Deadlocked on debt

Iran has yet to produce the project and trade flows bankers hoped for following signing of the JCPOA in 2016. The hurdles are largely born of the Trump administration – but not all. And while European lenders remain wary, Iran is looking eastward for debt.

Oliver Gordon (http://www.txfnews.com/Tracker/keyword/Oliver Gordon)
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The pre-Trump optimism of an Iran active in the international trade and project markets has mellowed. “The post-nuclear deal wave of 2016 has faded,” says Andreas Schweitzer, managing director at Iran-focused finance boutique Arjan Capital. And the rising threat of new US-led sanctions is expected to keep trade and project financings in Iran at a subdued level in 2018, albeit with the country increasingly turning east to meet its unrequited funding needs.

The direct and indirect issues dogging progress are largely US-made – but not all. While Iranian trade with the EU has improved significantly over the last two years, albeit from a low base, both parties seem increasingly “disappointed by the lack of speed, and the complication, of doing business together”, according to Schweitzer.

International banks – the vast majority of which have assets in the US – are largely unwilling to do business in Iran, which has left the market to the limited capacity of mid-size banks and banks with no US exposure. Project finance is particularly problematic, and with local interest rates still well above 20%, “Iran remains an equity country, not a debt one”, says Schweitzer.

The complex sanctions relief granted to Iran in 2016 under the Joint Comprehensive Plan of Action (JCPOA) still remains in place. It allows for most European companies to engage in most types of business with Iranian entities that are not otherwise blacklisted (conversely, there are very few open avenues for US companies to do business in the country).

However, in dealing with Iran, EU companies and financiers must navigate testing waters. “Many face the thorny task of ensuring that their Iranian counterparties are not blacklisted or owned by blacklisted entities, which has had a chilling effect on some deals,” says Matthew Oresman, a sanctions expert at Pillsbury Winthrop Shaw Pittman. “Furthermore, many European banks are still refusing to process the transfer of payments in and out of Iran, which has been a block to deal execution, as well as the payment for goods and services, and the repatriation of revenues back to the EU.”

East pounces as West dithers

Most European export credit agencies (ECAs) have opened for Iranian business over the last two years, but have hit a wall in the unwillingness of banks to process payments. All banks with dollar clearing accounts remain sensitive to Trump’s hardline stance. As Peter Luketa, managing director of export finance consultancy CB Advisors, says: “Some ECAs, such as EKN and Sace, have claimed to have supported Iranian trade business – but the deals appear to be trade finance, generally for short periods of up to two years, and cover comes in the form of trade insurance.”

Some European governments are proving more supportive than others. The Italian government is seeking a way to support its major exporters through Sace and the substantial trade agreements already reached with Iran. Earlier this month Italian development bank Invitalia Global Investment struck a €5 billion ($6.2 billion) deal with two Iranian banks for the financing of projects in the country.

Spain’s Cesce also recently concluded a second transaction in Iran through a Spanish-based bank with Middle Eastern ownership. By comparison “UK Export Finance (UKEF), which has been very vocal over the past two years, has become more lukewarm despite the pressure coming from prime sectors such as health,” claims Luketa.

A number of smaller European banks without strong US interests have announced framework agreements with some of the Iranian banks “but again without any real evidence of transactions going through”, says Luketa. In September Denmark’s Danske Bank reached a €500 million agreement with 10 Iranian banks to be used to fund projects in the country. And in the same month Austria’s Oberbank signed a similar €1 billion contract with 14 Iranian banks, backed by export credit guarantees from Oesterreichische Kontrollbank (OeKB).

Looking beyond Western institutions

With progress on the European front slow, Iran is increasingly looking east for trade development, with both Chinese and Korean institutions announcing multi-billion dollar lines of credit with a range of Iranian banks during the last quarter of 2017. In August Korea Eximbank (Kexim) signed an agreement with 12 Iranian banks to provide €8 billion of finance in the country. Then in September China's CITIC Trust struck a financing accord with five Iranian banks worth $10 billion. That agreement was swiftly followed by China Development Bank signing a memorandum of understanding with the Central Bank of Iran to lend $15 billon. Iran is also currently negotiating another $10 billion agreement with China Eximbank, Arash Shahraini, deputy CEO of the Export Guarantee Fund of Iran, tells *TXF*.

Russia too is using its state banks and Exiar to further expand its influence in the Iranian market. In December Russia Eximbank reached a financing agreement with no cap with four Iranian banks. And in October Exiar and the Central Bank of Iran signed a memorandum of understanding to facilitate ECA-backed financing of Russian-Iranian joint projects.

And unlike the vague financing memorandums signed with Western institutions, some of these Eastern-focused agreements are starting to produce concrete transactions. The turn of the year saw Chinese ECA Sinosure agree a $1 billion facility to fund a Sinopec-led development of the Abadan Oil Refinery in Southern Iran. That was after China Eximbank and China Development Bank had agreed a $2 billion financing package in December for the construction of five hospitals in the country.

In September Russia's Vnesheconombank (VEB) also signed a €1.2 billion loan deal with Iran's Bank of Industry and Mining to finance a thermal power plant project in Hormozgan Province. And in July China Eximbank signed a contract to finance the electrification of a 926-kilometre railroad from Tehran to the eastern city of Mashhad with a $1.5 billion loan. In the same month a South Korean-Japanese consortium, including Kexim, the Korea Trade Insurance Corporation and Nippon Export and Investment Insurance (Nexi), signed a preliminary agreement worth $3 billion to develop Siraf Refining Park, a downstream project in Bushehr Province.

Nonetheless, deal volume is still lagging well below the Iranian government's targets. According to the Iran's 6th five-year development plan (2016-2021), the government is looking to attract an annual $65 billion of foreign financial resources. In the budget agreed for the current financial year (21 March 2017-21 March 2018) the government has been allowed to attain $55 billion of foreign financial resources. In the budget for next year (March 2018-March 2019) a cap of $35 billion has been set for foreign finance, to which any of the unused balance of the previous year will be added. The total amount of foreign financing agreements finalised so far this financial year has reached over $50 billion, according to Shahraini. However, the vast majority of that figure derives from as yet untapped financing agreements rather than financially closed transactions.

A three-headed stasis

There exists an ostensibly-strong appetite for financing trade and projects in Iran, but the problem of converting that interest into hard deals appears threefold: the US' fluctuating stance on the country, the limitations of the existing US sanctions, and the KYC (Know-Your-Customer) risk involved with the Iranian counterparties.

The major obstacles have been spawned by the election of Donald Trump, who has reversed the US government's position on Iran from that of the Obama administration. As long as Trump continues to try to unpick the Iran nuclear deal and threatens to extend sanctions, Western companies and banks will hold back from investing in the country.

"The current US government is cultivating an air of uncertainty around the nuclear deal. Hence newly-incoming investors are hesitating to increase their Iran exposure, fearing that their US business might suffer," says Schweitzer. The US applies very strict control over the JCPOA agreement and violators risk hefty finds, as some of the large European banks have previously discovered. This attitude has amplified in recent months in order push for a renegotiation of the current agreement, according to Schweitzer.

Then there are the constraints imposed by the sanctions that still remain in place. US-dollar trading with Iran is still not permitted and as such all business needs to be conducted in other currencies. However while banks' corporate clients can hold euro accounts for these transactions challenges come when reinvesting money earned in Iran in an international corporate group. US citizens need to be fenced off from any involvement in the management of funds earned in Iran, and such funds cannot be invested in any business that touches the US – a tricky balancing act for the sprawling structure of a modern multinational institution.

There is also the compliance nightmare involved in dealing with Iran. Since late-2017 the entire Iranian Revolutionary Guards Corps (IRGC) has been subject to US anti-terrorism sanctions. The challenge for investors and their banks is that in the years since the revolution the IRGC has developed into a commercial empire involved across industrial construction, media, telecommunications, shipping and beyond. Iran is a challenging environment in which to conduct due diligence on individuals and companies, and suffers from endemic corruption, casting doubt on the reliability of what information can be accessed. It is thus proving a difficult task for foreign financiers to establish with whom exactly they are doing business.

Stephan Naber, managing underwriter of Dutch ECA Atradius, says: "The fact remains that the availability and quality of financial information on Iranian companies and banks that we base our underwriting on is not yet up to standard because of the previous sanctions period. As a result we are currently seeing less interest from companies for financing business deals with Iran."

And on a side note, “what has been surprising is that even when financial terms are on offer to Iranian banks they have been very slow to take advantage, reflecting once again the desire of the Iranian clients to negotiate and conclude on the best possible terms,” adds Luketa.

Possible remedies

The most obvious panacea to the impasse would be for the US Administration to clarify the future of the nuclear deal and to put in place measures to safeguard European banks and companies in doing business with Iran – unlikely at best while Trump remains in office.

But there are some measures that banks and corporates can implement themselves. Helmut Bernkopf, member of the board of executive directors of OeKB, says: “It would be essential for European banks and companies to put in place legal security that, within compliance with the relevant international regulations, ensures their business in Iran is not subject to US sanctions.”

Besides that, correspondent banking relations need to be reestablished which comprise the implementation of adequate compliance procedures, including the most up to date KYC/KYCC processes. Iranian banks would need to adapt to international standards and provide reliable information about the creditworthiness of their customers. “Clear regulations concerning anti-money laundering and combating the financing of terrorism for example are important international standards for banks,” says Bernkopf. “For the Iranian banking system it would be important to complete the FATF (Financial Action Task Force) Action Plan.”

European ECAs could also start to catalyse the market by expanding direct lending capacity in the country. Some, including Atradius, are already moving in that direction. Naber says: “Our offer of a direct lending facility for small Iranian transactions of up to €5 million is open and we have recently insured our first risks on it.”

There is also another, more drastic solution. Says Shahraini: “It seems that if the banking problems continue, in order to work with Iran the Europeans may have no other choice but to establish special banks that have no interests in the US and would therefore be immune from the sanctions.”

Outlook for 2018

So looking forward into 2018 the forecast remains markedly gloomy on Iran’s prospects as a trade and project finance market. On the sanctions front, “2018 will be another complicated year, which will have significant impact on those seeking to do business in Iran,” says Oresman.

The main open question is whether the US will walk away from the current nuclear deal and impose new unilateral nuclear-related sanctions, which Trump has already threatened. There is also a chance of the US, possibly acting in concert with the EU, imposing new sanctions on Iran for non-nuclear activities such as the development of ballistic missiles, support for terrorist organisations, or human rights violations. “In 2018, more tension in the US-Iran relationship is expected and more US sanctions, at least on specific entities, is likely,” says Oresman. “An increase of EU sanctions is also possible”

As for the Iranian trade and project finance market specifically, expect institutions from the East to be the lead players in a slow-moving market. “China will in my opinion continue to take advantage of their ever increasing ties with Iran and will be the main suppliers in the oil and gas, and infrastructure sectors,” says Luketa. However, transportation and energy will remain key and Luketa believes the major European exporters such as the Italians will find a way of providing financial support under the auspices of of their ECAs, Sace in particular.

On the business front, there should also be some opportunities for smaller European suppliers. Luketa comments: “The Iranians are meeting their past payment obligations whenever they are permitted, so the credit risk remains strong. As such we should see a handful of smaller transactions completed with European medium-sized enterprises.” Nonetheless such business will likely continue to be conducted via the Iranian banks rather than through corporate or pure project financing.

Overall, the lack of clarity from Western governments and political leaders about the future trade relationship with Iran is expected to continue in 2018, and consequently caution from financiers considering market entry or growth. “As long as the US attitude remains unchanged, large banks will also not change and deal with Iran,” concludes Schweitzer. Unfortunately that’s not the kind of regime change for which Trump has recently been tweeting.