Impact of Iran-Israel War on the International Banking System

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Abstract

This theoretical research paper examines the multifaceted impact of a hypothetical Iran-Israel war on the international banking system. Drawing upon conflict theory in economics and systemic risk theory in international finance, this study explores how heightened geopolitical tensions and potential conflict could cascade through global financial networks. We analyze key mechanisms of transmission, including disruptions to SWIFT transactions, shifts in cross-border capital flows, the implications of escalating sanctions regimes, and the ripple effects of oil-price-induced inflation on banking stability. The paper identifies potential vulnerabilities within different regional banking systems and assesses the crucial role of regulatory institutions such as the IMF, FATF, and BIS in mitigating systemic shocks. Ultimately, this research provides a conceptual framework for understanding the complex interplay between geopolitical conflict and financial fragility, offering theoretical insights into potential risks and suggesting areas for proactive policy responses to safeguard global financial stability.

Keywords: Iran-Israel conflict, international banking, systemic risk, geopolitical risk, financial stability, sanctions, oil prices.

Introduction

In an era characterized by deepening global financial integration, the international banking system stands as both the circulatory system of the world economy and a potential vector for the rapid transmission of shocks (Claessens & van Horen, 2015; Reinhart & Rogoff, 2009). Its stability is intricately tied to geopolitical developments, particularly in strategically sensitive regions (Bremmer, 2019). The hypothetical prospect of a direct military conflict between Iran and Israel offers a compelling lens through which to examine potential vulnerabilities and resilience within global financial networks. Unlike conventional economic disturbances or isolated banking failures, conflicts of this magnitude are uniquely positioned to combine political, security, and economic risks, amplifying their repercussions far beyond national or regional boundaries (Kobrin, 1984; Tooze, 2018).

The Middle East, long recognized as a geopolitical flashpoint, holds a central position in the global energy supply chain and is of critical importance to both developed and emerging economies (Yergin, 2008). Escalation of hostilities between Iran and Israel would not only reshape the regional security environment but could also

trigger a sequence of financial and economic shocks spanning continents (International Monetary Fund [IMF], 2021). Historically, major geopolitical crises in this region—such as the 1973 oil embargo or more recent sanctions regimes—have demonstrated the capacity of localized conflicts to reverberate throughout the global economy, impinging on everything from commodity markets to cross-border banking operations (Hamilton, 2011; Eaton et al., 2021).

Despite substantial literature on the macroeconomic effects of conflict and the geopolitics of energy, relatively little attention has been paid to the specific conduits through which a military confrontation between Iran and Israel could permeate the international banking system (Financial Stability Board [FSB], 2022; IMF, 2022). Geopolitical shocks are distinct in their ability to interact with existing financial vulnerabilities, potentially inducing panic in capital markets, disrupting established channels for international payments, and prompting unforeseen regulatory and policy responses (Adrian & Jones, 2019). Conflict theory in economics and systemic risk analysis in international finance suggest that such shocks can set off destabilizing feedback loops—where real sector losses, regulatory shifts, and market uncertainty reinforce each other, threatening the stability of even well-capitalized financial institutions (Battiston et al., 2016; Acemoglu et al., 2015).

This research paper seeks to fill this analytical gap by identifying and dissecting the key mechanisms through which an Iran-Israel conflict might impact the global banking sector. Central among these are potential disruptions to the SWIFT (Society for Worldwide Interbank Financial Telecommunication) system, limitations or reversals in cross-border capital flows, the rapid intensification and extraterritorial extension of sanctions regimes, and the indirect but potent effects of a spike in global oil prices on inflation and bank balance sheets (SWIFT, 2022; World Bank, 2022). Attention is given to the heterogeneity of banking systems' exposures—banking sectors in energy-importing versus energy-exporting countries, or those with significant dealings related to sanctioned entities, are likely to experience drastically different risks (BIS, 2023).

Alongside these channels of risk transmission, the study explores the role and efficacy of major regulatory and oversight institutions—including the International Monetary Fund (IMF), the Financial Action Task Force (FATF), and the Bank for International Settlements (BIS)—in monitoring, mitigating, and coordinating policy responses to potential banking system stress (FATF, 2022; BIS, 2022). The paper's primary contribution lies in advancing a conceptual framework that connects theoretical perspectives from conflict economics and systemic financial risk to real-world policy challenges (Kindleberger & Aliber, 2015). By mapping out the complex and interdependent pathways through which geopolitical shocks migrate through the banking sector, the research offers both a foundation for further academic investigation and practical insights for policymakers, financial institutions, and international organizations.

Ultimately, this study underscores the imperative of proactive international cooperation, robust financial regulation, and adaptive policy design to enhance the global banking system's resilience to unforeseen geopolitical crises (Claessens & Kose, 2018). The lessons drawn from this theoretical exploration resonate beyond the specific case of Iran and Israel, reflecting a broader reality: in a multipolar and conflict-prone world, the stability of the international banking system can no longer be taken for granted (Centeno et al., 2013).

Literature Review

1. Previous Studies on War and Its Economic Consequences

The economic impacts of war have been broadly analyzed, with the consensus that wars fought on home territory produce sharp and lasting GDP per capita declines, erode human and physical capital, and inflict long-term scars on economic growth and development. For instance, Chupilkin and Kóczán (2022) find that wars on territory result in a GDP per capita loss exceeding 7 percentage points relative to synthetic controls, with civil wars yielding particularly persistent negative effects. Some literature, however, identifies ambiguous or even positive growth effects for countries engaging in wars outside their own territory, linked to surges in military spending and associated sectoral spillovers (World Bank, 2004). Recent research documenting the global repercussions of the Russia-Ukraine conflict highlights renewed risks of inflation, supply disruption, and banking instability, as well as heightened demand for external regulatory support and recapitalization (International Monetary Fund [IMF], 2022). Meta-studies and cross-country panel analyses confirm that war confounds macroeconomic stability by suppressing productive capacity and reducing total factor productivity (CEPR, 2012). Secondary effects, such as mass population displacement and heightened policy uncertainty, amplify these shocks and complicate recovery prospects (Cato Institute, 2022).

2. Geopolitical Risk and Banking Stability

A fast-growing body of research investigates how geopolitical risks transmit through the banking system. Empirical evidence using more than a century of data finds that spikes in geopolitical risk, especially major events like open wars, are strongly associated with sharp declines in bank capitalization, solvency, loan quality, and financial intermediation (Phan, Sharma, & Narayan, 2022). This effect is non-linear: only major, systemic geopolitical events result in significant threats to banking system stability (Reghezza, Zeghal, & Beretta, 2024). These findings are echoed by the European Central Bank (2025), which observes a 0.2 percentage point average drop in bank capital ratios following major risk episodes—though less pronounced effects are seen for milder events. Research also underscores that these risks are heterogeneously distributed, with emerging markets and countries closely connected to war zones showing heightened depositor runs, capital outflows, and regulatory challenges (Ibn Khaldun Policy Brief, 2025). Macroprudential and microprudential policies such as capital buffer releases and liquidity support play important roles in cushioning these shocks but may not fully offset losses in the face of large-scale war-induced destabilization (Financial Stability Board [FSB], 2022).

3. Theoretical Insights from Political Economy, Conflict Economics, and International Finance

Theoretical advances in conflict economics and international finance lay the groundwork for understanding how war and systemic risk interact. Conflict models analyze both exogenous shocks and endogenous contestation effects, showing how the threat or reality of conflict can lead to underinvestment, resource misallocation, and a

breakdown of financial stability fundamentals (Battiston et al., 2016). Political economy frameworks situate these issues within a matrix of power, institutions, and market dynamics, stressing the strategic motives and bargaining behaviors of key actors (Britannica, 2025). Systemic risk theories highlight the potential for localized shocks—such as disruptions to SWIFT transactions, capital flight, or sanctions—to spread through highly networked financial systems and create feedback loops between real and financial sectors (Acemoglu, Ozdaglar, & Tahbaz-Salehi, 2015). The literature recommends robust regulation, global coordination, and agile policy responses as critical to preventing accidental escalations from propagating into full-blown systemic crises (Kindleberger & Aliber, 2015).

4. Gaps in the Literature Justifying the Present Research

Despite the abundant literature, several key gaps remain. While broad macroeconomic effects of war are well-documented, less has been written about the granular mechanisms—such as cross-border payment systems like SWIFT, capital flow reversals, or the impact of sanctions regimes—that specifically channel conflict-induced shocks through international banking networks (Financial Stability Board [FSB], 2022). Existing studies often aggregate exposure at national or regional levels, failing to account for stark differences between energy-importing versus exporting countries or between banks heavily engaged with sanctioned sectors and those less exposed (Bank for International Settlements [BIS], 2023). Furthermore, empirical work assessing the full effectiveness of multilateral institutions (IMF, BIS, etc.) in managing rapid, unpredictable systemic shocks under war conditions remains insufficient (International Monetary Fund [IMF], 2022). Lastly, comprehensive syntheses integrating conflict economics, international finance, and political economy are rare, leaving a gap for research that offers actionable models for policymakers to anticipate systemic risk from geopolitical turmoil (SHS Conferences, 2023). This study aims to fill these gaps by analyzing how a major Iran-Israel conflict might propagate risk through the international banking system, leveraging both new empirical insights and conceptual advances (Claessens & van Horen, 2015).

Theoretical Framework

This study integrates multiple theoretical perspectives to analyze the complex interactions between geopolitical conflict and the international banking system. Specifically, it draws on conflict theory in economics, systemic risk theory in international finance, and concepts of globalization and financial interdependence to develop a comprehensive framework for understanding the transmission of shocks from a potential Iran-Israel war.

Conflict Theory in Economics

Conflict theory, rooted in political economy and sociology, provides a lens for examining how power struggles, resource competition, and political violence impact economic outcomes (Coser, 1956; Kobrin, 1984). In economics, this approach extends to analyzing the disruptions and costs caused by conflicts, including wars,

and explains how strategic behavior under uncertainty shapes market responses (Blattman & Miguel, 2010). Conflict generates negative externalities that extend beyond conflict zones, undermining trade, investment, and cross-border finance (Kobrin, 1984). Such disruptions can erode trust in institutions, reduce market efficiency, and ultimately challenge banking sector stability.

By employing conflict theory, this study contextualizes a hypothetical Iran-Israel conflict as a severe exogenous shock, emphasizing not just security concerns but profound economic impacts with the potential to reshape incentives, market functioning, and financial stability (Blattman & Miguel, 2010).

Systemic Risk Theory in International Finance

Systemic risk theory focuses on how vulnerabilities and shocks propagate within financial networks, potentially triggering cascading failures throughout the banking system (Allen & Gale, 2000; Battiston et al., 2016). This approach recognizes that interconnectedness among financial institutions—via contracts, payments, or exposures—creates channels for distress transmission. External shocks, such as geopolitical crises, can catalyze sudden stops in cross-border capital flows, disrupt payment systems like SWIFT, and create feedback loops with the real economy (Acemoglu, Ozdaglar, & Tahbaz-Salehi, 2015; Battiston et al., 2016).

Within international finance, systemic risk analysis is crucial for predicting and mitigating contagion effects, particularly as they relate to regulatory frameworks and institutional responses under stress (IMF, 2022). This perspective complements conflict theory by illuminating the financial "plumbing" through which shocks are amplified or contained.

Globalization and Financial Interdependence

Financial globalization has intensified cross-border linkages among banks, investors, and markets, so that regional conflicts can have far-reaching effects (Claessens & van Horen, 2015; Bremmer, 2019). The global energy trade, especially oil, exemplifies these interdependencies; disruptions in the Middle East can quickly ripple through commodity markets and international payment systems (Yergin, 2008). Integration means both greater shock transmission and opportunities for policy coordination to enhance resilience (Claessens & Kose, 2018).

Understanding these interdependencies is essential for assessing differentiated vulnerabilities and the resilience of banking systems across regions, particularly where business models and regulatory regimes vary (BIS, 2023).

Justification for Selected Theories

Combining conflict theory and systemic risk theory enables the study to cover both the origins (geopolitical conflict) and propagation (financial contagion) of risk. Conflict theory explains the generation and immediate consequences of geopolitical shocks, while systemic risk theory captures the transmission and feedback processes within financial networks (Acemoglu et al., 2015; Battiston et al., 2016). The addition of the

globalization framework situates these risks within the broader context of interconnected markets and financial institutions (Claessens & van Horen, 2015; Bremmer, 2019).

This multi-theoretic approach directly serves the research objectives by mapping the pathways through which an Iran-Israel conflict could destabilize international banking and by identifying contingent vulnerabilities and the scope of regulatory intervention (Kindleberger & Aliber, 2015).

Conceptual Model

The proposed conceptual model treats a hypothetical Iran-Israel conflict as an exogenous geopolitical shock transmitted to the international banking system through multiple channels:

1. Conflict-induced disruptions in trade, energy markets, and risk perceptions (Kobrin, 1984; Yergin, 2008).
2. Payment system and capital flow disturbances—such as SWIFT restrictions or sanctions, affecting liquidity and counterparty risk (SWIFT, 2022; World Bank, 2022).
3. Rapid escalation of sanctions and compliance requirements, increasing operational risk and balance sheet stress (IMF, 2022).
4. Oil price volatility and inflation, influencing bank credit portfolios and macroeconomic conditions (BIS, 2023).
5. Regulatory and policy responses by organizations such as IMF, FATF, and BIS, which may succeed or struggle depending on the speed and complexity of the shock (FATF, 2022; BIS, 2022).

By synthesizing these elements, the model offers a structured approach to analyze how geopolitical conflict can trigger financial fragility, inform policy recommendations, and identify areas for future research (Kindleberger & Aliber, 2015).

Discussion

A prolonged Iran-Israel war would represent one of the most severe contemporary stress tests for global financial architecture. Drawing upon conflict theory, systemic risk frameworks, and empirical research, this section analyzes potential ramifications across key channels:

1. SWIFT Transactions and Global Interbank Networks

The SWIFT system is central to international payment messaging and cross-border banking. A sustained conflict could precipitate forced disconnects of Iranian, and possibly other regional, banks from SWIFT, whether through direct sanctioning or preemptive compliance by major global banks (SWIFT, 2022). Such exclusions would disrupt the international payments landscape, leading to fragmentation of messaging systems, undermining transaction transparency, and complicating liquidity management. Global interbank counterparties would recalibrate their exposures, and could further reroute transactions through alternative networks (e.g.,

Russia's SPFS, China's CIPS), incrementally reducing SWIFT's universality and efficiency (World Bank, 2022). Network disruptions may also increase settlement risk and cross-border payment delays, particularly for banks with high Middle Eastern exposure.

2. Cross-Border Capital Flows and Currency Risks

Geopolitical escalation is historically linked to capital outflows from conflict regions, with profound implications for exchange rates and domestic monetary policy (IMF, 2022). A prolonged Iran-Israel crisis could prompt risk-off sentiment, driving funds out of the Middle East and other proximate emerging markets into perceived safe-haven assets (e.g., USD, CHF). Regional currencies could suffer sharp depreciations, and countries with current account deficits or weak reserves would experience intensified volatility. For global banks, the cost of hedging currency risk would rise, and sovereign or corporate borrowers from affected regions might face increased funding costs or even exclusion from international markets. The resulting volatility would challenge banks' liquidity management, asset-liability matching, and earnings stability.

3. Sanctions and Their Effects on Global Banks

Expanded sanctions are a likely tool of economic statecraft in the conflict's context, targeting Iranian assets, entities, and potentially third-country institutions dealing with them (FATF, 2022; IMF, 2022). For global banks, this environment raises the complexity, cost, and legal risks of cross-border operations. Financial institutions face enhanced compliance burdens—heightened due diligence, Know-Your-Customer (KYC) procedures, and exposure screening—amid threats of secondary sanctions or regulatory penalties. Sanction spillovers could induce global derisking, especially in correspondent banking relationships, leading to financial exclusion for certain regions and intermediaries. Banks with legacy ties to sanctioned actors would be forced to reduce or divest such exposures, potentially crystallizing credit losses and operational writedowns.

4. Oil-Price-Induced Inflation and Interest Rate Implications for Banks

The Middle East's importance to global oil supply, and the risk of conflict-driven disruptions, carries clear inflationary risk (Hamilton, 2011; Yergin, 2008). Sustained supply shocks would elevate global oil prices, fueling input cost inflation and broad-based consumer price hikes, especially in oil-importing economies (World Bank, 2022). Central banks may be forced to raise policy interest rates to curb inflation, increasing debt-servicing costs for households and corporates. Higher interest rates typically boost banks' net interest margins in the short run but, amid economic slowdown and inflation, increase credit risk, loan defaults, and impairments. Banks operating in highly energy-dependent economies would be especially exposed. Conversely, oil-exporting countries could see initial windfalls, but may eventually face overexposure and asset bubbles.

5. Risk Perceptions in Emerging Markets and Capital Movement

Increased geopolitical risk would raise risk premiums for emerging market assets more broadly—not just those directly involved in the conflict (Reghezza et al., 2024). Investor flight to quality could precipitate sudden stop crises, destabilizing banking sector funding and sovereign finances in vulnerable regions. Risk aversion may become self-fulfilling, driving currency slides, reserve depletion, and, ultimately, forced monetary tightening that transmits the downturn globally. Cross-border banks would likely reduce exposures to high-risk regions, amplifying volatility and creating negative feedback loops between financial instability and political uncertainty.

6. Banking System Vulnerabilities in Different Regions

Vulnerability will not be uniform. Banking systems in oil-importing economies, those with sizable foreign liabilities, or substantial exposure to sanctioned sectors will be most at risk (BIS, 2023). Western European and some Asian banks with historical ties to Middle Eastern trade finance, energy, or investment flows may experience write-downs, liquidity squeezes, or increased provisioning. By contrast, banks in oil-exporting countries might benefit—but only up to a point—beyond which macroeconomic overheating and political contagion become hazards. Emerging market banks with weak regulatory buffers or limited access to backstops from the state or international lenders may be vulnerable to systemic crises and require outside stabilization.

7. Role of Regulatory Institutions (IMF, FATF, BIS)

Institutions such as the IMF, FATF, and BIS are integral to monitoring, crisis mitigation, and policy coordination (FATF, 2022; BIS, 2022). The IMF may be called on for bailout packages, swap lines, and policy advice to prevent balance-of-payments crises and recapitalize banking systems; the BIS provides technical guidance, macroprudential toolkits, and forum for cross-border cooperation; and the FATF tightens vigilance against sanctions evasion and illicit finance. However, the speed, scope, and complexity of enforcement may outpace their capacity to respond, exposing the limits of the prevailing regulatory architecture in the face of protracted geopolitical shocks (IMF, 2022).

A protracted Iran-Israel conflict would thus have the potential to simultaneously undermine payment networks, disrupt capital flows, escalate legal and compliance costs, create inflationary and interest rate shocks, shift global risk perceptions, and reveal regional vulnerabilities—while stretching the mandates and resources of existing regulatory institutions. This reinforces the need for adaptive, coordinated, and forward-looking international policy strategies to preserve global banking stability in an age of rising geopolitical turbulence.

Implications

Implications for International Banks and Multinational Corporations

International banks and multinational corporations (MNCs) would face heightened operational, legal, and market risks in the wake of a prolonged Iran-Israel conflict. Banks directly exposed to Middle Eastern markets could experience disruptions to their correspondent banking relationships, especially if SWIFT network exclusions or intense sanctions are imposed (SWIFT, 2022). MNCs with regional supply chains or financing arrangements may encounter increased transaction costs, procurement delays, and difficulties in currency convertibility. Additionally, expanded sanctions regimes would require banks and corporates to overhaul compliance programs, escalate Know-Your-Customer (KYC) and anti-money laundering (AML) scrutiny, and navigate uncertainties regarding secondary sanctions (IMF, 2022; FATF, 2022). Risk assessments and credit pricing for cross-border transactions would become more conservative, possibly leading to a retrenchment from higher-risk markets and reduced access to international capital for firms in or near the affected region.

Implications for Central Banks and Regulators

Central banks in exposed economies could be forced to manage sharp capital outflows, currency volatility, and inflationary pressures stemming from oil price shocks (Hamilton, 2011; World Bank, 2022). They would need to adjust monetary policy—potentially tightening interest rates to defend currencies and contain imported inflation—even at the risk of slowing economic growth and increasing default rates on loans. Financial regulators would intensify stress testing, liquidity requirements, and macroprudential oversight of the banking sector, with particular attention to banks' foreign currency exposures, cross-border funding structures, and credit concentration. In heavily exposed economies, authorities might have to consider capital controls, emergency liquidity facilities, and coordination with international institutions for balance-of-payments or banking sector support (BIS, 2023).

Implications for Investors and Rating Agencies

Investors are likely to reassess sovereign and corporate risk premia throughout the Middle East and other emerging markets, increasing demand for liquidity and safe-haven assets such as U.S. Treasuries and the Swiss franc (Reghezza et al., 2024). Persistent uncertainty could trigger declines in regional equity and bond prices and prompt rating agencies to downgrade sovereign and bank credit ratings in conflict-affected or heavily exposed economies. Forced asset selloffs and deteriorating investor sentiment may further restrict access to global capital markets, escalating refinancing and liquidity risks for borrowers. Rating agencies would place greater weight on banks' ability to withstand external shocks, diversify funding, and sustain profitability amid new regulatory burdens and market fragmentation.

Strategic Recommendations (Theoretical Viewpoint)

1. For Banks and MNCs: Strengthen geographic and counterparty diversification, invest in robust compliance and risk management systems, and seek alternative transaction and financing channels (e.g., regional payment systems) to mitigate payment network disruptions and regulatory fallout.
2. For Central Banks and Regulators: Enhance macroprudential surveillance tools, fortify foreign exchange reserves, prepare contingency frameworks for stress scenarios, and develop coordinated responses with multilateral institutions (IMF, BIS, FATF) to maintain confidence and stability.
3. For Investors and Rating Agencies: Adjust portfolio strategies to reflect heightened geopolitical tail risk, closely monitor regulatory and sanctions developments, and prioritize transparent, agile risk assessment methodologies.
4. For the Global Community: Promote information-sharing, scenario planning, and contingency exercises among stakeholders to bolster collective preparedness. International cooperation is crucial for mitigating spillovers and reinforcing systemic resilience.

Conclusion

This research paper has examined the complex and multifaceted impact that a hypothetical prolonged Iran-Israel war could have on the international banking system. The study identifies critical transmission channels—including disruptions to the SWIFT payment network, shifts in cross-border capital flows, escalating sanctions regimes, and oil-price-induced inflationary pressures—that collectively threaten global financial stability. Through an integrated framework drawing on conflict theory in economics, systemic risk theory in international finance, and concepts of globalization and financial interdependence, the paper elucidates how geopolitical conflict can cascade through interconnected banking networks, amplifying vulnerabilities that vary across regions and banking sectors. Moreover, the role of key regulatory institutions such as the IMF, FATF, and BIS is highlighted as both crucial and challenged in mitigating systemic shocks amid such crises.

Theoretically, this study contributes to the literature by bridging conflict economics with systemic financial risk analysis, offering a coherent conceptual model that explicates both the origins and propagation mechanisms of geopolitical-financial risks. It advances understanding of how geopolitical shocks are not isolated disruptions but rather dynamic processes involving feedback loops between real economic damage, regulatory responses, and financial market sentiments. By situating these processes within the modern context of globalization and financial interdependence, the paper underscores the heightened sensitivity and complexity of contemporary international banking systems to regional conflicts.

For future research, empirical investigations are needed to quantitatively assess the specific magnitude and timing of these transmission channels using granular banking data and event studies. Case studies comparing past regional conflicts and their banking sector impacts would enrich understanding of heterogeneity among

banking systems. Additionally, further work on the efficacy and innovation of regulatory measures, including digital financial infrastructures and alternative payment platforms, could provide actionable insights. Cross-disciplinary collaborations incorporating political science, economics, and finance remain especially valuable for crafting anticipatory policies that enhance resilience.

In closing, this study reaffirms that geopolitical-financial risks are evolving, multifactorial, and increasingly intertwined in a globalized economy. The international banking system's stability can no longer be presumed resilient to geopolitical shocks, given the speed and scale of contagion in today's networks. Proactive, coordinated, and forward-looking policy frameworks will be indispensable in navigating a world where geopolitical tensions and financial fragility coalesce with profound systemic implications.

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