

In the Shadow of Sanctions:  
Reputational Risk, Financial Reintegration, and the Political Economy of Sanctions Relief

*Abstract*

*Financial sanctions have become a major component of American foreign policy. Since 2015, the number of blacklisted actors has nearly tripled, coinciding with US financial campaigns against Iran, North Korea, and Russia. This paper centers an under-examined paradox of this proliferation: the complexity of lifting financial sanctions. Indeed, successful sanctions regimes necessitate both sticks (punitive sanctions) and carrots (sanctions relief). Yet financial sanctions often limit the effects of sanctions relief, as banks and other financial institutions risk hefty material and reputational costs if they are to cooperate with previously-sanctioned actors. Thus, while financial sanctions are effective at producing negative market reactions against a target, they can be hugely damaging if market actors do not cooperate with the lifting of sanctions. To capture this dynamic, this paper leverages process tracing to observe financial market reactions to sanctions relief in three key cases – Iran (2010-2015), North Korea (2002-2007), and Libya (1996-2008). It finds that in each case, the presence or absence of US Treasury blacklisting corresponds to the post-sanction willingness of financial actors to extend sanctions relief to targeted states. In doing so, this study identifies ‘reputational risk’ as the primary causal mechanism limiting a target’s reintegration into the global economy.*

**I. Introduction**

Why do global financial actors sometimes choose to financially reintegrate previously-sanctioned states, though at other times choose not to do so? Targeted states reasonably anticipate that when sanctions are removed, they should receive some form of relief, meaning that global financial actors—from banks to multinational corporations—should return to status-quo capital flows and foreign direct investment. However, there are marked inconsistencies in financial actors’ reintegration behavior. In many cases, financial actors have been so reticent to reinvest in previously-targeted jurisdictions, that the states initially imposing sanctions (i.e. sender states) have engaged in lobbying efforts designed to assuage private markets, and generate investment (Schwartz & Patrick, 2016; Lakshmanan, 2016). This paper therefore examines the implementation of sanctions relief by introducing a new theoretical argument for why financial actors engage with previously-sanctioned states, and why they do not.

Financial sanctions are tools that intend to limit the provision of certain financial services, restrict access to financial markets, and prevent the movement of capital between financial actors like banks, investment firms, and multinational corporations. Historically, states utilize such tools to 1) coerce a regime, or an entity within a regime to change their behavior, 2) constrain a target by denying it access to financial resources, and 3) signal disapproval by stigmatizing and isolating targeted entities (HM Treasury, 2018: 5).

In the aftermath of financial sanctions, significant problems can arise from the failure of sender states to coordinate relief for their targets. As Nephew explains, target states may reason that if they are willing to accommodate the conditions set by their persecutors, they will be able to resume business as usual. However, if target states perceive that there is nothing they can do to reattract global capital once sanctions are implemented, then their responses to sanctions become less predictable and less beneficial for the sender state. Financial sanctions are therefore a psychological tool as much as an economic one, and their power lies in sender states’ ability to turn sanctions ‘on’ and ‘off’ as they see fit (Nephew, 2018: 1).

It should be noted at the outset, for the purposes of this analysis, that sanctions ‘relief’ is not to be confused with sanctions ‘removal,’ as both terms will appear consistently throughout. Sanctions removal will be defined as the act of the sender state ending a given sanctions program

vis-à-vis a target. Sanctions relief, on the other hand, is simply the economic activity that follows sanctions removal, i.e. financial actors' reintegration behavior.

In this study, I argue that the extent to which financial actors reintegrate previously-sanctioned states depends on the type of sanctions program deployed against them, i.e. primary or secondary sanctions. Primary sanctions exclusively prohibit the citizens or companies of the sender state from engaging in forms of economic exchange with a target state. Although secondary sanctions also prohibit such sender-target exchanges, they also dissuade sanctions busting activity of third-party financial actors by targeting exchanges between third-party actors and the target state. In such instances, financial market regulators in the sender state 'blacklist' third-parties that they suspect of sanctions-busting, and bar them further access to their financial market. 'Blacklisting,' as will be shown, carries with it significant reputational costs, which damage financial actors' economic performance by reducing their access to key capital markets and other forms of investment.

Here, I expect financial actors to assign reputational risks to states targeted by secondary financial sanctions (i.e. cases in which illicit sanctions busters are blacklisted by financial regulators). In practice, this indicates that financial actors recognize the potential for reputational damage, commensurate with conducting business with previously-sanctioned states. Due to these higher reputational risks, financial actors will be *less* likely to financially-reintegrate target states. By contrast, I expect that financial actors will be *more* likely to extend financial reintegration to states only targeted by primary financial sanctions, where blacklisting is not employed. In these latter cases, financial actors do not assign reputational risks to previously-targeted states.

To test the plausibility of the reputational risk hypothesis, this study utilizes process tracing to analyze three key episodes involving the United States and their imposition and removal of financial sanctions: Iran (2010-2017), North Korea (2002-2007), and Libya (1996-2008). As the most significant global financial actor, the United States wields unmatched financial leverage in the international system, and by observing the effects of financial sanctions stemming from US financial markets specifically, we are able to hold specific market dynamics consistent across all cases, and effectively observe the variation in patterns of sanctions imposition and their consequent forms of relief.

This research lays the groundwork for wider discussion about the implications of contemporary sanctions policies and their externalities. By understanding the conditions in which successful sanctions programs lead to failed sanctions relief, scholars gain insight into the paradox at the heart of US financial sanctions. Indeed, while such tools are highly effective at producing negative market reactions against a target, they are simultaneously tools whose effects, once unleashed, are challenging to undo, directly limiting the effectiveness of sanctions relief itself.

## **II. *Hiding in Plain Sight: The Problem of Sanctions Relief***

Sanctions relief generally escapes significant scrutiny, particularly within the wider context of existing literature on sanctions. Historically, this literature has dealt overwhelmingly with questions of sanctions effectiveness (Pape, 1997; Allen, 2005; Drezner, 2000; Lekzian & Souva, 2003; Hufbauer et. al., 2008). Here, sanctions literature has explored the links between sanctions success and factors like the cost of sanctions to the sender and/or target state, the

regime type of targets, the matching of issue salience with the magnitude of sanctions measures, and whether or not sanctions measures are unilateral or multilateral.

Yet, effective sanctions policies necessitate two key components: sticks (punitive sanctions) and carrots (sanctions relief), and while much of the literature around these components has dealt with the former (Fearon, 1998; Drezner, 2000; Lopez et. al., 2004), much less work has been done on the latter. To date, work on the latter has addressed the challenges of lifting multilateral sanctions evenly across parties (Adebehr, 2014), the impact of sanctions relief on exporting industries (Domjan et. al, 2014), and the two-level game between domestic and international constituencies *leading* to sanctions removal (Dorussen & Mo, 2001; Krustev & Morgan).

Despite these inroads, research examining what happens *after* the removal of sanctions remains largely undertheorized, which is surprising given that sanctions relief occupies a central role in effective sanctions programs, and the ability for sender states to credibly offer a return to sustainable growth and well-being. As Solingen (2012) explains, sanctions relief constitutes a ‘positive inducement,’ one that seeks “to obtain policy change by promising rather than threatening, by rewarding rather than punishing.” Moreover, successfully lifting sanctions allows sender states to credibly offer positive inducements in exchange for changes in target state behavior. Consequently, inducements seek to influence the behavior of actors by providing benefits rather than imposing costs.

However, much like the *imposition* of sanctions, relieving sanctions requires significant coordination between public and private sector actors. Typically, the cumulative resources of private sector actors dwarf those of national governments, and thus, for sanctions relief to be effective and efficient, the interests of sender governments must align with those of private sector actors. Here, the role of private actors in the *post*-sanction environment is particularly important, as their ability and willingness to re-integrate target states into the global economy ultimately determines how much economic benefit a target state is likely to receive, how such benefits are distributed domestically, and how such outcomes shape the behavior of targeted states going forward. The implications of this research gap are striking, as without understanding the internal dynamics of sanctions relief, the implementation of defective policy measures may continue to the detriment of sender states.

### ***III. Theoretical Argument***

To gain further insight into the conditions in which financial actors are more or less likely to reintegrate former targets, one must first understand the nature of US financial sanctions, reputational risk, and how such factors regulate the relationship between private sector actors and states. This study holds the assumption that there exists a relatively frictionless movement of capital between states. This condition is predicated on a further assumption that states have jurisdictional and regulatory authority over their domestic financial markets, and thus retain the ability to grant or deny access to inflows of capital. This unique ability of states to dislocate private capital from national financial markets—by tying political conditions to market access—provides states with an important source of leverage that can have significant market effects. These two conditions form the foundation of financial sanctions.

## *Financial Sanctions*

As the primary anchor-point of this analysis, the United States and its domestic financial market are endowed with the infrastructural means of controlling market access and global transactions, and do so through two key factors: US dollar dominance, and the distribution of global financial infrastructure.

US dollar dominance is a key mechanism of America's coercive capability in several respects. First, as Cohen (2003) shows, the use of strong currencies such as US dollars in international transactions is highly desirable due to 1) the political stability backing such currencies, 2) their 'exchange convenience,' and 3) access to large transactional networks. As such, global actors are keen to retain access to financial markets in which dollar transactions and dollar-denominated capital can be acquired. Zarate (2013), among others (Cohen, 2005; Kirshner 2008), thus explains the extent to which the dollar "serves as the global reserve currency and the currency of choice for international trade." This capacity for dollar-clearing provides the United States Treasury with a coercive capability through their jurisdictional stranglehold over international payments, and with 80 percent of international trade and 87 percent of foreign exchange transactions involving the US dollar, the US Treasury has significant control over international access to US capital (Caytas, 2016: 454, 462).

Moreover, America's privileged access to the technological infrastructure connecting the global financial system enables it to extend this regulatory jurisdiction well beyond its borders. Farrell & Newman (2019), for instance, argue that the distribution of key financial infrastructures – such as the SWIFT messaging system and the internet – provides certain states exorbitant privilege in their ability to control access to their financial markets.

However, there is an additional aspect to US financial sanctions that amplify their effects on global capital, and that is that US financial sanctions are implemented as *secondary* sanctions. In practice, this means that the Treasury can not only sanction illicit actors, but also any third-party actors found to be doing business with them. The development of secondary sanctions created a new set of incentives for private-sector actors by raising the potential costs associated with sanctions-busting behavior, and creating *reputational risks* for non-compliant third-party actors. Secondary sanctions threaten the financial reputations of legitimate institutions, and thus threaten to exclude such actors from global financial markets and restrict the pool of actors willing to conduct business with them (Feaver & Lorver, 2010).

## *Reputational Risk*

Reputational risk is the "risk arising from negative perception on the part of customers, counterparties, shareholders, investors... or regulators that can adversely affect a bank's ability to maintain existing, or establish new business relationships and continued access to sources of funding" (Basel Committee on Banking Supervision, 2009: p.19). Such reputational effects are often measured in terms of lost revenue, increased operating, capital or regulatory costs, or destruction of shareholder value (Feaver & Lorver, 2010).

Reputation assumes special importance in banking and financial sectors, as asymmetric information about other financial actors' conduct can create systemic risk in which trusting relationships between financial actors begin to break down (Allen & Santomero, 1997; 2001). Of particular import to this analysis, Sharman (2009) shows that 'blacklisting' constitutes a speech act, in which financial actors are not simply labeled as 'illicit,' but in fact *become* illicit.

Reputation is thus an ‘intangible asset’ that investors trust will be directly related to future profitability or decline.

While existing studies on reputational risk address the impact of sanctions implementation on individual firms’ share prices, there appear to be few studies addressing the persistence of these reputational effects following sanctions removal. Amour, Mayer & Polo (2017) show that the initial enforcement of financial sanctions by UK regulatory authorities has negative impacts on the market price of penalized firms, yet the authors simply address the initial announcement of misconduct and its effect on share price, rather than the corresponding changes in share price when punitive measures are lifted. Others, like Eggenberger (2018), show that OECD blacklistings of Liechtenstein and Nauru triggered adverse market reactions that proved effective at altering these states’ behavior to become compliant with global money laundering regulations. Interestingly, Eggenberger briefly mentions the difficulty these states had in attracting foreign investment *years* after their initial infractions and changes in their behavior, yet does not engage with this longer term reputational effect.

By observing the effects of reputational damage on the sanctions relief of actors once deemed ‘illicit,’ it is possible to get a more complete picture of how reputational risk lingers after target states are released from sanctions, and thus allows us to observe the long-term implications of one of the most prolific policy tools in use today. Based on the preceding conditions, I posit the following hypothesis:

*H: Financial actors will be less likely to reintegrate former secondary sanctions targets into the global economy, though more likely to reintegrate targets of primary financial sanctions.*

Figure 1 specifies the theoretical argument. As seen in Track 1, I expect that in cases of secondary sanctions, financial actors will deem states as sources of reputational risk. Firms anticipate that the reputational costs associated with reinvestments will outweigh potential benefits. They therefore choose not to financially reintegrate the previously-sanctioned states. However, as seen in Track 2, cases where states have experienced primary sanctions should lead to the opposite phenomenon. Specifically, financial actors should view these states as low-risk and subsequently financially reintegrate them into the global economy.



Figure 1.

#### IV. *Competing Explanations*

##### *Sender State-Market Signaling*

Rather than the reputational risk hypothesis, the extent to which previously-sanctioned states re-establish financial integration to the global economy may be a function of sender states credibly signaling to private market actors that their intent to remove sanctions is lasting, and target states credibly signaling their commitment to the conditions of sanctions removal. Sanctions have important signaling properties insofar as they transmit preferences and intentions between actors. Yet the complexity of sanctions signaling is often compounded by how actors send signals credibly. Credible signals are often those that are most costly to the sender, i.e. signals that generate higher political costs that the leader would not be willing to accept if they were not also willing to carry out the threat (Fearon, 1997; Schwebach, 2000). However, as Lektzian & Sprecher (2007) note, states choosing to implement sanctions will often design such measures to minimize costs to themselves and, as a consequence, sanctions may in fact signal weakness and indecisiveness, rather than signals of resolve, rendering sanctions an ineffective signaling mechanism.

Generally, our understanding of the use and effectiveness of sanctions as signaling mechanisms exists in the context of bilateral relationships between sender states and target states, and how such signals relate to the bargaining space between them. However, this literature has somewhat neglected the fact that sanctions also fundamentally signal resolve or weakness to third party actors, such as firms, upon whom the implementation of sanctions is heavily reliant. Thus, the ways in which private market actors interpret such signals will likely impact their patterns of investment behavior, yet this literature does not clearly define how signaling affects non-state actors' behavior.

One might expect, all things being equal, that the removal of sanctions would signal to private market actors that: 1) the target state felt that such measures were sufficiently damaging to credibly negotiate removal, and 2) their resolve to sustain sanctions relief would drive them to credibly maintain their compliance with sender state conditions. As Grabel (2000) explains, compliance with international norms and financial regulations are central tenets of policy credibility, and therefore form strong preconditions for capital mobility and integration into global financial networks. Overall, the cumulative effects of these conditions suggest that the removal of financial sanctions would signal a less-risky environment for investment, and thus generate greater financial reintegration of the target state back into global markets.

If signaling effects were responsible for the level of financial reintegration, then poor levels of financial reintegration would suggest that states signaled their preferences and intentions inefficiently. However, as will be shown, insufficient signaling cannot account for the lack of financial reintegration target states are likely to experience. Sender states in the cases addressed below engaged in strong lobbying efforts designed to assuage private market actors and actively *encourage* the reintegration of previously-targeted actors to the global economy. Despite these active efforts, cases in which secondary financial sanctions were implemented were accompanied by lower levels of financial reintegration, which this paper proposes is a result of reputational risk.

## V. *Methodology*

To illustrate the dynamics linking reputational risk and sanctions relief, this study employs a process-tracing approach to analyze three key episodes involving the United States and the imposition and relief of financial sanctions: 1) Iran (2010-2017), North Korea (2002-2007), and Libya (1996-2008). Here, there are two positive cases (Iran and North Korea), each emphasizing reputational risk and the hypothesized negative effects on sanctions relief. In the third, Libya, we examine a negative case in which reputational effects and their impact on sanctions relief are expected but do not materialize.

The data required for this analysis includes flows of foreign direct investment, as well as news-media, business reporting, and primary source materials such as public statements and press releases by firms. These data were chosen as they reflect the reputational risk considerations of private-sector actors involved in the implementation and relief of US financial sanctions, and how such considerations impact market behavior.

### *Case Selection*

In a study reliant upon a small sample of cases, it is important to acknowledge the possibility of selection bias, as small-N studies place very real restrictions on randomly selecting cases out of a larger universe of cases. Collier & Mahoney (1996) explain that, within the realms of international relations and comparative politics, scholars may often select extreme cases on the dependent variable, leading to biased estimates of the impact of a given independent variable over the generalized population of cases. However, this study seeks to leverage three ‘substantively important’ cases, defined by Mahoney & Goertz (2006) as cases possessing “special normative interest,” and that play a “current or major role in domestic or international politics.”

All three cases share vital components. In all three cases the *source* of financial sanctions remains constant, emanating from the United States, and thus we can assume that global financial actors are reacting to a similar set of financial regulations and seeking to retain access to the same financial market. Second, all three cases were designed as ‘financial embargoes’, meaning severe restrictions on almost all capital inflows and outflows from a target state, a condition which allows us to control for variation in the magnitude of different sanctions programs. Third, as all three cases involve US financial sanctions targeting the nuclear programs of other states, we are also able to control for variation in issue salience between cases. The variation under observation, therefore, is the variation in reputational risk accompanying different types of sanctions implemented between these various cases, and the downstream macro-economic impacts on financial actor behavior. The selection of these cases thus allows us to more keenly observe how the causal mechanism itself varies with different mediating conditions (Gerring, 2007a; Seawright and Gerring, 2008).

### *Process-Tracing*

This study utilizes a process tracing approach to observe four critical phases: 1) sanctions implementation, 2) initial market reaction to sanctions, 3) sanctions removal, and 4) subsequent market reaction to removal. In addressing these phases specifically, this study allows us to observe the initial variation in sanctions measures applied to US targets (either secondary or primary measures), followed by the impacts of such measures on targeted economies, and the subsequent economic effects accompanying their removal. Here, the necessary and sufficient conditions that would confirm the reputational risk hypothesis would be 1) the condition of US financial regulations granting the US power to bar access to US financial markets (necessary condition), and 2) the tangible act of blacklisting financial actors, third-party or domestic (sufficient condition). As will be seen, the cases referenced in this study offer a range of evidence allowing us to affirm causal inference, and pass a series of smoking gun and doubly-decisive tests.

For the purposes of this study, applying process-tracing to a small-N sample offers a more informative analysis than that of a statistical, large-N approach. This study’s primary purpose is to isolate and assess the impact of reputational risk, and the ways in which it alters financial actors’ *decision-making*, a purpose for which a statistical approach would seem ill-suited. Indeed, while quantitative methods allow us to observe the effect of one or more independent variables on a given dependent variable, statistical outputs still require the explanatory power of largely-unobservable causal mechanisms to assess causation, something for which process-tracing is more well-suited. Moreover, given the current lack of appropriate theorization about the reputational causal mechanism in sanctions and IPE literature, a more incisive qualitative approach assessing its impact is certainly appropriate from both an empirical and theory-building perspective.

## **VI. *Sanctions Relief in the Case of Iran***

The initial implementation of financial sanctions in the Iranian episode proved extraordinarily effective in altering Iranian nuclear policy and behavior. However, during the phase of removing financial sanctions, global financial institutions were largely averse to reintegrating Iranian banks and institutions into the global financial system. As will be shown,

the reticence of these financial actors to provide financial reintegration is directly limited by residual reputational risk stemming from US financial sanctions between 2010 and 2015.

### *Iranian Sanctions and their Impacts*

In 2010, the United States introduced the Comprehensive Iran Sanctions, Accountability and Divestment Act (CISADA), a series of financial sanctions prohibiting US and foreign-based financial institutions from dealing with sanctioned Iranian actors and institutions. Under this sanctions program, virtually all Iranian financial institutions, including the Iranian Central Bank, found themselves cut off from SWIFT—the global financial messaging system designed to send and receive money transfers. To that end, US financial sanctions sought to prevent global financial institutions from “handling any transactions with foreign banks that [in turn handled] transactions on behalf of an Iranian bank” (Katzman, 2019: p.i).

These secondary sanctions thus extended US financial restrictions from Iranian actors to *any* global financial institution found to be non-compliant with US sanctions measures. In return, non-compliant actors would ultimately be barred “from conducting deals in the United States or with the US dollar” (Laub, 2015). The coinciding reputational risks for global financial actors were so potent that even in cases where the Treasury extended oil import waivers for cooperative states, their “banks [were] no longer prepared to take the reputational risk of handling the payments. The result [was] that some banks cut their links with Iran even if legally they [did] not need to” (Blas, 2012).

The accumulation of reputational and material risks began a cascade of financial divestments from Iran’s oil sector beginning in July of 2010. By September of that year, the US State Department announced that numerous European energy giants, including Glencore, Trafigura, Total, BP, Royal Dutch Shell, LUKOIL and ENI had collectively pulled between \$50 billion and \$60 billion of upstream energy investments in Iranian oil production. US financial sanctions also triggered a general wave of capital flight, as “foreign direct investment tumbled from \$4 billion in 2010 to ‘a complete halt’ in 2012.” (Mufson, 2015).

During this period, US regulators reinforced these sanctions by levying major fines against global banks for processing transactions to and from Iran in violation of US financial sanctions. This included the likes of BNP Paribas, HSBC, and ING, while firms such as JP Morgan, Wachovia and Citigroup were cited for inadvertent lapses in anti-money laundering standards that led to Iranian sanctions evasion (Viswanatha, 2012). The impact of these fines stimulated an increasingly robust effort on behalf of large global banks to improve their anti-money laundering standards and invest heavily in compliance officers to screen payments and transactions that could come to be troublesome for their downstream performance (Sun, 2019).

Although the short-term impacts of reputational risk produced a strong, negative market reaction toward Iranian targets, the long-term consequences of this reputational effect would prove highly damaging, as the threat of reputational damage associated with non-compliance with US sanctions quietly filtrated throughout the global financial system, creating a condition in which the removal of sanctions had an observably muted impact on Iran’s financial reintegration into the global economy.

### *Sanctions Removal: Global Financial Institutions’ Response to the JCPOA*

The formal removal of sanctions in 2015 came in the form of the Joint Comprehensive Plan of Action (JCPOA), which afforded Iran several key inducements. First, and most important

of which was the easing of secondary sanctions, which removed “(1) sanctions that limited Iran’s exportation of oil and sanction foreign sales to Iran of gasoline and energy sector equipment, and which limit foreign investment in Iran’s energy sector; (2) financial sector sanctions” (Katzman, 2019: 44). The ultimate expectation of these conditions was that, “with the Central Bank no longer in the vise-like grip of the US Treasury, and with SWIFT messages flowing, Iran’s financial sector [would] soon be operating at pre-sanctions levels” (Nephew, 2016: 11).

The *expected* effects of unwinding US financial sanctions were therefore predicted to be significant. According to the World Bank, foreign direct investment was expected to “climb to as much as \$3.5 billion in a couple years” (Mufson, 2015), while others, such as the Foundation For the Defense of Democracies, asserted that the effect of the JCPOA would provide an economic boost “from capital inflows that facilitate investment and employment,” though noting that “global companies are still reticent to invest in Iran,” and that there was “no evidence of new investment yet” (FDD, 2014: 8).

The removal of financial sanctions brought with it a number of key sanctions relief outcomes. Foremost among these, Iran’s access to the SWIFT electronic payments system was restored in early 2016, which enabled Iran to re-establish capital mobility between it and the global financial system. However, despite this restoration of Iranian capital mobility, the US Congressional Research Service noted that global banks were reticent to reenter the Iranian market after the 2016 easing of sanctions, largely due to “lingering concerns over past financial penalties for processing Iran-related transactions in the U.S. financial system” (Nephew, 2016: 65). Regarding this noticeable dearth of global investment after sanctions removal, Reuters reported that, despite the fact that “international financial sanctions on Iran were officially lifted in January [of 2016]... [Iran] has secured banking ties with only a limited number of smaller foreign institutions,” adding that “banks appear to be increasingly reluctant to do business now with Iran... [due to] extreme nervousness about that whole issue from a reputational risk perspective” (Saul & Hafezi, 2016).

This sanctions relief period witnessed the emergence of an ‘over-compliance’ trend in global finance that rendered most large banks reluctant to underwrite deals with Iran (Rezaei, 2017). So strong was this trend for ‘over-compliance’ that a senior European banker, speaking to the Guardian in January 2016, stated, “I am yet to find one tier-one European investment bank that wants to go back into Iran,” a level of caution that is consistent with most banks stating that “there was no change in their existing policy” after the removal of sanctions (Kamali Dehghan, 2016). Iran’s reintegration with international banking was “sufficiently slow and vexing [to] the Supreme Leader of Iran” who used his annual Nowruz speech in 2016 to criticize the United States for the lack of sanctions relief having reached Iran after sanctions had been removed (Nephew, 2016: 11).

### *The P5+1 Pro-investment Initiative*

Was state signaling insufficient to induce global financial actors to reintegrate Iran into the global financial system? What is clear is that sender governments and their domestic banks strongly diverged on their desire and willingness to restore financial relations with Iran. In contrast to reticent global financial actors, the United States expressed a strong desire to improve Iran’s global reintegration, in order to facilitate and incentivize its compliance with the non-proliferation conditions of US sanctions. During this post-JCPOA relief period, the US Department of State conducted a series of meetings with the heads of several of the world’s

largest banking institutions, signaling to market actors not simply that it was safe to once again do business with and invest in Iran, but also signaling US preferences for Iran's reintegration into the global financial system.

In May of 2016, US Secretary of State John Kerry chaired a joint meeting of nine executives from Europe's largest banks, along with officials from the US Treasury, British Foreign Secretary Philip Hammond, Britain's Secretary of State for Business Sajid Javid, and Norman Lamont, Britain's trade envoy to Iran (Brunstromm, 2016). Among the banking delegation was Deutsche Bank CEO John Cryan, HSBC UK head Antonio Simoes, Credit Suisse CFO David Mathers, as well as representatives from Standard Chartered, BNP Paribas, Santander, Royal Bank of Scotland, Lloyds, and Barclays. During this meeting, Reuters reported that Kerry "told Europe's top banks they have nothing to fear from resuming business with Iran as long as they make proper checks on trade partners and pursue 'legitimate business'" (Brunstromm, 2016). Kerry stated soon afterward, that the United States "[wanted] to make it clear that legitimate business, which is clear under the definition of the agreement, is available to banks" (Brunstromm, 2016), and further signaled that, "[the Iranians] have an expectation that the sanctions that are supposed to be lifted are in fact lifted" (Schwartz & Patrick, 2016). Despite this public, state-driven initiative, Iran's annual foreign direct investment declined between 2016 and 2017, dropping from \$3.02 billion in 2016 to \$2.35 billion in 2017,<sup>1</sup> all despite a sharp rise in crude oil prices from \$36.77 per barrel in January 2016 to \$66.87 per barrel by December of 2017,<sup>2</sup> a spike of more than 45%.

The removal of secondary financial sanctions thus did not precipitate the level of sanctions relief and financial reintegration that was expected. The United States and its P5+1 partners hoped, and *needed* global financial institutions to reintegrate targeted Iranian entities as a matter of long-term non-proliferation goals. Yet private market actors had, over time, become highly compliant with US secondary financial sanctions due to the potential reputational costs of blacklisting, and the removal of secondary measures in this instance did not immediately undo such ingrained risk aversion. Reputational risk thus extended beyond the removal of financial sanctions, complicating Iran's reintegration into the global economy. Indeed, "stigmatizing all business with Iran [had become] the new sanction," and that sanction was privately enforced against the wishes of world powers (Lakshmanan, 2016).

### *Competing Hypothesis: State-Signaling and Financial Actor Responses*

If signaling effects were responsible for the level of Iran's financial post-sanction reintegration, then poor levels of financial reintegration would suggest that states signaled their preferences and intentions inefficiently. However, as the evidence above reflects, the removal of financial sanctions under the JCPOA was accompanied by a strong, public, US-orchestrated campaign designed to assuage financial actors of any concerns related to the future reintegration of Iranian targets. Despite such explicit signals of state preferences, market actors did not respond in a way that, *ceteris paribus*, would be consistent with expected market behavior following the removal of sanctions. The nature, clarity and consistency of US signaling, and how it related to financial actor interests, thus does little to explain financial market reticence, unless such market behavior can be understood in terms of its reputational risk calculations.

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<sup>1</sup> CEIC Data, "Iran Foreign Direct Investment." <https://www.ceicdata.com/en/indicator/iran/foreign-direct-investment>

<sup>2</sup> Markets Insider. Oil (Brent), <https://markets.businessinsider.com/commodities/oil-price>

Reputational risk is more effective as an explanation for the reintegration dynamics we see in this episode, as it allows us to take into account the specific costs and risks that remained in place for financial actors once sanctions have been removed with the signing of the JCPOA. Moreover, it specifically acknowledges the nature of financial actor agency in ways that state signaling explanations cannot. Signaling explanations would expect that the strong signals being sent by the United States and other members of the sending coalition would have resulted in more exuberant market behavior and a higher likelihood of Iran being more fully reintegrated. Yet in the absence of such a market reaction, it is increasingly clear that reputational risk concerns were the prime inhibitor to reintegration, as financial actors remained wary of engaging with previously-sanctioned Iranian financial actors and institutions.

The removal phase and P5+1 pro-investment initiative thus provides strong doubly-decisive evidence in which both necessary and sufficient conditions are met, and appears to confirm the reputational risk hypothesis, while significantly weakening the competing ‘state signaling’ hypothesis.

## **VII. *Sanctions Relief in the Case of North Korea***

Similar reputational dynamics can be seen in the case of US financial sanctions on North Korea in the early 2000s, in which the United States sought to entice the Kim regime to return to Six-Party nuclear talks via the imposition and removal of financial sanctions. Yet, the unwinding of secondary financial sanctions on North Korea would prove immensely difficult. The initial market reaction to sanctions, in which global banks rejected North Korean funds and transfers like an illness, could not easily be reversed, and as a consequence the United States lost its ability to credibly offer sanctions relief from its own sanctions measures.

### *North Korean Financial Sanctions*

North Korea, like Iran, has a long and complex history of nuclear-related sanctions. In November 2002, the withdrawal of North Korea from the Non-Proliferation Treaty (NPT) triggered a prolonged nuclear scramble, for which The Six-Party Talks became the primary diplomatic venue. Seeking to improve its bargaining position, the United States implemented financial sanctions targeting global banks responsible for facilitating illicit regime activity and sanctions evasion.

A significant aspect of the regime’s nuclear activities during this period derived from North Korea’s ability to access the global financial system through a sophisticated illicit network of financial institutions. Included within this network was a North Korean domestic bank, Tanchong Commercial Bank, the North Korean Mining and Development Corporation (KOMID), as well as Daedong Credit Bank, at the time the only international bank doing business in North Korea itself (Zarate, 2013: 225). The regime also retained a complex web of bank accounts spanning from Austria to Macau, Russia, Vietnam, Singapore and, crucially, China.

Beginning in 2002, the United States began a regulatory campaign known as the ‘Bad Bank Initiative,’ targeting North Korea’s illicit financial ties (Zarate, 2013, 232). Here, the US Treasury sought to engineer a severe market reaction, targeting North Korean funds, and blacklisting complicit financial actors found to be harboring North Korean funds.

As will be shown in the pages to come, the imposition of secondary financial sanctions in this instance produced strong reputational risk concerns among global financial institutions that directly limited their desire to comply with US sanctions relief. To more directly address these dynamics, we will first discuss the case of Banco Delta Asia – a Macau-based bank – and the wider market and reputational implications that accompanied its blacklisting by the US Treasury. While secondary measures would ultimately produce their desired outcome in financially severing the Kim regime from the global financial system, sanctions removal did not financially reintegrate regime-affiliated institutions once capital mobility had been restored.

### *Banco Delta Asia and Reputational Risk*

One of North Korea's major points of entry into the global financial system was the Macau-based Banco Delta Asia (BDA), which US regulators found to be laundering North Korean funds through approximately 50 North Korean-held accounts (Zarate, 2013: 225). In September 2005, the US Treasury made BDA the focal point of its Bad Bank initiative and financial constriction campaign, publishing a 'Section 311' regulatory advisement instructing US banks to end any and all relationships with what it described as "a primary money-laundering concern" facilitating North Korean nuclear proliferation (Zarate, 2013: 226).

As Zarate explains, "in a single stroke the bank was converted into a financial pariah in the US and international financial system" (Zarate, 2013: 240). Beginning soon after this regulatory action was "a chain of market-driven rejections of North Korean accounts and transactions" (Zarate, 2013: 240) including a run on approximately \$133 million of private BDA deposits – which accounted for some 33 percent of the bank's total deposits (Greenless & Lague, 2007). Globally, "other financial institutions began severing their ties with North Korea, not wanting to risk entanglement in North Korean illicit activities and possible expulsion from US financial markets" (Lague & Greenless, 2007). The compliance officers and general councils of international banks with North Korean clients "quickly realized the reputational risks they faced" (Zarate, 2013: 241) and "started to shun business with North Korea, creating an informal financial embargo of the country" (Greenless & Lague, 2007).

Importantly, Chinese state-owned banks, who had been amongst the most permissive financial institutions facilitating North Korean access to global financial markets, reacted to the BDA regulation just like other banks, as "they, too, were worried about appearing to be facilitating North Korean illicit financial activity, and they began to close and scrutinize North Korean accounts and transactions. Chinese banks wanted access to New York and wanted to be perceived as legitimate international financial institutions" (Zarate, 2013: 242). Soon, major Chinese financial institutions – such as The Bank of China, Chinese Citic Bank, the Chinese Construction bank, and Shanghai Pudong Development Bank – began freezing a number of accounts containing several million dollars (Firfield & Kirchgaessner, 2006), and blocking financial transactions between Chinese and North Korean companies and individuals (Fairclough, 2006).

### *Sanctions Relief: Failed Attempts to Financially Reintegrate North Korea*

The cumulative impact of this US-led market reaction included important diplomatic concessions in November 2006, when North Korea agreed to return to Six-Party Talks "on the premise that the issue of lifting financial sanctions [would] be discussed and settled" (Zarate,

2013: 253). The principle action in unwinding such financial sanctions centered around the ‘unfreezing’ of \$25 million of North Korean assets held by Banco Delta Asia, and the repatriation of such funds to Pyongyang.

Interestingly, “American senior officials would often ask if the briefers were misstating ‘million’ instead of ‘billion,’” due to the fact that, “twenty-five million dollars seemed a small price to pay to bring the North Koreans back to the Six-Party Talks” (Zarate, 2013: 255). However, as Zarate explains, “the amount of money wasn’t the issue – they wanted the frozen assets returned so as to remove the scarlet letter from their reputation... [as] the first step in restoring their ability to do business with banks” (Zarate, 2013: 255-256). Securing the return of these assets via a recognized and ‘legitimate’ international financial institution thus represented an opportunity for North Korea to demonstrate that “their assets were no longer toxic and could be touched again without fear of subsequent [sanctions]” (Zarate, 2013: 257).

However, removing secondary financial sanctions on BDA proved to be an intensely difficult exercise, for doing so required the United States Treasury to find a reputable financial institution willing to receive tainted North Korean assets and divert them to Pyongyang. In the course of doing so, the Treasury found that “no bank... would even touch such a transaction,” due to fears that they would “be subject to some form of sanction or additional attention in the future” (Zarate, 2013: 258).

#### *Market Failure: US intervention in North Korea’s Financial Reintegration*

In seeking to reintegrate North Korea into the global financial system, the United States actively sought the cooperation of Chinese financial officials with intent of transferring toxic North Korean assets through the Chinese financial system. Yet, despite being explicitly reassured that compliance with US sanctions relief measures was safe, Chinese financial actors actively resisted financially reintegrating North Korea into their financial system due to concerns “about the taint of North Korean accounts and the reputational impact [it] could have” on their access to global capital markets (Zarate, 2013: 256). Chinese financial officials “saw this as a moment to insulate the Chinese banking system from North Korea’s illicit financial activity,” and by refusing to expose Chinese banks to toxic North Korean assets and their corresponding reputational risks, Chinese finance officials had refused to comply with the US sanctions relief initiative (Zarate, 2013: 262).

Further US government efforts to mobilize global financial actors in transferring of North Korean assets proved extremely difficult. Assistant Secretary of State for East Asian and Pacific Affairs, Chris Hill “spent weeks trying to find a bank that would help in the transfer of the assets” (Zarate, 2013: 263). In 2007 the BBC reported that, “banks around the world have refused to touch the money” (BBC, 2007b) and that “banks in China and Vietnam [had] been approached and [had] refused to get involved” (BBC, 2007a). As a result, US officials increasingly sought assistance from US banks in assisting with the transfer of North Korean funds, none of which were ultimately willing to expose themselves to such funds. One such bank – Wachovia – was approached by the US State Department, but “refused to carry out the transaction” (Weissman, 2007). The bank resisted complying with the US sanctions relief initiative out of concern that handling North Korean funds would make them vulnerable to “future sanctions or regulatory actions” and sought “assurances that it [would not be] in breach of section 311 [of the Patriot Act]” before ultimately declining any and all assistance to the US Treasury (BBC, 2007a).

Due to market wariness of toxic North Korean assets, the United States was forced to channel illicit North Korean funds through the New York Federal Reserve Bank and the Russian Central Bank (Yukhananov & Strobel, 2014), who then transferred North Korean assets through the Far Eastern Bank in Vladivostok – where North Korea kept a long-unused account. From there, Far Eastern transferred the funds to the North Korean Foreign Trade Bank (Zarate, 2013: 264), and on June 25, 2007, a North Korean Foreign Ministry spokesman finally confirmed the receipt of its BDA funds (Davenport, 2019).

As reflected above, the reticence of global financial actors to comply with US sanctions relief initiatives was a direct consequence of reputational dynamics linked to the US Treasury's secondary financial sanctions. Reputational effects in these preceding cases have shown a certain degree of 'stickiness,' i.e. that once reputational risks have been applied to certain 'illicit actors', such reputations are not easily undone, even in cases where sender states explicitly attempt to undo their own sanctions measures for their own national security purposes.

The removal phase of sanctions in the North Korean episode once again provides doubly-decisive evidence in which both necessary and sufficient conditions are met, and appears to confirm the reputational risk hypothesis while comprehensively ruling out the competing 'state signaling' hypothesis. In these phases we see clearly the impact of reputational risk on financial actor reintegration behavior, existing alongside what would appear to be strong state signaling. Here, financial actors that had previously comprised North Korea's financial network refused to cooperate with reintegration, behavior that was mirrored by financial actors who had no previous involvement with North Korean capital or accounts, despite the fact that both sets of actors were directly approached by the Treasury to channel North Korea's tainted funds from BDA.

#### *Competing Hypothesis: State Signaling and Financial Actor Responses*

If signaling effects were responsible for the lack of North Korea's financial reintegration, then we would expect to have seen the United States signaling its preferences and intentions inefficiently, leading to financial actor reticence. However, the removal of financial sanctions in the North Korean episode was accompanied by direct US intervention with financial actor decision-making, in a way that was designed to assuage financial actors of any concerns related to the future reintegration of North Korean targets. In spite of these explicit signals many global banks actively resisted reintegration. Cumulatively, this suggests that, though strong state signaling was present, it does little to explain financial market aversion to reintegrating North Korean financial institutions, unless such market behavior can be understood in terms of the reputational risk calculations of individual financial actors.

Reputational risk thus appears to be the more effective explanation regarding the reintegration dynamics we see in the North Korean episode, as it allows us to take into account the specific costs and risks that remained in place for financial actors once the United States attempted to remove sanctions. This case provides doubly-decisive evidence for the impact of reputational risk on financial actor reintegration behavior, and substantially weakens our competing hypothesis.

We will now discuss a negative case, one in which financial sanctions were applied and subsequently relieved, yet one in which the target state was not rejected by global financial actors once capital mobility had been restored. As will be shown, the reintegration of Libya into the global economy occurred due to a distinct lack of reputational risk dynamics, a condition that

this study asserts is due to US financial sanctions on Libya being ‘primary’ financial sanctions that avoided blacklisting third-party financial actors.

### *VIII. Sanctions Relief in the Case of Libya*

Unlike the reputational dynamics illustrated in the Iran and North Korean episodes -i.e. strong market-driven rejections of previously-sanctioned states- the Libyan episode reveals the inverse phenomenon, the removal of financial sanctions followed by a swift and positive response by global financial actors. Libya thus represents an intriguing test case, illustrating not only how financial sanctions might be more effectively implemented, but the conditions under which the removal of such financial measures might lead to more successful relief overall.

As with the previous two cases, US sanctions removal in Libya became heavily linked to the nuclear weapons program of the target state. In July of 1995, IAEA reports asserted that Libya had made a “strategic decision to reinvigorate its nuclear activities, including gas centrifuge uranium enrichment,” a technology that could be used to enrich uranium for use in nuclear reactors (Davenport, 2018). The US policy response -in August, 1996- was the passage of the Iran-Libya Sanctions Act (ILSA), authorizing the Executive branch to impose financial sanctions against foreign companies investing over \$40 million into the Libyan oil sector, a figure that was lowered further to \$20 million in 2002 (Davenport, 2018). These measures “threatened US market access to any foreign company” engaging with or investing in this most vital of Libyan sectors (Nephew, 2018).

Over the coming months and years, Libya became increasingly cooperative on issues relating to its nuclear program and its wider non-proliferation efforts. Indeed, “Libya wanted to be largely normalized and was prepared to pay a price to achieve this end,” but in exchange, Libya “also wanted to receive the benefits of this normalization” (Nephew, 2018: 6). Libya’s improved compliance behavior was, in fact, tied directly to the quality of sanctions relief and financial reintegration it experienced following the removal of financial sanctions, as the regime “had gained concrete benefits from sanctions being lifted in the form of improved access to international markets and sources of capital” (Nephew, 2018: 20). In 2003, the year prior to sanctions removal, Libya’s FDI inflows stood at just \$143 million, a figure that would suddenly skyrocket to \$ 1.03 *billion* in 2005, the year following removal (IndexMundi – Libya FDI Inflows).<sup>3</sup> FDI inflows would continue to grow steadily in the post-sanction period, to \$2.06 billion in 2006, \$4.6 billion in 2007, and \$4.1 billion in 2008 (IndexMundi). This is a significant market response, given that between the implementation of the Iran-Libya Sanctions act in 1996, and the removal of these financial sanctions in 2004, the highest net inflow of FDI stood at just \$145 million, occurring in 2002 (IndexMundi). By understanding the nature of the measures implemented during this episode, and their coinciding reputational risk dynamics, it will be possible for us to more effectively understand the nature of financial sanctions more broadly, and the conditions for successful relief of these measures more specifically.

#### *The Iran-Libya Sanctions Act: Primary Financial Sanctions At Work*

Why did Libya experience such strong financial reintegration into the global financial system following the removal of US financial sanctions, while Iran and North Korea did not?

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<sup>3</sup> Libya’s FDI data can be found at [www.indexmundi.com/facts/libya/indicator/BX.KLT.DINV.WD.GD.ZS](http://www.indexmundi.com/facts/libya/indicator/BX.KLT.DINV.WD.GD.ZS)

Such curious variation can be explained by examining the ILSA itself, reflecting reputational risk dynamics that appear to be muted.

The ILSA in effect “blacklisted foreign firms for their activities in Libya” (Schwartz, 2007: 564), and was designed “to deter investment by non-US companies in [Libya’s] oil production sectors” (Meyer, 2008: 929). The violation of US secondary financial sanctions could result in the denial of access to US capital and any import-export financing or support for non-US firms and financial actors (Meyer, 2008: 929). The terms of these provisions, i.e. the denial of access to US capital to non-compliant global actors, were *secondary* sanctions measures intended to “influence the activities of foreign firms operating [in Libya]” (Meyer, 2008: 930). However, the unilateral implementation of these secondary measures by the United States proved politically problematic, particularly with the European Union, who began to implement their own “retaliatory laws to block or offset any damage to their companies’ business interests” (Meyer, 2008: 929).

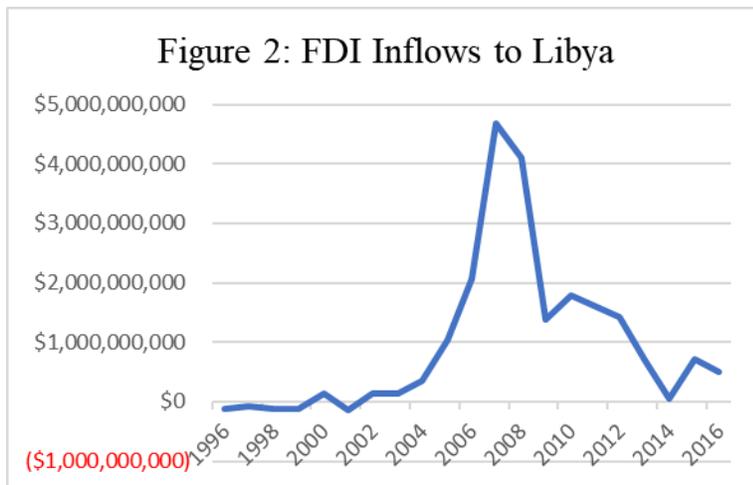
In the face of this strong political backlash, “the United States ultimately relented by means of presidential waiver of application of the disputed secondary sanctions provisions” (Meyer, 2008: 929-930). In 1998 the European Union received important concessions that the United States would “not seek or propose, and [would] resist, the passage of new economic sanctions legislation based on foreign policy grounds which is designed to make economic operations of the other behave in a manner similar to that required of its own economic operators” (Smis & van der Borgh, 1999: 231). The Clinton Administration, in response, extended waivers to EU member states, thus “exempt[ing]... EU companies from the most controversial aspects of the [ILSA],” effectively removing secondary financial sanctions and the threat of blacklisting for foreign financial actors (Smis & van der Borgh, 1999: 232).

With secondary measures removed, so too was the threat of US Treasury blacklisting and the corresponding reputational effects threatening exclusion from US financial markets for interacting with an actor under US sanctions. European financial actors could now operate in a regulatory environment that did not preclude them from conducting business with Libya, freeing them from the threat of blacklisting, unlike their US counterparts. Importantly, by the time the ILSA was finally removed in 2004, the dynamics of the reputational risks, which had stunted sanctions relief in Iran and North Korea, were of drastically different character in the Libyan case. As will be shown, financial sanctions removal preempted an immense and sustained inflow of foreign direct investment, as Libya experienced strong reintegration into the global financial system.

### *Sanctions Relief: A Positive Market Response*

The global market response to the removal of financial restrictions on Libya was very different to that of previous cases this study has discussed because financial actors perceived sanctions as primary and thus low-risk. According to Nephew (2018), “for those measures most directly linked to external participation, Libya benefited greatly from sanctions removal” (Nephew, 2018: 17). As seen in Figure 2, during the period in which the Iran-Libya Sanctions Act had been implemented (1996-2004), inflows of foreign direct investment averaged only \$24,155,456 per year (IndexMundi).

Following the removal of the secondary sanctions statute in 1998, global financial actors did not immediately reinvest in Libya, as UN Security Council members, France and Great Britain retained an embargo on oil-related investments and technology transfers, and, moreover,



US financial sanctions still applied to US firms, particularly US oil production firms. In practice, this meant that Libya could not access vital technologies required to modernize their production facilities and extraction methods, all of which ultimately contributed to a lack foreign oil and gas investments (Bruce St. John, 2008: 83). Indeed, “it soon became clear that the American oil companies would have to participate to generate the desired level of investment. Libya needed leading-

edge exploration and development technology as well as the enhanced oil recovery techniques necessary to soften the natural decline in maturing fields” (Bruce St. John, 2008: 83).

However, the official removal of US sanctions triggered an enormous market reaction. Between the official removal of sanctions in 2004 and the onset of the global financial crisis in 2008, average inflows of FDI to Libya shot up to \$2.45 billion, reaching as much as \$4.68 billion in 2007 and a further \$4.1 billion in 2008 (IndexMundi). Libya’s financial reintegration into the global financial system was aided by a series of Exploration and Production Sharing Agreements (EPSAs), competitive bidding processes designed to stimulate investment in oil and gas exploration, all of which had previously been subject to sanction. The demand was immediate and substantial. In response to an offer of 15 onshore and offshore exploration areas in 2005, Libya “received applications from more than 120 oil companies. Libyan authorities later narrowed the field of potential bidders to 63, including several large US oil groups” who were now free from the constraints of US financial sanctions (Bruce St. John, 2008: 85). Among the entrants were US firms ChevronTexaco, and Occidental Petroleum, as well as Petrobras of Brazil, Indian Oil from India, Medco Energy International of Indonesia, Oil Search of Australia, and Verenex Energy of Canada (Bruce St. John, 2008: 85). Additional second, third and fourth rounds of EPSA offerings occurred throughout the course of 2005, 2006, and 2007, generating an additional 119 exploration and extraction applications (Bruce St. John, 2008: 86).

In conjunction with Libya’s EPSAs, the regime developed a bilateral engagement model encouraging foreign direct investment into the petroleum sector, a move that yielded further financial reintegration after the removal of financial sanctions. Included within this bilateral model were a series of successful negotiations with Occidental Petroleum in 2005, and Royal Dutch/Shell in 2004-05 (Bruce St. John, 2008: 86). Moreover, on a state visit to Libya in 2007, Prime Minister Tony Blair announced a seven-year bilateral contract between Libya and British Petroleum worth \$900 million, designed to develop natural gas processing, transportation and liquefaction for export (Bruce St. John, 2008: 86). In the same year, Libya’s Swiss-based petroleum retailing business, Tamoil, was able to be sold to US private equity firm, Colony Capital, the largest sale of a state-owned asset to that time (Bruce St. John, 2008: 87). As shown by Nephew, in regard to inflows of foreign direct investment “Libya did well after 2004 and until 2008-2009, [prior to] the onset of the Great Recession,” an event that, in conjunction with the

onset of civil war in 2011, brought to a premature halt Libya's long-term economic recovery (Nephew, 2018: 17).

This rapid, enthusiastic market response to sanctions removal is curious when placed alongside the reticence of global financial actors in the Iranian and North Korean episodes. While all three cases share the same sender-state, program magnitude, and issue salience, such cases also revealed key variation in the reputational dynamics built into their respective legal frameworks, dynamics which appear to account for the variation of financial reintegration experienced by US targets.

In the Iranian and North Korean episodes, the fact that global financial actors had been exposed to the threat of Treasury blacklisting, and thus internalized strong compliance behavior in response to its corresponding reputational risks, greatly clarifies the post-sanction market reaction in which financial reintegration was not extended to US targets. Yet, such actors had not faced such acute reputational risks during the period in which financial sanctions were in place in Libya. In this case, threats of US Treasury blacklisting and market exclusion for non-US financial actors had been removed via the use of Presidential waiver, in turn restricting investment into Libya by US firms exclusively, and removing the stigma of conducting business with Libya for non-US firms. As Nephew (2018) explains, "considering the fact that countries outside the United States had been more or less free to invest in Libya, it is unlikely to be entirely coincidental that the end of US sanctions in 2004 paced a massive infusion of new investment into Libya" (Nephew, 2018: 18).

The reputational dynamic governing relations between targets, and the private market actors responsible for reintegrating them, is thus a crucial piece of variation explaining the divergence in market responses to the removal of financial sanctions in these instances. Consequently, this variation also reflects the reputational 'stickiness' of blacklisting after the removal of secondary financial sanctions, and the downstream impact of reputational damage on the reintegration of previously targeted actors themselves.

In a process-tracing context, this case is different in the sense that the *absence* of necessary and/or sufficient conditions will determine the success of the hypothesis. Given the absence of observable variables, this case appears to provide strong smoking-gun evidence in which the sufficient condition (US treasury blacklisting of third-party financial actors) is *not* present, and thus explains, in theoretically consistent manner, the more enthusiastic market responses to sanctions removal in the Libyan episode. The necessary condition (the condition of US financial regulations granting the Treasury power to bar access to its financial markets) *is* still present, placing this case in the smoking-gun category of evidence. This case appears to confirm the reputational risk hypothesis, while substantially weakening the competing 'state-signaling' hypothesis.

### *Competing Hypothesis: State Signaling and Financial Actor Responses*

State signaling in the Libyan episode appears somewhat differently in the sense that state signaling was far more muted than in previously discussed cases, yet financial actors appeared far more responsive to Libya's reintegration. There was no overt, state-led campaign advocating for Libya's reintegration into the global economy. Rather, signals of state preferences were signaled indirectly through the passage of US sanctions legislation such as ILSA, and reciprocal shifts in Libya's proliferation behavior. These signals were predominantly transmitted between state actors, and less directly between state actors and financial actors themselves.

If signaling effects were responsible for Libya's successful financial reintegration, then it is reasonable to expect that financial actors reacted positively to the United States signaling its preferences and intentions for the removal of financial sanctions, as well as Libya's reciprocal responses. However, if signaling effects were responsible for Libya's reintegration, then it is puzzling that *less*-direct signaling of US preferences would result in *greater* levels of reintegration for a previously targeted actor than in the Iran and North Korean episodes, respectively.

Reputational risk appears to be the more effective explanation regarding the reintegration dynamics we see in the Libyan episode, as it allows us to observe financial actor behavior in the absence of reputational risk, in a way that is also logically consistent with the cases preceding it. While this study has not sought a comprehensive understanding of how *long* reputational risk lingers, it certainly appears that by 2004, many global financial actors had little reputational concerns regarding their investment behavior in Libya's oil sector.

## IX. *Conclusions*

This study introduces an original theoretical argument for why financial actors reintegrate previously-sanctioned states into the global financial system under certain conditions but not others, offering one of the first systematic examinations of the implementation of sanctions relief.

The increased use of financial sanctions in global affairs has arisen, in part, because of these tools' effectiveness in financially isolating illicit actors from the global financial system itself. Previous studies have shown that the effectiveness of implementing such tools is largely a result of reputational risk calculations tied to the blacklisting of firms by the US Treasury for non-compliance with US sanctions measures. This study shows that the same dynamics that are so effective at generating compliance from private market actors are the very same dynamics that make removing such financial measures particularly challenging.

As shown in the Iran and North Korean episodes, global financial actors complied strongly with US secondary financial sanctions during their implementation period, yet these actors also showed a strong aversion to assisting the United States in reintegrating previously-sanctioned actors into the global financial system once such measures were lifted. In the Libyan episode, however, the removal of secondary statutes in the financial sanctions of the Iran-Libya Sanctions Act removed the threat of blacklisting by the US Treasury for non-US firms, and, importantly, any reputational effects associated with being blacklisted, i.e. exclusion from US capital markets. Indeed, the *absence* of reputational risk embedded in US sanctions measures does well in explaining the swift and positive market response to the removal of financial restrictions on Libya.

The implications of this research suggest a strong paradox in the tools of US economic statecraft, one that ultimately threatens to render US financial tools wholly ineffective. While US financial sanctions certainly benefit from the reputational effects associated with the US Treasury blacklist, the same dynamics may ultimately prevent the United States from being able to credibly offer positive inducements to its targets in exchange for more compliant state behavior.

In highlighting these peculiar dynamics, this study sought to illuminate the apparent 'stickiness' of reputational risk as a long-term condition, rather than a short-term reaction, and the challenges faced by policy-makers who have traditionally treated global financial institutions

as infrastructure, rather than agents. Consequently, this study reveals secondary sanctions to be blunt objects with largely irreversible effects, rather than ‘smart’ tools that are designed to limit negative externalities associated with their implementation. The ease of implementation and the magnitude of their effects will undoubtedly be attractive to policymakers with limited tenure and short-termist agendas. However, the pyrrhic nature of secondary sanctions suggests that their implementation will ultimately limit future policy options for the sender, calling into question their long-term viability as tools of economic statecraft. Interestingly, it is primary sanctions that allow for long-term policy flexibility, which is particularly important if the financial reintegration of the target becomes strategically beneficial to the sender.

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