Date of Hearing: April 22, 2013

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
AB 978 (Blumenfield) – As Amended: April 15, 2013

SUBJECT: Financial Institutions: Iran sanctions

SUMMARY: Requires the Commissioner of Department of Financial Institutions (Commissioner) to prescribe regulations to require state chartered banks and credit unions (licensees) that maintain a correspondent account or a payable-through account with a foreign financial institution to establish due diligence policies, procedures and controls in order to comply with Iran sanctions. Specifically, this bill:

1) Provides that the Commissioner shall prescribe regulations to require licensees that maintains a correspondent account or a payable-through account with a foreign financial institution to establish due diligence policies, procedures, and controls to comply with the Federal Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA).

2) Requires licensees with correspondent accounts or a payable-through account with a foreign financial institution to establish at every 12-month exam period that the licensee is not knowingly engaging with foreign financial institutions in violation of CISADA.

3) Specifies that no licensee shall maintain specified accounts with a foreign institution that the United States Treasury Department's Office of Foreign Assets Control (OFAC) has placed on the list of foreign institutions in violation of CISADA.

4) Requires the Commissioner to review all federal regulations related to financial institution compliance with CISADA with 60 days of implementation and make appropriate modification to state regulations.

5) Provides for an administrative fine of up to, but not exceeding $100,000.

6) Specifies that the Commissioner shall refer all pertinent information regarding potential violations to the Secretary of the United States Treasury.

7) Requires a state chartered bank, when under examination by the Commissioner, to demonstrate that they are compliance with CISADA.

8) Provides that state chartered bank that has been examined by a federal regulaters and that maintains a correspondent account or a payable-through account with a foreign institution shall submit a declaration of compliance with the regulations required under this legislation.

EXISTING STATE LAW

1) Pursuant to the Iran Contracting Act of 2010, prohibits any person or entity that engages in investment activities in the energy sector of Iran, as specified, from bidding on, submitting a proposal for, or entering into a contract with a public entity for goods or services. [Public

Contract Code, Section 2200 et seq].

2) Prohibits the use of investments in companies doing business in the energy and military sectors of Iran to satisfy an insurer's capital requirements. [Insurance Code, section 1241.2].

3) Prohibits California Public Employees' Retirement System CalPERS and the State Teachers' Retirement System (CalSTRS) from investing public employee retirement funds in a company with active business relations in Sudan or that has invested or engaged in business operations with entities involved in the development of petroleum or natural gas resources of Iran. (Government Code Sections 7513.6 and 7513.7.)

FISCAL EFFECT: Unknown

COMMENTS:

According to information provided by the author, this bill is necessary as:

> *California continues to aid Congress in its efforts to increase economic pressure on Iran to cease its pursuit of nuclear weapons – one of the gravest threats to security in the Middle East and the world. In 2012, the Legislature passed AB 2160 that became law to disallow investments in Iran from assets that would otherwise contribute to the evaluation of financial solvency of insurers operating in California. In 2010, the Legislature passed AB1650 that became law to prohibit state and local governments from contracting with companies known to be doing restricted business in Iran's energy sector, ensuring that California tax dollars do not support companies whose investments support Iran's nuclear program.*

United States' sanctions have been the primary feature of U.S. policy toward Iran since its 1979 revolution. Bilateral sanctions and those of the United Nations are more recent, only since 2006.

The Iran Sanctions Act (ISA) is the core of the energy-related U.S. sanctions. It took advantage of the opportunity for the United States to try to harm Iran's energy sector when Iran, in November 1995, opened the sector to foreign investment. To accommodate its insistence on retaining control of its national resources, Iran used a "buy-back" investment program in which foreign firms gradually recoup their investments as oil and gas is discovered and then produced. With input from the Administration, on September 8, 1995, Senator Alfonse D'Amato introduced the "Iran Foreign Oil Sanctions Act" to sanction foreign firms' exports to Iran of energy technology. A revised version instead sanctioning *investment* in Iran's energy sector passed the Senate on December 18, 1995 (voice vote). On December 20, 1995, the Senate passed a version applying the provisions to Libya, which was refusing to yield for trial the two intelligence agents suspected in the December 21, 1988, bombing of Pan Am 103. The House passed H.R. 3107, on June 19, 1996 (415-0), and then concurred on a Senate version adopted on July 16, 1996 (unanimous consent). The Iran and Libya Sanctions Act was signed on August 5, 1996 (P.L. 104-172). Since its enactment in 1996, ISA has attracted substantial attention because it is an "extraterritorial sanction"—it authorizes U.S. penalties against foreign firms, many of which are incorporated in countries that are U.S. allies. American firms are separately restricted from trading with or investing in Iran under separate U.S. executive orders. Its application has been further expanded by several laws enacted since 2010. In addition, several executive orders have been issued that authorize the application of ISA sanctions to specified violators.

Originally called the Iran and Libya Sanctions Act (ILSA), ISA was enacted to try to deny Iran the resources to further its nuclear program and to support terrorist organizations such as Hizbollah, Hamas, and Palestine Islamic Jihad. Iran's petroleum sector generates about 20% of Iran's GDP (which is about $870 billion), about 80% of its foreign exchange earnings, and about 50% of its government revenue for 2012. Iran's oil sector is as old as the petroleum industry itself (early 20th century), and Iran's onshore oil fields are past peak production and in need of substantial investment. Iran has 136.3 billion barrels of proven oil reserves, the third largest after Saudi Arabia and Canada. With the exception of relatively small swap and barter arrangements with neighboring countries, virtually all of Iran's oil exports flow through the Strait of Hormuz, which carries about one-third of all internationally traded oil exported by Iran and other countries on the Persian Gulf. Iran's large natural gas resources (940 trillion cubic feet, exceeded only by Russia) were virtually undeveloped when ISA was first enacted. Its gas exports are small, and most of its gas is injected into its oil fields to boost their production.

ISA consists of a number of "triggers"—transactions with Iran that would be considered violations of ISA and could cause a firm or entity to be sanctioned under ISA's provisions. When triggered, ISA provides a number of different sanctions that the President could impose that would harm a foreign firm's business opportunities in the United States. ISA does not, and probably could not practically, compel any foreign government to act against one of its firms. Sanctions imposed against violators are discussed below, unless specified.

In the 111th Congress, H.R. 2194, (Iran Refined Petroleum Sanctions Act) was passed by the House on December 15, 2009, by a vote of 412-12. A bill in the Senate, the "Dodd-Shelby Comprehensive Iran Sanctions, Accountability, and Divestment Act," (S. 2799), passed the Senate, by voice vote, on January 28, 2010. It was adopted by the Senate under unanimous consent as a substitute amendment to H.R. 2194 on March 11, 2010; it added to the House bill several provisions beyond amending ISA—provisions affecting U.S.-Iran trade and other issues. The conference report resembled the more expansive Senate version. The President signed the final version—the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA) on July 1, 2010 (P.L. 111-195), which, among other provisions, amended ISA to make sanctionable additional factors.

Section 104 of CISADA provides for the Secretary of Treasury to prescribe regulations to forbid banks in the U.S. from opening new correspondent accounts or payable through accounts with banks that process significant transactions for the Iranian government or its affiliates, as well as, any entity that is sanctioned by U.S. executive orders.

Foreign banks that do not have operations in the United States typically establish correspondent accounts or payable-through accounts with U.S. banks as a means of accessing the U.S. financial system and financial industry. The provision leaves it to the Treasury Department to determine what constitutes a "significant" financial transaction. The premise of the provision is that cutting off Iran's access to the international financial system harms Iran's economy primarily by preventing Iranian traders from obtaining letters of credit to buy or sell goods.

What has occurred as a result of the multitude of Iran sanctions. The Congressional Research Service in a report published in January of 2013 on Iran Sanctions provides the following:

> The accumulation of international, bilateral, and multilateral sanctions is beginning to take a dramatic toll on Iran's economy—trend increasingly admitted by Iranian leaders. On February 24, 2013, Ahmadinejad presented his proposed 2013-2014 budget and said

that “This was a very difficult year for our economy.”51 The indicators of the effect of sanctions and mismanagement on Iran’s economy include

Oil Export Declines. Oil sales account for about 80% of Iran’s foreign currency earnings, and the proceeds are controlled by the government (Central Bank), not the private sector. The EU oil embargo and the restrictions on transactions with Iran’s Central Bank have dramatically reduced Iran’s oil sales. In 2011, Iran exported an average of about 2.5 million barrels per day (mbd). In early March 2013, the Energy Information Agency reported that Iran’s sales in February 2013 were about 1.28 mbd—roughly half the 2011 level. If sustained, this drop will likely deprive the Iranian government of about $50 billion for all of 2013.

Falling Oil Production. To try to adjust to lost oil sales, Iran began storing some unsold oil on tankers in the Persian Gulf, and it is building new storage tanks on shore. Iran stored about 20 million barrels to try to keep production levels up— shutting down wells risks harming them and it is costly and time consuming to resume production at a shut down oil well. However, that strategy was unsuccessful and Iran overall oil production has fallen to about 2.6 million barrels per day from the level of nearly 4.0 mbd at the end of 2011.

GDP Decline. The sanctions, and particularly the drop in oil exports, have caused Iran to suffer its first gross domestic product contraction in two decades. According to a GAO study on the effect on Iran of sanctions since 2010, Iran’s GDP likely contracted in 2012 by about 1.4%. Other sources predict that it will contract an additional 1.2% in 2013.

Hard Currency Depletion. The IMF estimated Iran’s hard currency reserves to be about $101 billion as of the end of 2011, and the reserves are estimated to have fallen to $90 billion at the end of 2012. A further decline to about $85 billion is expected by the end of 2013. And the February 6, 2013, imposition of sanctions on Iran’s ability to repatriate hard currency will likely cause the depletion rate to increase as Iran is virtually forced to conduct trade through barter arrangements. Analysts at one outside group, the Foundation for the Defense of Democracies, believe Iran’s hard currency reserves might be exhausted entirely by July 2014 at current rates of depletion.

Currency Collapse. The regime has been working to contain the effects of a currency collapse. The value of the rial fell on unofficial markets from about 28,000 to one U.S. dollar to nearly 40,000 to one dollar in one week in early October 2012. Earlier, the rial had fallen from about 13,000 to the dollar in late September 2011 to about 28,000 to the dollar as of mid-September 2012— including a significant decline from about 23,000 to the dollar to the 28,000 to the dollar level in the first two weeks of September 2012. To try to stretch its hard currency reserve, on October 15, 2012, Iran said it would not supply hard currency for purchases of luxury goods such as cars or cellphones (the last 2 of the government’s 10 categories of imports, ranked by their importance). The government is still supplying hard currency for essential and other key imports. Importers for essential goods can obtain dollars at the official rate of 12,260 to the dollar, and importers of other key categories of goods can obtain dollars at a new “reference rate” of 28,500 to the dollar. The regime also threatened to arrest the unofficial currency traders who sell dollars at less than the rate of about 28,500 to the dollar. However, unofficial trading moved offshore to the emirate of Dubai, and observers say the market rate there is about 39,000 to the dollar in mid-February 2013.

Inflation. Some Iranians and outside economists worry that hyper-inflation might result from the currency collapse. The Iranian Central Bank estimated on January 9, 2013, that the inflation rate is about 27%—the highest rate ever acknowledged by the Bank—but many economists believe the actual rate is between 50% and 70%. This has caused Iranian merchants to withhold goods or shut down entirely because they are unable to set accurate prices. Almost all Iranian factories depend on imports and the currency collapse has made it difficult for Iranian manufacturing to operate. In order to keep the prices of pistachio nuts down, in February 2013 the government placed a moratorium on exports of that product. Observers say that, to try to deflect the effect of sanctions, some Iranian importers of foreign goods have shifted to exporting goods from Iran— benefitting from the fall of the value of Iran's currency. And many Iranians have accelerated their consumer purchases for fear of further price increases ahead—causing a notable increase in business, according to many Iranian merchants.

Shipping Difficulties. Beyond the issue of the cost of imported goods, the Treasury Department's designations of affiliates and ships belong to Islamic Republic of Iran Shipping Lines (IRISL) reportedly are harming Iran's ability to ship goods at all, and have further raised the prices of goods to Iranian import-export dealers. Some ships have been impounded by various countries for nonpayment of debts due on them.

Domestic Payments Difficulties. Suggesting Iran's operating budget is already struggling, some reports say the government has fallen behind in its payments to military personnel and other government workers. Others say the government has begun "means testing" in order to reduce social spending payments to some of the less needy families. In late 2012, it also postponed phase two of an effort to wean the population off subsidies, in exchange for cash payments of about $40 per month to 60 million Iranians. Phase one of that program began in December 2010 after several years of debate and delay, and was praised for rationalizing gasoline prices. Gasoline prices now run on a tiered system in which a small increment is available at the subsidized price of about $1.60 per gallon, but amounts above that threshold are available only at a price of about $2.60 per gallon, close to the world price. Before the subsidy phase out, gasoline was sold for about 40 cents per gallon.

Auto Production. Press reports indicate that sanctions have caused Iran's production of automobiles to fall, as of early 2013, by about 40% from 2011 levels. Iran produces cars for the domestic market, such as the Khodro, based on licenses from European auto makers such as Renault and Peugeot.

Flights Curtailed. Because of the decline in Iran's trade with European countries, KLM and Austria Airlines announced in January 2013 that they would be ending flights to Iran later in 2013. Lufthansa, some other European airlines, and most airlines in the Persian Gulf, Middle East, and South Asia region still fly to Iran regularly.

Mitigation Attempts. Mitigating some of the effects are that some private funds are going into the Tehran stock exchange and hard assets, such as property. However, this trend generally benefits the urban elite.

Prior to the enactment of CISADA the Treasury Department issued fines against financial institutions to pressure them into ceasing business with Iran. In 2004, the Treasury Department fined UBS $100 million for the unauthorized movement of U.S. dollars to Iran and other sanctioned countries, and in December 2005, the Treasury Department fined Dutch bank ABN Amro $80 million for failing to fully report the processing of financial transactions involving Iran's Bank Melli. In the biggest such instance, on December 16, 2009, the Treasury Department announced that Credit Suisse would pay a $536 million settlement to the United States for illicitly processing Iranian transactions with U.S. banks. In June 2012, Dutch bank IMG agreed to pay a $619 million penalty for moving billions of dollars through the U.S. financial system, using falsified records, on behalf of Iranian and Cuban clients.

The most recent action occurred when Standard Chartered agreed in August 2012 to a $340 million settlement with New York State regulators for allegedly processing transactions with Iran in contravention of U.S. regulations. The settlement was the largest fine ever collected by a single U.S. regulator in a money-laundering case. The accusations provided that the bank had schemed for over a decade to hide over 60,000 transactions totaling more than $250 billion for Iranian clients. An interesting component of this case is that New York state banking regulators pursued their action against Standard for violations of several provisions NY state law (Copy of regulator order here, http://www.dfs.ny.gov/banking/ea120806.pdf). For example, Standard was accused of failing to maintain accurate books and records, obstructing the regulatory investigation, failing to report crimes and misconduct, falsifying books and reports, filing false instruments, falsifying business records, and engaging in unauthorized Iranian transactions in violation federal law.

Financial institutions in the U.S. and California irrespective of state or federal charters must comply with sanctions established by federal statute and/or Presidential executive order. The mere fact that a bank or credit union is regulated by a state regulator does not lesson, nor detract from their compliance responsibilities with these and a multitude of other federal laws. A failure of these entities to comply with the myriad of sanctions or the OFAC list could face severe federal penalties.

Suggested Amendments.

The current language in the bill contains several issues that need resolution. In order to clarify intent of AB 978 that state regulators have authority concerning compliance with federal sanctions staff recommends a more straightforward approach.

1) Strike Sections 2 and 3 of bill.

2) Insert the following as new Section 2:

Section _____ is added to Financial Code to read:
______(a) The commissioner when conducting examinations under sections 500 and 14250 shall ensure that a licensee that maintains a correspondent account or payable-through account is in compliance with the Iran Sanctions, Accountability, and Divestment Act of 2010 and associated regulations and Presidential Executive Orders. If the commissioner finds that a licensee is in violation the commissioner may bring an

action in accordance with Section 566 or 16200, and shall forward evidence of the violation the United States Treasury Department.
(b) This section shall cease to be operative if both of the following apply:
(1) Iran is removed from the United States Department of State's list of countries that have been determined to repeatedly provide support for acts of international terrorism.
(2) Pursuant to the appropriate federal statute, the President of the United States determines and certifies to the appropriate committee of the Congress of the United States that Iran has ceased its efforts to design, develop, manufacture, or acquire a nuclear explosive device or related materials and technology.

Previous legislation.

AB 1650 (Feuer/Blumenfield)of 2010. Chaptered. Prohibits California governments from contracting with companies doing restricted business in Iran.

AB 2160 (Blumenfield) of 2011. Chaptered. Disallows investments in Iran from assets that would otherwise be considered when considering financial solvency to do business in California.

REGISTERED SUPPORT / OPPOSITION:

Support

None on file.

Opposition

None on file.

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