctions from 2012, the last year in which oil revenues were above $100bn.

## ASTRONOMICAL SUMS

Freshly-released Central Bank of Iran (CBI) figures for the 2017-18 fiscal year (which ended on 20 March), published this week, pegs end-year bad loans at an astronomical 1,300 trillion rials ($30.9bn at the official rate – see box). As of January the non-performing loans equated to roughly 11% of total loans, down from 15% when incumbent President Hassan Rohani swept to power in 2013 on a promise of economic recovery.

At the start of the current Iranian year (21 March), the CBI instructed all banks listed on the Tehran Stock Exchange (TSE) to retain profits and increase their capital. However, this neatly overlooked the fact that most banks are not making any profits.

Speaking late last year, Parviz Aghili-Kermani, board member and managing director of Iranian privately-owned Middle East Bank, warned it could cost Tehran $200bn to overhaul the banking sector – getting on for half the size of the country's annual GDP ($428bn) – another astronomical figure well beyond the scope of reform efforts.

## CAN CRISIS BE AVERTED?

Despite a major banking crisis looking like a foregone conclusion, industry consensus maintains that Tehran will be able to avert such a crisis from fully engulfing its banks by enforcing a radical clean up and consolidation.

Following re-election last May, President Rohani vowed that his administration would aim to become the first to instill fundamental banking reforms since the 1979 Islamic Revolution (MEES, 26 May). Fine words, but ultimately they are unlikely to be realized.

## ROHANI DOUBLE BILL FLOPS

The first (2013-17) Rohani administration undertook an extensive review of previous reform measures and made amendments, devising the "twin bank reform bills" – one for banking reform and one for CBI reform. These were submitted to parliament on 15 August last year but progress was predictably faltering (MEES, 3 November 2017).

The previous Ahmadinejad government also tried and failed to implement reforms while battling nuclear-related sanctions.

Which begs the question: Is history set to repeat itself?

"I believe the Iranian government and the CBI will continue their reform process regardless of the impact of the re-imposed US sanctions," says Bijan Khajehpour, an Iranian economist and managing partner of Vienna-based Atieh International Consulting.

"There have been two main reasons behind the reform process. Firstly, to facilitate Iran rejoining the global financial system and secondly to push back against corrupt dealings in the financial sector that have empowered some of the shady power centers. However, the other side - hardliners, corrupt networks and so on - will also push back against the reform" delaying the process, he says.

> Banks that cannot attract capital will be merged. Iran's current 35 banks could be merged into less than 10."
>
> *- Bijan Khajehpour, Economist*

> Iran's banks have $31bn of bad loans. Sector overhaul will cost $200bn.

Iran's rejoining the global financial system looks like more of an uphill task than ever given that the bulk of the system is dollarized and a key element of US President Trump's renewed sanctions will be blocking access to the US financial system for any firms dealing with Iran (MEES, 18 May).

## FORCED MERGERS

To start with, it seems likely that the CBI will push for an asset revaluation and then a recapitalization of the banks. Those banks that cannot attract capital will be merged with the larger banks and some may have to be bailed out by the government – if Tehran can afford it.

Mr Khajehpour believes it is possible that Iran's current 35 banks could be merged into less than 10.

One area on which the authorities have already started a clean-up operation is the unlicensed credit and finance institutions that distorted the banking market to begin with (MEES, 10 February 2017).

On 14 March, the CBI announced that Mehr Eqtesad and Samen will be

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acquired by Ansar Bank while Hekmat Iranian, Kowsar and Ghavamin (two credit institutions and a bank) will be merged into a single bank.

"The CBI governor noted recently that 25% of the country's liquidity is in these financial institutions, most of which are unregulated and affiliated to powerful religious or revolutionary foundations," says Mr Khajehpour. "It is a political struggle and the CBI will only manage to push the entities towards more regulation at a slow pace."

## FOREX CONTROLS: THE RIAL DEAL?

Adding to current woes, the ongoing turmoil in the country's foreign exchange market has further exacerbated the banking sector crisis with many businesses and private sector players unable to access or receive foreign exchange at the government unified exchange rate of $1=IR42,000 (MEES, 13 April).

To boost its foreign reserves supply, the CBI on 12 May ordered that any purchases of foreign currency made by Iranian banks – from foreign tourists, diplomatic missions based in Iran and offices of foreign banks – must be at the unified exchange rate.

Exchange control regulations will now allow each traveler leaving by air to take out of the country in cash €5,000 or its equivalent in other currencies while those travelling by land, rail or sea can take out €2,000 (MEES, 18 May).

"I think the capital controls will remain in place and they will probably also go back to the sanctions-era policy of forbidding access to foreign currencies for some activities and prioritizing who can get what capital," Columbia University's Richard Nephew, formerly US lead sanctions expert during the Iran nuclear negotiations, tells MEES.

Now, following Trump's withdrawal from the nuclear deal, "it would be politically useful [for the Iranian authorities] to use the cover of US sanctions enforcement to argue that the banks have failed due to the foreigners" he adds.

## BANKING ON THE EU

Of course, also critical to the future health of Iran's banking sector is its ability to transact with the international business community – for which the US move is a game-changer.

Speaking after a meeting with EU signatories to the Iran deal in mid-May, EU foreign policy chief Federica Mogherini noted that while it cannot provide legal and economic guarantees to Iran, "We are talking about solutions to keep the deal alive," including measures to allow Iran to keep exporting oil and for European banks to keep doing business with Tehran. But such EU moves may prove futile.

Even after the lifting of international economic sanctions in January 2016, Iran's banks have remained largely cut off from their international counterparts due both to residual US measures and the related 'fear factor' (MEES, 10 June 2016).

Proposals to enable European banks to bypass US sanctions have so far been met with skepticism by EU states.

## SWIFT ACTION

Tehran nonetheless remains optimistic that the EU may be able to influence the global Swift network for payment transfers – instrumental for keeping Iran's banks connected – given it is domiciled in Brussels and majority-owned by European institutions.

But not everyone shares this optimism for its efficacy.

"It is an important point to be able to stop the US cutting Iran off from Swift, but in reality, Swift is the icing on the cake," Ross Denton, a partner specializing in sanctions at law firm Baker & McKenzie, tells MEES.

"The US can cut off most Western trade with Iran without cutting off Iranian access to Swift. It does seem likely that the Trump administration will put severe pressure on Swift to cut off Iran, again in principle requiring it to choose between the US and Iran markets."

On this point it is worth remembering however that Iranian banks had developed a system for transactions during the harshest sanctions years, when locked out of Swift.

Mr Khajehpour believes that more critical than Swift will be the involvement of key EU central banks in the process.

## IRAN NICHE FOR EU BANKING MINNOWS?

"I think the EU will manage to assign some of the mid-sized European banks as the main platform for financial transactions with Iran. The EU side will have to draft some plans and offer some guarantees that these links will continue," he says.

"The main guarantee that the EU can offer is that some of the larger European central banks, such as the Bundesbank, will facilitate Iran payments."

On 22 May, six German credit unions or 'Volkbanken' announced that they are still providing trade finance to Iran. They will likely continue doing so until 6 August when the legally-binding sanctions will come into effect.

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## IRAN'S PARLIAMENT SLAMS GOVERNMENT POLICY OVER RIAL CRISIS

Iran's sudden decision on 9 April to unify the country's two-tier exchange rate system and eliminate the parallel market in a desperate attempt to arrest the plunging Iranian rial has come under fire from the Majlis Research Center (MRC), the think tank at the Iranian parliament.

The MRC says that compelling exporters to sell their foreign exchange earnings to the banking system at the unified rate of $1=IR42,000 via the government's Forex Management Integrated System (Nima) would cause a fall in exports. Sellers would rather sell them on the higher-priced black market. It adds that the government's measures are insufficient and should have been bolstered with additional financial arrangements.

Following the April unification of the two-tier exchange rate system, the CBI has fine-tuned the exchange rate multiple times to reflect changing market variables. This has raised the dollar's value in very small increments to $1=IR42,155, which is still far off from where the real market exchange rate should be. The unofficial rate hit record lows of around of around $1=IR60,000 in April.

Iran's market volatility in recent months is ascribed by the MRC to a number of factors. These include restrictions on local banks making international money transfers, overreliance on the US dollar and forex smuggling. This was then exacerbated by growing capital flight as geopolitical risk grew in the run up to the US withdrawal from the nuclear accords last month. Finally, restrictions recently introduced by the UAE, Turkey and China made transfers more difficult, risky and expensive.

The US Treasury Department is due to reimpose a wide range of Iran-related sanctions after the expiry of wind-down periods of 90 and 180 days.

The MRC slams the government efforts to eliminate the parallel market by decree for ignoring the "basic principles of economics" to allow the market to determine the equilibrium price for the local currency. Here it is echoing similar criticism by economists like Mousa Ghaninejad that the closure of the parallel market will result in the emergence of unofficial markets, inefficiencies in the economic system and corruption (MEES, 27 April).

The MRC urges Iran to develop an alternative to the Swift international payment transfer system in conjunction with its main trading partners in China, Russia, Turkey and the EU, but such an objective looks entirely unrealistic. The group also calls for Iran to replace Dubai as its main forex center with a closer ally – such as Oman, Russia or China; again, this is unlikely to get off the ground.

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But Germany's major banks - Deutsche Bank, Commerzbank and DZ Bank - are avoiding any Iran-related transactions for fear of US reprisals.

Commerzbank had to cough up a $1.5bn fine in 2015 to resolve a US investigation into its dealings with Iran and other sanctioned countries while France's BNP Paribas was fined $10.6bn.

Deutsche Bank says it has always been "reticent" regarding financing Iran deals while DZ Bank says it is stopping all foreign payments relating to Iran.

On 29 May Switzerland's Banque de Commerce et de Placements announced that it had suspended new transactions with Iran and is winding down its activities.

"I think that big banks will stay out, as they have, and little banks will be willing to go in if they have minimal US exposure and their home government's support," Columbia University's Mr Nephew says.

"This is where the interesting thing comes in vis-a-vis the EU. If the EU is prepared to help create the liquidity necessary for those little banks to do transactions with Iran and they can be protected from the US, then I think this will relieve pressure on Iran and undermine US sanctions considerably. This is why it was a mistake to decide to 'go it alone' on sanctions."

However, Mr Denton thinks it is unlikely that the EU will be able to draw up the necessary measures to mitigate the consequences of US withdrawal and keep the JCPOA alive.

## EU MEASURES: TIME RUNNING OUT

Top Iranian officials have said that the EU needs to come up with the package of economic guarantees by early June to prevent the crisis from escalating further.

"I am very pessimistic. In order for the JCPOA to survive, the EU and others will have to come up with a series of measures that completely avoid any US influence," he says.

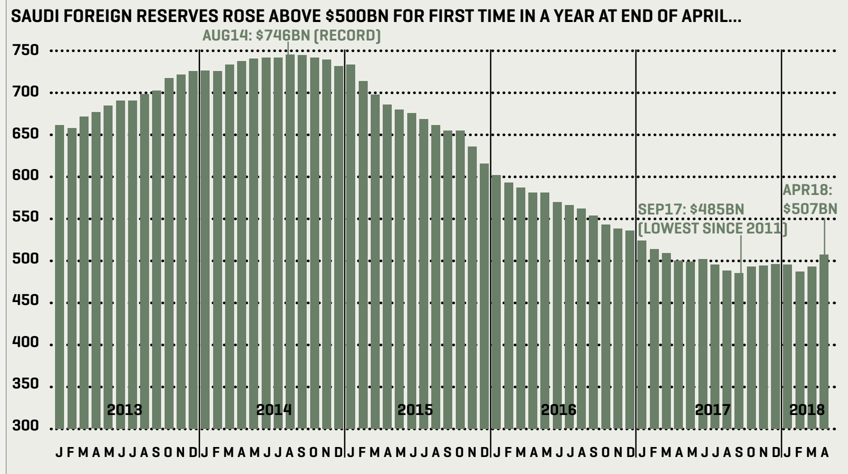
"It is not enough to squeeze out US dollar and US entities, including US banks. Most, if not all, major Western banks rely heavily on the US market, and will not be interested in trading access to the US for access to Iran. While to a lesser extent EU entities like the EIB [European Investment Bank] can provide appropriate amounts of finance without a US nexus, EU suppliers of goods will be reluctant to supply the Iranian market for the same reason, even if they could get paid through the EIB."

And so for now, the fate of Iran's banking sector and indeed broader economy hangs in the balance.

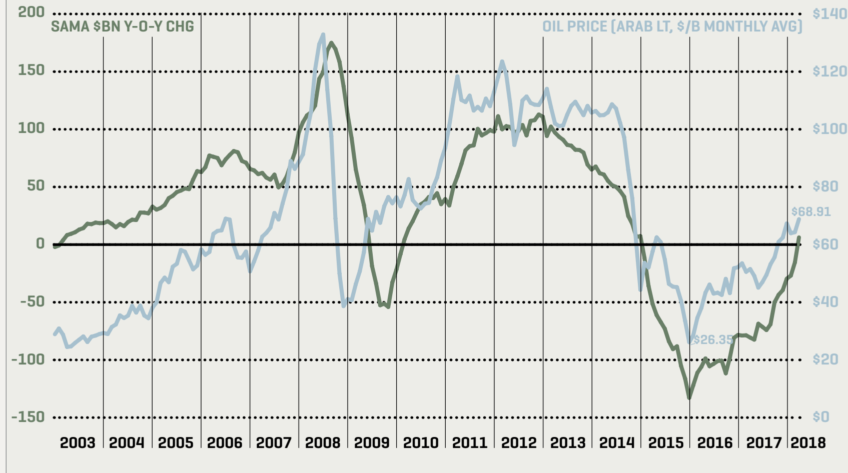
### SAMA NET FOREIGN ASSETS ($BN)

SOURCE: SAMA, MEES.

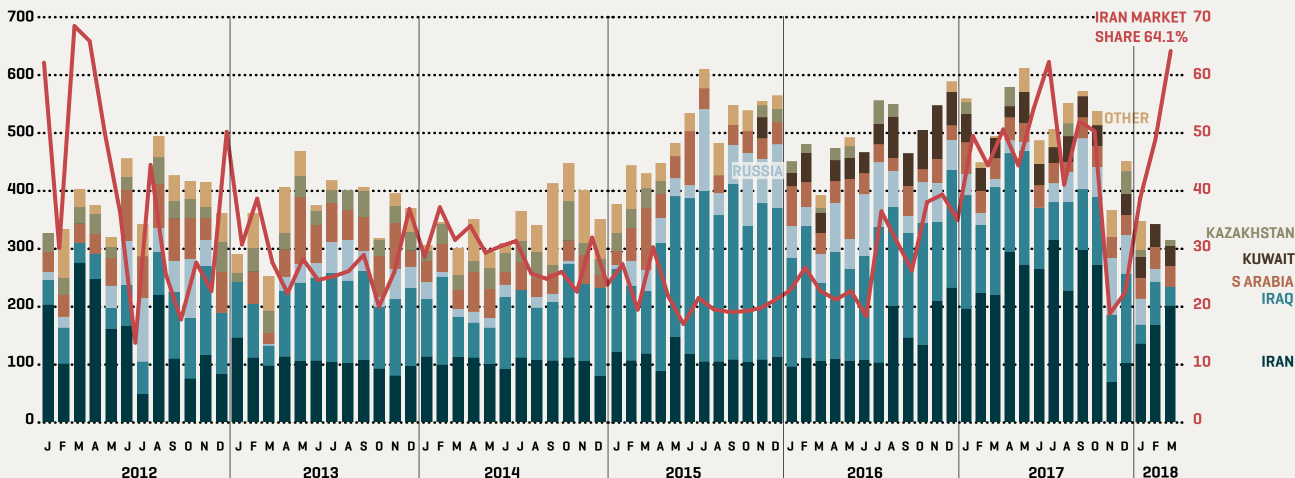
SAUDI FOREIGN RESERVES ROSE ABOVE $500BN FOR FIRST TIME IN A YEAR AT END OF APRIL...




...WITH THE RECENT REBOUND COMING AS PRICES FOR ARAB LIGHT HIT $69/B, THE HIGHEST SINCE 2014




### TURKEY CRUDE IMPORTS ('000 B/D): IRAN MARKET SHARE RISES TO 6-YEAR HIGH OF 64% IN MARCH

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