BRIEFING

TAX3 in FOCUS

Latvia Cracks Down on Unscrupulous Banking

The European Parliament's Financial Crimes, Tax Evasion and Tax Avoidance Committee (TAX3) sent a delegation to Latvia in August 2018.[1] Members welcomed the new law aimed at significantly limiting the exposure of the Latvian financial sector to money-laundering risks.[2] Key elements are enhancing the exchange of information between financial institutions and law enforcement agencies, and curbing transactions with shell companies.[3]

Indeed, for almost thirty years, supervision of Latvian banking has posed major challenges, primarily due to the dynamic cross-border nature of banks' activities. In 2018, Latvian authorities have realised that the situation of the country's banking sector became unsustainable. Efforts are being carried out to redress the situation and these are already bearing fruit. New measures primarily aim at reducing non-resident deposits and shell companies, and increasing criminal proceedings against entities involved in money laundering.

In one generation Latvia has carried out a successful transition to market economy, democracy, rule of law, and private ownership. Banks have played an important role in Latvia's economic development. They thrived in an open and entrepreneurial climate. Overall, this worked well, but Latvia has gone through four serious banking crises, in 1995, 1998-9, in 2008-9 and in 2018. The crises have been very different, but each of them has led to consolidation and changes to the banking system. Until recently, a particular feature of the Latvian banking sector was the significant role played by non-resident deposits, which were as important as resident deposits. Foreign deposits at Latvian banks are mostly related to business links with Russia. From a high of over 50% of total deposits in 2015, they have decreased to a mere 21% in August 2018 following the introduction of stricter rules against money laundering and the financing of terorrism.

Indeed, Latvia became exposed to money laundering risks for many reasons. To begin with, it had carried out in-depth market economic and judicial reforms. It turned into a very open and entrepreneurial economy with a thriving banking sector having many internationally owned banks. In 2004 Latvia became a member of the European Union and in 2014 it joined the euro area. These developments proved instrumental in its ambition to become a regional financial business center. At the same time, Russians, Ukrainians and citizens of other former Soviet States with significant wealth keep their money abroad. In parallel with attracting customers from these countries, Latvia set up supporting schemes and infrastructure, e.g. a golden visa programme (see Box 1) and special tax incentives for business, three special economic zones and two free ports.

In the previous decade, various prominent money laundering cases occurred in the Latvian banking system. They involved certain banks, but not all. Some were deeply involved, while others had minor engagement.[4] Today, capital and liquidity ratios are comfortably above required levels. The ratio of non-performing loans has fallen below the EU average and coverage of loan loss risk with provisioning is high(see Table 1). The three largest banks (AS SEB Banka, Luminor Bank AS and Swedbank AS)[5] are directly supervised by the European Central Bank, like ABLV before its closure (see below). Latvia benefits from the Single Resolution Mechanism, which provides an EU-wide framework for orderly resolution of large banks. The smaller Latvian banks are supervised by Latvia's Financial and Capital Market Commission.[6]

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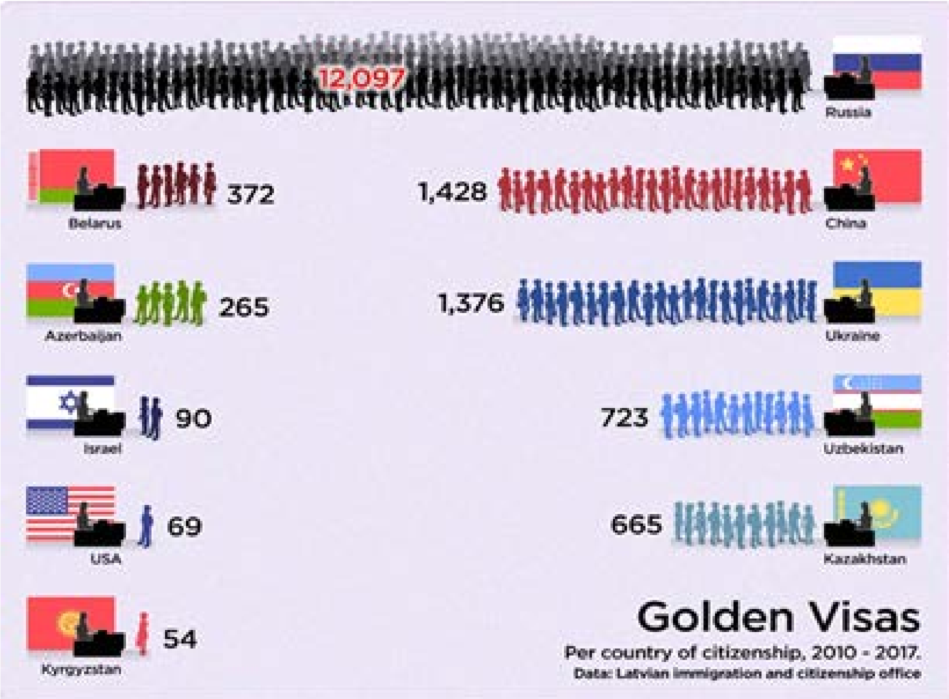
Box 1: Golden Visa Programme [7]

Latvia launched a Golden Visa Programme in 2010. Initially started as a post-2008 crisis economic development tool, at some point it acquired renewed political significance.

Chart 1: Latvian golden visa awarded by country of citizenship



Under the programme foreigners could acquire the right to reside in Latvia, an EU Member State; by buying a property in the countryside for a minimum of EUR 71,150, or in Riga for EUR 142,300 making the Latvian Golden Visa one of the best bargains in Europe. During the programme's first year approximately 300 people applied. The number grew rapidly and by 2014 (the year that Russia annexed Crimea) it increased to nearly 6,000. Almost 90% of the applicants originated from the ex - Soviet Union, predominantly Russia. Latvia appears attractive for this particular group as Russian is widely understood in Latvia, with 25% of the population being Russians.

In response to increasing concerns about applicants, Latvia introduced entry quotas, tighter background checks and a higher participation fee of EUR 250,000. These measures led to a significant decrease in the number of granted permits and more visa refusals. The main cause for refusal was "risk of spying", followed by "inability to prove legality of applicant's income". By the end of 2017, the programme had lost attractiveness. While it did not give a massive boost to business, it brought EUR 1.44 billion mostly from property deals.

On various occasions, Latvia's protection against money laundering and financial crime proved to be ill-functioning and unfit, while having very attractive banking and overall business facilities in a context of transparent and free capital movements in the euro area and EU. The most recent case was ABLV Bank. Following the closure of the bank in late February 2018, the total assets of the Latvian banking system dropped by EUR 2.5 billion or 10% from Q2 to Q3 in 2018 and by 13.6% for Q2 2018 on annual basis (see Table 2).

Table 1: Latvia: Financial soundness indicators

% of total	2013	2014	2015	2016	2017	2018 Q2
Non-performing debt	5.6	7.7	5.1	5.2	4.7	5.3
Non-performing loans	-	9.7	6.5	6.3	5.6	5.9
Non-performing loans non-financial corporations	-	12.0	11.1	11.1	10.4	10.7
Non-performing loans households	-	12.3	10.4	7.9	5.9	5.6
Coverage ratio	79.3	39.9	37.7	35.3	35.9	32.2
Loan to deposit ratio	-	67.3	59.9	62.4	60.6	70.6
Tier 1 ratio	16.5	17.5	19.0	17.3	18.4	20.1
Capital adequacy ratio	18.0	20.2	21.8	20.4	21.6	22.3*
Return on equity	8.8	10.2	10.7	14.3	7.6	4.1
Return on assets	0.9	1.0	1.2	1.5	0.88	0.56

* 2018 Q1 data.

Source: ECB.

Table 2: Total assets changes of the Latvian banking sector in EUR billion

	2018 Q2	2018 Q3	2018 Q2 - Q3 growth	2018 Q2 annual growth	2018 Q3 annual growth
total Assets	24.4	21.9	-10%	-13.6%	-10.4%

Source: ECB.[8]

The Development of the Banking System

After the collapse of the Soviet Union, each former republic introduced its own currency and set up its own settlement and banking systems. Between 1991 and 1993 more than 60 new private banks entered the Latvian market as a result of the quick privatisation of the state banks and low entry requirements. After half a century of communist rule Latvia decided to implement a free market economy. This approach was reflected, amongst other things, in deregulation of prices and market-determined interest rates. Moreover, Latvia did not establish any deposit insurance mechanism. However, little was known about the banks and the banking regulators. The transition to market economy, corruption, unfavourable trade financing, currency and interest rate risks together with poor management resulted in massive bank failures.

Latvia positioned itself as an offshore financial hub for the Russia/Commonwealth of Independent States region, with a large Russian-speaking population, geographic proximity to Russia, and, beginning in 2004, European Union membership. Some Latvian-headquartered banks tended to cater to this non-resident business. Conversely, large Scandinavian subsidiaries' commercial banks dominated Latvia's domestic banking market for household and business customers. At the same time, financial transactions in non-resident banking may be more complex and difficult to investigate, while banks' business relations can be volatile, short-term, and exposed to different cycles across regions. This lower degree of transparency and predictability requires specific supervisory actions by the authorities and adequate response by banks active in this sector.[9]

Money Laundering and Financial Crime

In the absence of stricter currency control and capital flow restrictions Latvia largely extended financial services to foreign clients. Latvian banks served as east-west financial bridge and had promoted themselves as a gateway to

Western markets, promising Swiss-style banking secrecy. Latvian banks catering to non-resident customers played a key role in the biggest illicit international financial scandals in recent years. Some of the highlights include: "The USD 20 billion Russian Laundromat", "The USD 3 billion Azerbaijani Laundromat", "The USD 1 billion Moldovan bank heist", "The USD 1 billion Kazakh bank fraud", "The USD 230 million Russian tax fraud" uncovered by Sergei Magnitsky, "The USD 10 billion Russian "mirror trading" scheme", "The USD 5.5 billion asset-stripping of Ukraine's largest bank", public corruption involving the transit of natural gas through Ukraine, fines against the second- and third-largest non-resident banks, Norvik and Rietumu, and anti-money laundering failures that allowed their customers to circumvent international sanctions against North Korea.[10, 11]

In February 2018, Latvia's third-largest lender, ABLV Bank unexpectedly collapsed. Although the bank was profitable and well capitalised, the shareholders decided on 26 February 2018 to voluntary liquidate the bank.[12] The triggering event happened when the Financial Crimes Enforcement Network at the US Treasury proposed to ban activities of ABLV in the US due to concerns related to money laundering, bribing officials, and breaching the North Korea embargo. This raised doubts about the soundness of the bank's business model, causing a sudden drop in the bank's confidence and massive depositors run. As a result the bank's liquidity position was depleted. As the Single Resolution Board decided not to take any resolution action,[13] the owners proceeded with the liquidation of the bank. Furthermore, in October 2018, the Financial and Capital Markets Commission announced record fines to be paid by two Latvian banks - including a EUR 2.2 million fine on LPB bank (formerly known as Latvian Postal Bank) - for breaches of regulatory provisions against money laundering and terrorist financing[14].

Latvia recognises its vulnerability and prioritises the combat against money laundering and financial terrorism. Amending legislation and enhancing supervision positively impacts the efficiency of the prevention system. The problem however is not only in regulating but rather in adequately implementing the rules.[15] In its 2018 report[16] the Moneyval (the Council of Europe Committee on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism) recognised that Latvia should do more to enforce its laws against financial crimes. Having a solid legal framework, its main focus should be to use its legal tools.

1 http://www.europarl.europa.eu/news/en/press-room/20180830IPR11314/tax3-committee-concludes-visit-to-riga

2 https://likumi.lv/ta/en/id/178987-law-on-the-prevention-of-money-laundering-and-terrorism-financing

3 https://ec.europa.eu/info/sites/info/files/file_import/2018-european-semester-country-specific-recommendation-commission-recommendation-latvia-en.pdf

4 http://www.oecd.org/eco/surveys/economic-survey-latvia.htm

5 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.list_of_supervised_entities__201810.en.pdf

6 https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-latvia-en_1.pdf

7 https://www.occrp.org/en/goldforvisas/latvias-once-golden-visas-lose-their-shine-but-why

8 http://sdw.ecb.europa.eu/reports.do?node=1000003244

9 http://ec.europa.eu/economy_finance/publications/country_focus/2014/pdf/cf_vol11_issue6_en.pdf

10 https://www.ft.com/content/175fa58c-1652-11e8-9376-4a6390addb44

11 http://delna.lv/wp-content/uploads/2018/01/Delna_Connections_2018_small-2MB.pdf

12 Money laundering - Recent cases from a EU banking supervisory perspective

13 https://srb.europa.eu/en/node/495

14 https://eng.lsm.lv/article/economy/banks/regulator-hands-out-fines-to-two-latvian-banks.a296667

15 The European Commission asked the European Banking Authority to conduct a breach-of-EU-law inquiry in i.a. Latvia, where the ABLV Bank case raised concerns about the effective enforcement of the anti-money laundering rules by national authorities.

16 http://www.fatf-gafi.org/media/fatf/documents/reports/mer-fsrb/Moneyval-Mutual-Evaluation-Report-Latvia-2018.pdf

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