European Financial Services Round Table

August 2023

EFR PAPER: EU SANCTIONS POLICY: REVIEWING THE EXPERIENCE IN EUROPE AND RECOMMENDATIONS FOR THE FUTURE

Introduction

On 24th February 2022 Russia invaded Ukraine, causing widespread international condemnation and the imposition of new sanctions on Russia by the EU, US, UK, and others with unprecedented velocity and scope. The purpose of this paper is to highlight the work undertaken by the financial services sector including the re/insurance industry, as well as make observations about the experience and challenges, together with recommendations for the future.

The deployment of economic sanctions against Russia and Belarus is on a scale that is new and reflects the importance of the economic dimension in modern conflict. The experience provides an opportunity to reflect on how sanctions have been applied, how effective they have been in achieving their aims, and how this can be improved on in the future. The main takeaway is that to be a truly credible and effective tool, financial institutions need to be able to apply sanctions relatively easily, consistently and in a coordinated manner.

The Russian invasion of Ukraine has changed the global political landscape, causing a worldwide response with significant and new sanctions being imposed against Russia and Belarus. In a short period, more than 3000 new sanctions were implemented by the EU, US, UK, Switzerland and Japan including, but not limited to targeted list-based sanctions with asset freeze obligations (OFAC app. 2000 new SDNs in total, EU - to date - sanctioned close to 1800 individuals and entities); economic sanctions (restrictions on import/export of certain Russian and Belarusian goods and services and of certain EU, UK or US goods to Russia); other measures such as SWIFT disconnection of Russian and Belarussian banks and the introduction of a prohibition on accepting deposits exceeding EUR100k from Russian and Belarusian nationals or residents; a prohibition to facilitate maritime transport of Russian origin oil and petroleum products 'to and between third countries', unless sold under a certain 'price cap'; specific re/insurance-related prohibitions in relation to aviation and marine, along with general "financial assistance" prohibitions.

Since February 2022, the EU has imposed 11 packages of sanctions against Russia and several new sanctions against Belarus.

Observations and challenges

We would like to first recognise the response to the invasion of Ukraine on the part of policymakers. There has been unprecedented collaboration on sanctions by the EU, US, UK and other countries. The deployment of sanctions is strongly supported by the financial sector, and we have welcomed the cooperation with authorities to apply policy quickly and effectively.

When applying sanctions on such a scale, it is inevitable however, that that challenges will arise in terms of interpretation, and determining their applicability due to their complexity. These challenges are described below under three overarching headings with a view to identifying how policy can be strengthened in the future.

1. Call for a more coordinated global approach regarding the interpretation of sanctions

1.1 Difference in regulation across EU, US, UK, compounded by differing interpretation by EU Competent Authorities (NCAs)

Despite the strong collaboration on Russia sanctions on the part of the EU and other countries, regulations in the US, UK and EU differ, which presents operational and legal challenges for companies operating internationally. Moreover, the interpretation of EU regulations varies between NCAs in EU Member States, leading to inconsistencies and resulting in delayed decisions and customer frustration. These challenges are not specific to financial firms but are also faced by EU NCAs.

Conflicts of law also present difficulties for the harmonisation of controls within banking and re/insurance groups and institutions involved in cross-border operations. For the reasons set out above, there has been a need, as far as possible[1], to evaluate each customer scenario on a case-by-case basis, based on local guidance and regulatory feedback. This has resulted in tailored approaches in different countries, causing perceived and actual inconsistencies.

The following are examples of how the absence of alignment has caused confusion and potential delay:

- Absence of alignment with regard to when various entities and/or their owners are designated: for example, the designation of the owners of Alfabank caused considerable market dislocation as different financial institutions took deviating views concerning ownership or control. Alfabank was subsequently designated raising concerns over why there was any delay.
- Absence of alignment between when specific entities or individuals are designated by various sanctions authorities: there are examples where different sanctions authorities have designated specific entities and/ or individuals at different times.

1.2 Absence of formal guidance and ad hoc nature of available guidance leading to inconsistent application and avoidable risks

In the absence of formal guidance, firms have relied on ad hoc guidance from EU NCAs and European authorities. This has sometimes resulted in guidance that runs counter to long-standing approaches or guidance on European measures, which is inconsistent across different jurisdictions. There are also examples where NCA website guidance is hard to follow and it can even be difficult to find the relevant sanctions. As a result, it sometimes takes a lot of time to reach a conclusion based on the information provided. There are further difficulties including the lack of responsiveness, either due to being swamped or simply by the complexity of the issues.

The absence of such guidance creates ambiguity in the approach: for example, in the case of Euroclear and Clearstream, a sanctions authority was asked to clarify whether Euroclear controls may be relied upon for payment of coupons on structured notes. The questions went unanswered for over two and a half months, during which time firms that were blocking payments to sanctioned persons at Euroclear were running the very real risk of cross default. This meant that law-abiding actors were effectively being punished for seeking to comply with unclear rules. To add to the complexity, when a similar situation arose at Clearstream (different NCA), the opposite guidance was given.

In the re/insurance sector, uncertainty over whether coverage of exports of fertilizers to third countries was prohibited led to considerable market disquiet in relation to coverages in Asia and Africa. Initial guidance indicating that coverage was not permitted was subsequently revised.

[1] For reinsurance there will often be limited information available on underlying insured risks. For this reason, it is now standard market practice to include a sanctions exclusion clause.

1.3 Clarification of distinction between designated entities and those under firewall status

There has also been an ongoing discussion on the distinction between designated entities and those under "firewall" status, when the designated party controls an EU entity that is placed under sanctions de facto, while its interests are 100% European. This is an area where the European Commission has proposed the creation of a specific status for such entities, so as to let them continue to operate, which would be welcome.[2]

2. Call for better guidance regarding the application of sanctions

2.1 Lack of understanding of the need for licences

When sanctions were originally put in place after the invasion of Ukraine, some policymakers, especially in Europe, were not immediately aware of the need and urgency for licences. General licences were not granted in the EU and relied on individual outreach to sanctions authorities in each country. The same applied in Switzerland while, in the UK, guidance on how to obtain licences was very limited.

Once the need for general licences was understood, there was still a delay between the designation of certain entities and the granting of related permissive licences. This caused firms to operationalise cessation of activity, only to then unpick those controls, which dislocated resources.

The length of general licences was rarely adequate for the commercial activity required. In the US, 3-month licences were the norm (and still often had to be extended), while the norm in the UK was 30 days. In some ISDA agreements, the notice period for termination given a sanctions trigger was 30 days, meaning the 30-day licence was too short. Both the 30-day and the 3-month windows were in any event too short for winding down complex activities. The length of time for granting specific licences is also long. One relevant authority undertook to give a response in 5 weeks but was not adequately resourced for the number of queries it received. Better guidance at the time of issuing sanctions could decrease the ad hoc guidance workload and allow better allocation of resources to individual licence queries, for example.

2.2 Scope for circumvention

Circumvention has emerged as a particular challenge including through different assets and tools, such as:

- The use of digital assets
- Huge amount of cash withdrawals made on ATM with Russian cards
- The forced conversion of Russian sanctioned securities (ADR/DGR)

In many cases financial institutions have no insight into the underlying transactions (in sanctioned, e.g. dual-use goods) with the result that they lack the means to identify attempts at circumvention.

3 The scale of the sanctions created significant resource challenges

3.1 Complexity, time and resource pressure on teams

The speed and complexity of the new sanctions put considerable pressure on compliance and legal teams, which needed to assess the impact of the new measures, update applicable policies, procedures, and guidance, as well as systems and controls. This was, at the same time as assessing the impact of the sanctions on specific clients and counterparties, particularly challenging in the case of complex client structures. Firms also saw a significant increase in customer queries and dialogue on customer transactions.

[2] Reg (EU) 2023/1215 (11th package) which creates a derogation for firewalls in Art. 6 b para. 5d of Reg. (EU).

These issues were also compounded by additional regulatory reporting, NCA Thematic Sanctions Investigations, including third party testing screening, and internal audit processes.

New sanctions also led to a significant increase in the volume of alerts generated by the name and transaction screening systems, which resulted in backlogs.

Furthermore, any avoidable operation pressure caused by sanctions measures binds resources that could otherwise be used to better detect circumvention. Circumvention has emerged as a particular challenge, including through different assets and tools such as the use of digital assets, the huge amount of cash withdrawals made on ATMs with Russian cards and the forced conversion of Russian sanctioned securities (ADR/DGR). Circumvention risk, particularly in relation to the former Soviet states, has also become a significant challenge. Although we do understand the legitimate concerns of authorities about circumvention, it would be good to be mindful of the financial industry's capacity to detect and prevent this.

3.2 Determination of the sanction status of clients within a reasonable timeframe

The vastly increased number of sanctioned persons and the need to evaluate and assess complex structures on a case-by-case basis to conclude whether customers or re/insured parties were subject to sanctions due to ownership or control requires considerable time and resources, given that appropriate documentation needs to be obtained in some cases. It should be noted that, in many instances, full documentation on Russian corporate structures is not available to the private sector. Whilst incomplete information may weigh on a risk assessment in terms of deciding whether to enter into a new relationship, companies may be sued if they fail to honour contractual terms, if there is an existing contractual relationship. This can also result in a perceived slower response time.

3.3 New types of sanctions not utilised in other sanctions programs

Controls have had to be developed at a rapid pace to implement new types of sanctions (e.g. €100K deposit controls or oil price cap). Specific problems arose, for example, when the €100K sanctions became effective, essentially without any notice and without any detailed regulatory guidance and reporting tools. These sanctions continued to pose challenges after taking effect, e.g. paying interest on regulated products for customers whose deposits exceed €100k.

It is also worth noting that the €100k threshold was specific to the EU and misaligned with the UK and US. The application of the rules also led to unnecessarily complex, burdensome and error-prone processes, due to (i) banks' internal systems generally being designed to block debits, not credits, or only on the ground of information found in a SWIFT or SEPA message, and (ii) KYC processes requiring banks to collate identity or fiscal documents, rather than visas or work permits. Closer upfront coordination with banks would have avoided such issues.

3.4 Resource pressure on authorities

The pressures described in this section also apply to sanctions authorities and, while we recognise the challenges that authorities have faced, there has been a sizeable backlog in licence approvals. Authorities have also been reticent to express views that would assist firms in interpreting sanctions requirements in complex scenarios, e.g. to determine whether a client/counterparty is considered to be under the ownership or control of a designated party. Some of the pressure that firms have faced would be relieved by greater capacity within sanctions authorities and a willingness to engage on the complexities in the application of sanctions policy where necessary and as appropriate.

4 Unintended consequences

- The designation of the National Securities Depository (NSD) created uncertainty concerning all Russian securities, due to the central role the NSD plays in the settlement of these securities. Considering the targeted nature of the various restrictions on Russian investment, it is likely that this was not intended. These effects should be considered more carefully going forward.

- In order to properly implement the restrictions on deposits and selling securities, in particular to manage the carve-outs for Swiss/EU citizens and residents, banks have had to obtain information concerning additional nationalities and residence permits that are not part of the regulatory KYC requirements (and, for example, to explain to UK clients with UK citizenship or permanent residency but who were born in Russia that they can no longer purchase these securities). These adverse effects should be balanced more carefully against what the restrictions are trying to achieve.

Recommendations

The issues highlighted above summarise the main challenges faced by financial institutions in applying new sanctions policies on an unprecedented scale within a rapid timeframe. The purpose of highlighting these difficulties is to generate discussion on how to improve the framework so that, going forward, governments and the financial services sector, and other actors, can work together to deliver sanctions policy as effectively as possible.

We note that the Institute for International Finance has recently produced a 'lessons learned' paper[3] aimed at global policymakers and we endorse the suggestions it contains. The recommendations set out below aim to be consistent with those suggestions, while reflecting the experience of European industry.

1) The importance and international nature of sanctions policy should be reflected in the EU's institutional structure and international relations

Sanctions have become a crucial arm of foreign policy and this needs to be adequately reflected in the European Commission's institutional set-up and activities. While it is for the European Commission to determine how best to organise itself, it should ensure that there are sufficient staff and resources dedicated to the development and application of sanctions policy, with an institutional structure that aids effective decision-making. This could also include supporting consistent approaches between national NCAs.

The EU should also lead efforts to promote coordination at international level. At the minimum, this should involve establishing MoU's with relevant jurisdictions and bodies[4]. It could also involve a review of how sanctions policies are discussed and coordinated in key international forums, such as the G7.

2) The European Commission should increase the transparency of legal control tests and policy

Establishing the control of an entity and if it is subject to sanctions is a highly complex exercise that is compounded by the absence of clarity over when and how determinations are made by relevant authorities.

The European Commission should seek to reduce this uncertainty by improving the transparency of both the criteria and process for decision-making. This can involve setting a two-legged test for qualitative control that specifies that: 1) where a firm is more than 50% owned by a sanction target then it is subject to sanctions; or 2) where this is not the case, the entity is not subject to sanctions unless or until it has been sanctioned by the relevant authority. The practice of the US authorities in issuing FAQs or other guidance indicating the impact of designations is helpful (e.g. OFAC FAQ on Polymetal).

This can be assisted by an active policy of transparency whereby far more material is published on authorities' views towards affected firms. This would greatly reduce uncertainty for financial entities and allow swift action to be taken, rather than seeking to second guess authorities' views. It should be noted that even if a preliminary view published by an authority is subsequently changed, this would be an improvement on the status quo.

---

[3] Cross-Border Coherence in the Effective Design and Implementation of Financial Sanctions and the Prevention of Sanctions Evasion: Lessons Learned and Issues Going ForwardInstitute of International Finance, February 2023 32370132_iif_sanctions_staff_paper_final_february_2023_g7_pdf.pdf

[4] A tangible example of such cooperation on coherent sanctions implementation is the OFAC-OFSI enhanced partnership as announced last October. See here.

3) The European Commission should provide clear, detailed and timely guidance on the application of sanctions.

In the longer term, there should be a European body responsible for issuing licenses and guidance that is valid for all EU member states as cooperation between the NCAs is important but ultimately not sufficient.

The absence of a European body - an OFAC-like entity -, which can only be deplored at this stage, makes it all the more important for European authorities to coordinate with each other in order to provide detailed guidance on the application of sanctions to ensure the effective and balanced implementation of policy across the Union. This should be structured in such a way to allow firms to receive the necessary level of detail that they need to gain a clear understanding of the application of standards and be able to act accordingly. Particular attention should be given to the value of FAQs and their legal status in the event companies rely on them. The development of a tool similar to the ESAs guidelines, member states must comply with or explain the motive for their divergence, should also be envisaged. Recognition of the information available to companies in the normal course of business (e.g. the tiering approach applied to compliance with price cap sanctions and use of sanctions exclusion clauses by re/insurers) should be taken into account more generally when drafting sanctions and related compliance guidance. It would also be important to address the current challenges posed by some NCAs such as a lack of responsiveness, either due to being swamped or simply by the complexity of the issues.

Moreover, when making corporate and institutional designations, consideration should always be given as to whether it is feasible to grant a wind-down licence at the same time as the designation is made, as per established OFAC practice, in order to allow firms to exit in-scope transactions and relationships in an orderly way and avoid increased market risk or threats to financial stability.

4) Create a forum for information-sharing between the public and private sectors

Cooperation between the public and private sector has been very good throughout the process. However, the scale and highly complex nature of sanctions policy means that it is inevitable that issues have arisen that were unforeseen, and improvements can be made. We would strongly recommend establishing a forum that ensures an ongoing dialogue between those responsible for devising sanctions policy and those responsible for implementing it. In addition to information exchange, the purpose would be to identify lessons learned, best practice and obstacles that can be removed to improve the delivery of policy in the future. Such a forum which, to the extent that it involves market competitors, would need to comply with applicable competition laws could meet annually or semi-annually with working groups tasked to investigate specific issues. For instance organising dedicated workshops in the short term that allows both parties to share experiences and improvements, would be beneficial and the attendance of key trade bodies would enhance industry learning.