

March 5, 2012

Iran and S.W.I.F.T.

Iran continues on the path of building a nuclear program; although it hasn't been confirmed that the program is for nuclear weapons, informed opinion generally believes that the country is probably working towards weapon capability. There is grave concern about how to deal with such an outcome. Analysts are divided on the issue, ranging from believing that Iran with a nuclear weapon would be a major calamity to holding the position that if the U.S. managed the U.S.S.R. without causing Armageddon, Iran can probably be managed as well. Still, the vast majority of heads of state (and Western leaders especially) would probably feel better if Iran never acquires a nuclear weapon.

However, it isn't all that easy to prevent a government with even modest resources to develop nuclear weapons if they are so inclined. Most nations don't go down that path because the usefulness of such weapons is questionable. But, as Pakistan, India and North Korea (and probably Israel) have shown, if a nation is fully committed, they can usually achieve nuclear power status. This doesn't mean all nations that try actually finish; Syria and Iraq were prevented from achieving nuclear status by Israeli attacks, and Libya abandoned its nuclear efforts after the U.S. ousted Saddam Hussein from power. Thus, discouraging a nation from "going nuclear" appears possible but it usually requires aggressive efforts.

To varying degrees, Western nations want to discourage Iran from developing nuclear weapons but they clearly want to avoid a military conflict. Even Israel, who has been the most hawkish on this issue, has not conducted any overt attacks on Iran's nuclear program despite persistent threats to carry out airstrikes. There are a number of reasons for the reluctance of countries to attack Iran—their facilities are dispersed in hard to strike areas, the country has numerous asymmetric methods to retaliate, and Iran could, at least temporarily, close Persian Gulf shipping which would send oil prices skyrocketing.

Thus, the West is trying to figure out a way to discourage Iran from developing a nuclear weapon that doesn't require military action. Covert activity, cyber warfare and sanctions have been employed to act as deterrents to Iran's nuclear program. These have all played some role in slowing Iran's progress but, for the most part, the country still is enriching uranium and denying IAEA inspectors full access to suspicious weapons research sites.

Recently, the Obama administration and Congress have been pushing to restrict Iranian banks from the S.W.I.F.T. system. This proposal has received an unusually hostile response from Iran; for the most part, Iran has become inured to sanctions, so the recent reaction suggests this one may really have an impact. In this report, we will offer a short history of Iranian sanctions and other measures designed to hamper Iran's nuclear program. From there, we will discuss the

S.W.I.F.T network and how cutting access would affect Iran. As always, we will conclude with the potential market ramifications.

A History of Actions Against Iran

Iran became an enemy of the U.S. shortly after the 1979 Iranian Revolution. Iran had been a significant ally of the U.S. under the Shah which colored the view of America by the insurgents that ousted the Iranian regime. On November 4, 1979, Iranian students and militants took over the American Embassy in Tehran, setting off a hostage crisis that lasted 444 days. This action led to the first sanctions against Iran as President Carter issued Executive Order 12170 ten days later. This order froze \$10 bn of Iranian assets, including gold, bank deposits and other properties. These assets remain frozen to this day. In addition, Carter suspended Iranian oil imports to the U.S. which also remains in place.

The Iran-Iraq War prompted further sanctions as the U.S. ostensibly supported Iraq. In 1984, all weapons sales and other assistance to Iran was suspended. In October 1987, President Reagan issued Executive Order 12613 which prohibited all trade with Iran. Increasing tensions with the U.S. during Iranian President Rafsanjani's term led to President Clinton issuing Executive Order 12957 in March 1995. This order replaced President Reagan's order, tightening penalties with Iran. Not only were the trade prohibitions of earlier orders reiterated but there were added prohibitions against the re-export of American goods to Iran.

In 1996, Congress passed the Iran-Libya Sanctions Act (ILSA) which penalized foreign oil companies that exceeded \$20 mm of investment in Iran's oil industry. ILSA restricted loans by American banks to

violating entities and allowed the president to ban oil trade with the violating company.

The election of Sayyid Khatami to the Iranian presidency in 1997 led to some relaxation of sanctions against Iran. Khatami was considered a liberal and the U.S. wanted to support him in his attempts to reform Iran. Unfortunately, the ultimate leader of Iran is Ayatollah Khomeini and he opposed the reform movement. The election of Mahmud Ahmadinejad to the presidency in 2005 ended the thaw, especially after he defied world opinion and restarted uranium enrichment. On June 29, 2005, President Bush signed Executive Order 13382 which froze the assets of persons and companies tied to Iran's nuclear program.

The United Nations also moved against Iran, with UNSCR 1737 in December 2006, UNSCR 1747 in March 2007, UNSCR 1803 in March 2008 and UNSCR 1929 in June 2010. All these resolutions involved sanctions which required Iran to cease uranium enrichment and each one ratcheted up economic penalties, including the right to inspect shipping in open waters and further restrictions on banking and finance. In addition, penalties against individuals connected to the nuclear program were increased, hampering their ability to travel.

There have been other actions taken as well. At least five nuclear scientists have been assassinated since 2007, mostly by bombs attached to their cars. There have been explosions at various suspected nuclear sites. Although these have been blamed on accidents, it is quite possible that at least some of them have occurred via espionage. Finally, in June 2010, the Stuxnet computer virus was reported to have adversely affected Iran's nuclear industry. The virus was technically a "worm" which caused malfunctions to occur in Siemens industrial

software and equipment which are used in Iran. The virus causes equipment, such as nuclear centrifuges, to malfunction. In addition, the virus prevents the machine from signaling to its operator that a problem exists. Thus, the human operator does not know a malfunction exists and cannot intervene to prevent damage from occurring. The virus appeared to be quite successful, causing a noticeable slowdown in Iran's enrichment activities. However, it does appear Iran has overcome this hurdle and has resumed uranium enrichment.

The S.W.I.F.T Sanctions

The Society for Worldwide Interbank Financial Telecommunication (S.W.I.F.T.) is a cooperative that operates a worldwide financial messaging network; its purpose is to allow financial institutions to easily and safely exchange messages. It currently connects over 10,000 financial institutions in 210 countries. It was created in 1973 to replace the Telex. Headquartered in Belgium, it has 23 offices in major financial centers around the world and is overseen by the G-10. Although media reports suggest it is a money wiring service, this is not exactly accurate. It is a messaging service; it securely transmits information about accounts and transactions between institutions. Once a bank receives instructions via S.W.I.F.T., it can safely transfer funds to a correspondent bank. Without S.W.I.F.T, a bank would be hard pressed to determine if instructions were legitimate. Isolating Iranian financial institutions from S.W.I.F.T. would make it very difficult to safely move funds into or out of Iran. In 2010, S.W.I.F.T. processed nearly 2.3 million messages for Iranian financial institutions.

In early February, the Senate Banking Committee unanimously approved legislation that would punish S.W.I.F.T. for

violating Iranian sanctions because of the services it provides to Iran. S.W.I.F.T. has indicated that it will likely comply, essentially closing the Iranian banking system from the rest of the world.

This action, coupled with sanctions already in place, will make trade with Iran very difficult. At present, it is nearly impossible to insure Iranian oil exports, meaning that a tanker of Iranian oil is subject to total loss if it sinks, is lost or pirated. These latest sanctions mean that a bank in India, with shipping documents indicating an Iranian tanker has offloaded its cargo, cannot tell an Iranian bank via normal channels that it has received the cargo and is ready to pay. At some point, alternative pay structures could be established but buyers will likely demand discounts to compensate for the additional work required to buy Iran's oil.

Ramifications

The International Energy Agency indicated in its February Oil Market Report that Iranian exports have already been affected by the threat of sanctions. This same report indicated that China was cutting its oil purchases from Iran. Interestingly enough, it wasn't because China wanted to support sanction efforts to curb Iran's nuclear program. Instead, the Chinese apparently have discovered the strength of their bargaining position and are demanding better prices. Thus far, Iran has refused to reduce its rates. It's highly likely that, at some point, Iran will be forced to take less for the oil it sells and other buyers will simply opt for other suppliers.

How will Iran react? Its best weapon is to drive oil prices high enough to threaten global growth. To accomplish this goal, it not only needs to reduce its own oil sales but also prevent other Persian Gulf oil producers, the only ones in the world with

idle capacity, from offsetting the loss of Iranian supplies. It is unlikely that Iran wants to suffer through military strikes if it can avoid it and it possesses ample covert capabilities. Thus, it would be reasonable to anticipate rising tensions in Bahrain and potential sabotage to oil facilities in the region.

The Obama administration wants to avoid a military conflict with Iran because such strikes cannot guarantee an end to Iran's nuclear program but will almost surely embroil the entire region in conflict. Iran knows this and thus will try to help the U.S. avoid war by not committing any overt acts

that will trigger a conflict. At the same time, Iran must increase the cost of sanctions to the point where it becomes counterproductive to maintain them.

Thus, we can expect an environment of fear that will keep oil prices elevated until one side "blinks." Unfortunately, such an environment is susceptible to mistakes, meaning that the odds of a military conflict, though still relatively low, are rising.

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