FINANCIAL SANCTIONS AND BANKING-SECTOR RESILIENCE: CROSS-BORDER PAYMENTS, LIQUIDITY RISKS, AND POLICY ADAPTATION

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I. Introduction

Financial sanctions operate through the infrastructure that allows banks, firms, and households to move value across borders. An asset freeze can prevent a designated person from using funds; restrictions on a bank can limit its access to foreign counterparties; and the loss of a correspondent relationship can make an otherwise lawful payment slower, more expensive, or impossible. These effects are not confined to the entity named in a sanctions measure. Because international banking depends on interconnected institutions, a restriction at one node can alter payment routes, compliance decisions, and liquidity needs elsewhere in the network.

The central issue is therefore not simply whether sanctions impose costs on their direct targets. It is how a policy instrument designed to change conduct interacts with a financial system that depends on confidence, settlement finality, correspondent banking, and the availability of liquid assets in the required currency. The same network structure that gives financial sanctions their leverage can transmit operational and liquidity pressure to institutions that are not themselves sanctioned.

This essay argues that banking-sector resilience under financial sanctions depends on the ability to separate three tasks that are often treated as one: implementing legal restrictions accurately, preserving the continuity of permitted payments, and maintaining liquidity when ordinary settlement channels become unavailable. Resilience does not mean weakening sanctions or creating channels to evade them. It means designing governance, payment infrastructure, liquidity planning, and international coordination so that lawful activity can continue while prohibited activity is blocked. The argument proceeds from the structure of cross-border payments to the transmission of sanctions-related risks, before considering policy adaptation and the principal objections to it.

II. Financial Sanctions and the Architecture of Cross-Border Payments

A cross-border payment is rarely a direct transfer between two banks in different countries. Banks commonly rely on correspondent banking relationships: one institution holds an account with another and uses it to make payments in a currency or jurisdiction where it does not operate directly. A chain of correspondent accounts, settlement systems, and messaging services allows banks to connect customers to the international financial system. The arrangement is efficient when relationships are stable, but it also creates points at which access can be restricted.

Financial sanctions can act on different parts of this architecture. Authorities may freeze assets, prohibit transactions with designated persons, restrict the provision of financial services, or limit a bank's access to particular markets and counterparties. Exclusion from a financial messaging network is distinct from a legal asset freeze: messaging infrastructure transmits payment instructions, while funds may settle through accounts and systems governed by separate rules. Nevertheless, loss of messaging access or correspondent relationships can make payments substantially more difficult even where the underlying economic activity is not itself prohibited. The distinction matters because legal restrictions, technical connectivity, and settlement capacity are related but not interchangeable.

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The international network is unevenly connected. Research by Cipriani, Goldberg, and La Spada explains how financial sanctions interact with the structure of international payments and the central role of major financial hubs. More recent work by Matvos and Neiman finds that sanctions imposed during 2021–2026 reduced targeted banks' access to major-currency networks by severing correspondent relationships. Some affected institutions retained access through longer and more fragile chains of intermediaries; banks in heavily sanctioned economies that were not themselves designated also experienced reduced connectivity, consistent with wider de-risking.[1] These findings illustrate a key mechanism: sanctions can affect not only a bank's legal status but also the willingness of other institutions to maintain a relationship with it.

The resulting network effect is especially important for smaller economies. A bank with few correspondent relationships has fewer practical alternatives if a major provider exits. A payment may be rerouted through additional intermediaries, each requiring documentation, screening, operational coordination, and settlement liquidity. Every extra link can introduce delay, fees, uncertainty, and a further point of failure. Network resilience therefore depends not on the number of nominal payment options alone, but on whether those options are legally available, operationally reliable, and capable of settling in the currencies customers need.

III. From Compliance Decisions to Liquidity Risk

Liquidity risk arises when a bank cannot meet payment obligations when due without incurring unacceptable losses. Sanctions can intensify this risk even when they do not directly remove the bank's liquid assets. If a correspondent account is frozen, closed, or made unavailable for a particular transaction, balances held through that relationship may no longer be usable for the intended payment. The bank may still report assets on its balance sheet, but the timing, currency, jurisdiction, or legal conditions attached to those assets can prevent them from functioning as immediate liquidity.

A second channel is uncertainty. Banks must determine whether a customer, beneficial owner, counterparty, vessel, goods shipment, or payment purpose falls within a relevant restriction. When ownership is opaque or rules change quickly, a bank may delay a transaction while seeking clarification. A delay can cause a payment queue to grow, increase intraday funding needs, and create uncertainty about when incoming funds will become available. For a bank that relies on predictable settlement flows, the difference between an asset being valuable and an asset being usable at the required moment is critical.

A third channel is defensive de-risking. To avoid legal exposure, some institutions may terminate entire classes of relationships rather than assess individual customers and transactions. Such decisions can be commercially understandable where compliance costs are high and the potential penalty is severe, but broad withdrawal can affect legitimate businesses and households. UN Trade and Development has linked the decline of correspondent banking relationships in many developing economies to compliance costs and uneven capacity, noting that reduced connectivity can constrain trade, particularly in less-developed, landlocked, and small-island economies.[2] De-risking can therefore turn a targeted restriction into a broader access problem.

Liquidity pressure can become more severe when several risks occur together. A bank may need to replace a lost correspondent, hold additional balances in another currency, pay higher fees to intermediaries, and meet customer withdrawals at the same time. Foreign-exchange markets may be less liquid or more expensive during geopolitical stress, making it harder to convert available resources into the currency required for settlement. If customers lose confidence and move deposits, the bank faces both an outflow of funding and a greater need to make payments through less familiar channels. Sanctions-

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related liquidity risk is thus not identical to credit risk: a bank can hold assets that are ultimately recoverable and still face acute short-term funding pressure.

IV. Cross-Border Payment Disruption and Financial Stability

The consequences extend beyond an individual institution because banks are connected through payment obligations, correspondent accounts, foreign-exchange transactions, and common service providers. A disruption at one bank can delay payments to firms that need to pay suppliers, workers, or lenders. Suppliers may then delay shipments, while exporters may wait longer for receipts. In economies where remittances are a major source of household income, payment friction can also affect consumption and small-business cash flow. The International Monetary Fund's analysis of geopolitical tensions and cross-border payments identifies restrictions as a channel through which fees and foreign-exchange margins can rise while payment volumes fall.[3] These effects can be economically meaningful even when a transaction is delayed rather than formally prohibited.

Operational and reputational pressures may reinforce liquidity risk. A bank that cannot explain when a payment will clear may face customer complaints, loss of business, or rapid withdrawals. A bank that processes a prohibited transaction, however, may face penalties and further restrictions. Compliance staff are therefore required to make decisions under competing pressures: avoid prohibited dealings without creating unnecessary interruptions to legitimate activity. Poorly integrated screening systems, unclear escalation procedures, and incomplete customer data make that balance harder to achieve.

The European Central Bank's banking-supervision analysis of geopolitical instability has highlighted how sanctions and reputational concerns can translate into acute liquidity, counterparty, and operational risks, including for banks with indirect connections to affected markets.[4] The wider lesson is that exposure cannot be measured only by counting sanctioned counterparties. A bank may have no direct relationship with a designated entity yet depend on a service provider, correspondent, or funding market that is affected by the same event. Effective resilience analysis must map indirect dependencies and plausible second-round effects.

At the same time, a sanctions shock should not automatically be treated as a system-wide solvency crisis. Some disruptions are temporary operational bottlenecks; others reflect legally immobilised assets, persistent loss of market access, or a fundamental change in funding conditions. Distinguishing these cases is essential. Supervisors need to assess the location and usability of liquid assets, the concentration of correspondent relationships, the maturity of funding, foreign-currency mismatches, and the speed with which payment routes can be replaced. A single headline measure of liquidity may conceal the fact that funds are held in the wrong currency or cannot be transferred through an available legal channel.

V. The Limits of Simple Substitution

One response to sanctions is to redirect payments through alternative banks, currencies, or payment infrastructures. Such adaptation may preserve lawful trade where the alternative route is permitted and operationally credible. But substitution is not frictionless. A new route may have fewer counterparties, less market depth, limited convertibility, or different settlement hours. Additional intermediaries can lengthen payment chains and increase the chance of errors, compliance holds, or settlement failure. A bank cannot assume that a replacement route provides the same reliability as the route it has lost.

Currency substitution also involves balance-sheet trade-offs. A bank that receives more payments in a currency used less frequently by its customers may accumulate assets that are difficult to deploy. Converting those balances may incur spreads or require access to foreign-exchange markets that are themselves constrained. If the bank borrows in one currency but holds liquid assets in another, exchange-rate movements can raise the local-currency cost of meeting obligations. Diversification can reduce

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dependence on a single provider, but excessive diversification into illiquid or unfamiliar instruments can create new risks.

Alternative payment systems may improve redundancy, but they do not remove the need for legal clarity, credible settlement, adequate liquidity, and trusted counterparties. The Bank for International Settlements has noted that cross-border payments remain more costly, slower, less accessible, and less transparent than domestic payments, in part because of limited interoperability and differences between national systems.[5] Sanctions can amplify these existing frictions. The appropriate lesson is not that alternative systems are inherently ineffective, but that their resilience must be evaluated by practical settlement capacity rather than by the mere existence of a technical connection.

VI. Policy Adaptation: Resilience Without Evasion

The first requirement is a sanctions-compliance framework that is accurate, risk-based, and adaptable. Banks need current screening data, clear ownership information, documented escalation paths, independent testing, and staff who understand the difference between a confirmed prohibition and a transaction that requires further review. The US interagency examination manual describes an effective Office of Foreign Assets Control compliance programme as one proportionate to the institution's products, services, customers, and geographic exposure, supported by internal controls, testing, accountability, and training.[6] The broader principle applies beyond any single jurisdiction: controls should respond to actual risk rather than rely on blanket assumptions about customers or locations.

The second requirement is to integrate sanctions scenarios into liquidity stress testing. A useful scenario should test more than a generic rise in funding costs. It should ask what happens if the largest correspondent relationship is terminated, a currency account becomes temporarily inaccessible, payment processing is delayed for several days, or customers withdraw deposits after a disruption. Banks should estimate the amount of immediately usable liquidity by currency and legal entity, identify collateral that can actually be mobilised, and test whether contingency funding plans remain workable under the same restrictions. Stress tests should also consider simultaneous pressures on foreign-exchange swaps, intraday settlement, and customer payment queues.

Third, banks should reduce avoidable concentration. This does not mean maintaining relationships with institutions where doing so would violate applicable law. It means identifying excessive dependence on a single correspondent, processor, custodian, or technology provider and, where lawful and commercially feasible, establishing tested alternatives. Contingency routes should be documented before a crisis, not improvised after a payment channel has failed. Operational exercises can reveal whether alternative providers can handle the required volumes, currencies, documentation, and settlement windows.

Fourth, public authorities should coordinate legal guidance and supervisory expectations. Conflicting or ambiguous interpretations across jurisdictions increase the cost of compliance and can encourage excessive withdrawal from legitimate business. Clear explanations of restrictions, timely updates, and practical channels for resolving uncertainty can help banks distinguish prohibited transactions from permissible ones. Coordination does not require governments to weaken sanctions; it can improve their precision and reduce collateral disruption. The Financial Stability Board's recommendations for bank and non-bank payment providers emphasise more consistent, risk-proportionate regulation and supervision as a way to reduce unnecessary complexity in cross-border services.[7]

Fifth, resilience requires stronger payment infrastructure and better information exchange. Standardised payment messages, interoperable systems, reliable identity and ownership data, and

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effective mechanisms for correcting errors can reduce routine friction. Central-bank liquidity arrangements across jurisdictions may also help eligible payment providers manage intraday funding needs, provided that collateral, counterparty, and central-bank risks are carefully controlled.[8] These tools cannot override sanctions law or make immobilised assets available. Their role is narrower but important: to support settlement of lawful payments and make the system less vulnerable to operational bottlenecks.

VII. Counter-Arguments

A first objection is that broader resilience measures may weaken the pressure sanctions are intended to create. If banks develop additional payment routes and liquidity buffers, targets may find it easier to continue external transactions. This concern is serious: a resilience policy must not become a blueprint for evasion. The answer is to distinguish continuity for permitted activity from circumvention of prohibited activity. Alternative routes should be subject to equivalent screening, ownership transparency, recordkeeping, and supervisory oversight. Where a transaction is legally prohibited, operational redundancy must not be used to complete it.

A second objection is that sanctions-related costs are a necessary part of effective enforcement. Financial institutions may reasonably choose to exit high-risk relationships when the cost of monitoring them exceeds the expected commercial return. Regulators cannot eliminate all delays without accepting a greater risk of prohibited transactions. This objection correctly recognises that compliance involves trade-offs. However, it does not follow that indiscriminate withdrawal is always the safest or most effective response. Better data, clear rules, and proportionate controls can allow banks to distinguish among risks more precisely. The goal is not zero friction, but justified friction: delays and refusals grounded in legal requirements or demonstrable risk rather than uncertainty alone.

A third objection is that no bank can fully insulate itself from geopolitical decisions made by governments. That is true. Resilience cannot guarantee uninterrupted access to every currency, market, or counterparty. Nor should private institutions decide independently to disregard lawful public policy. Yet limited control over the initial shock does not make preparation irrelevant. Banks can still improve liquidity visibility, reduce operational concentration, clarify decision rights, and plan for lawful continuity. Resilience is not immunity; it is the capacity to absorb disruption without allowing it to spread unnecessarily.

VIII. Conclusion: Precision as a Condition of Resilience

Financial sanctions draw their force from the interconnected structure of international finance. Restrictions on a bank or payment channel can change correspondent relationships, increase the number of intermediaries, raise compliance costs, and make liquid assets less usable at the moment they are needed. These effects can extend to non-designated banks and legitimate customers through de-risking, payment delays, foreign-exchange costs, and confidence pressures. The critical vulnerability is not simply the loss of access, but the interaction between access, liquidity, operational continuity, and legal uncertainty.

A resilient banking sector must therefore pursue three objectives together: enforce applicable restrictions, preserve lawful payment activity, and prepare for the liquidity consequences of disrupted connections. Risk-based compliance, currency-specific liquidity stress testing, tested contingency routes, consistent supervisory guidance, and interoperable payment infrastructure can support these objectives. None removes the policy choices inherent in sanctions, and none should be used to evade them. Their purpose is to ensure that enforcement remains targeted and that avoidable operational failures do not magnify its effects on the wider economy.

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The decisive measure of resilience is not whether a bank can continue every transaction under every geopolitical condition. It is whether the bank can identify what is prohibited, determine what remains permissible, and settle lawful obligations with adequate liquidity and transparent controls. Precision in enforcement and resilience in payment operations are not opposing goals. Properly designed, each strengthens the other.

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