Latvia's Banks: The Story from the Beginning

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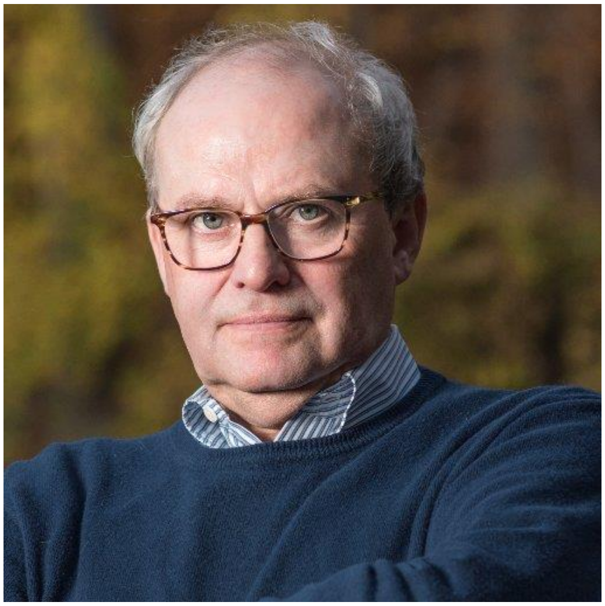

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Dr. Åslund has served as an economic adviser to several governments, notably the governments of Russia (1991 to 1994) and Ukraine (1994 to 1997). In 1991-92, he was Member of the International Baltic Economic Commission. In 2013 The Cross of Recognition of the Fourth Class for distinguished contribution in strengthening the international reputation of Latvia, most notably by renewing trust of financial markets in the sovereign of Latvia (awarded by President Andris Berzins). He is chairman of the Advisory Council of the Center for Social and Economic Research, Warsaw, and of the Scientific Council of the Bank of Finland Institute for Economies in Transition.

He has published widely and is the author of 14 books, including with Valdis Dombrovskis, *How Latvia Came through the Financial Crisis* (2011). Other books of his are with Simeon Djankov, *Europe's Growth Challenge* (OUP, 2017) and *Ukraine: What Went Wrong and How to Fix It* (2015). *How Capitalism Was Built* (CUP, 2013), and *Russia's Capitalist Revolution (2007)*. He has also edited 16 books.

Previously, he worked at the Peterson Institute for International Economics, the Carnegie Endowment for International Peace, the Brookings Institution, and the Kennan Institute for Advanced Russian Studies at the Woodrow Wilson Center. He was a professor at the Stockholm School of Economics and the founding director of the Stockholm Institute of East European Economics. He served as a Swedish diplomat in Kuwait, Poland, Geneva, and Moscow. He earned his PhD from Oxford University.

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Executive Summary

The aim of this paper is to describe the development of the Latvian banking system and to clarify the state of anti-money laundering and counter-terrorism defense (AML/CTF). The banking industry's dramatic progress over the last twenty years is shown in an economic and political context.

Since its renewed independence in August 1991, Latvia has carried out a highly successful transition to democracy, rule of law, market economy, and private ownership. It ranks quite high by all governance standards. From the outset, the Bank of Latvia has had an independent governor and board. The stability of the Bank of Latvia is evident from the fact that during the last 26 years, it has only had two governors. Latvia developed a vibrant banking system, which has survived and sustained through crises in 1995, 1998-9, and 2008-9. The country went through swift crisis resolution, restored macroeconomic stability, returned to high growth, and minimized the social cost. The banking system is financially strong and is regulated by the independent Financial and Capital Market Commission (FCMC). At present, Latvia has 23 banks, 16 are Latvian banks, while the remaining seven are branches of foreign banks. The banking system is competitive and not very concentrated. By European standards, the volume of the banking assets is relatively small at 130 percent of GDP.

The problem, to which this paper is devoted, has been publicized cases of money laundering and myths surrounding the current banking system. In the period 2008-15, four major money laundering cases that involved some Latvian banks were revealed. The cases have been thoroughly investigated, and serious punishments, including the revocation of two bank licenses and multiple million-euro fines have been imposed.

The Latvian authorities have carried out all conceivable measures to put an end to all money laundering. They have adopted all desired legislation and the consensus judgment is that implementation has become firm since 2015. In 2004, Latvia became a member of the European Union (EU), after having adopted extensive EU legislation. In 2005, it started cooperating with the US Treasury Financial Crimes Enforcement Network, and the US Treasury has been a driving force in AML/CTF endeavors. The main effort was undertaken from 2014 to 2016. In January 2014, Latvia adopted the euro and become a member of the Eurozone as well as the European Banking Union, being supervised by the European Central Bank (ECB). In November 2014, the ECB established the Single Supervision Mechanism (SSM) for banks in the European Union, which became operational on January 1, 2016. The ECB supervises the three biggest Latvian banks, while the other Latvian banks are supervised by the Latvian FCMC in cooperation with the ECB.

In July 2016, Latvia became a member of the Organization for Economic Cooperation and Development (OECD), which is the gold standard for best practices among 35 member countries, in particular, the OECD supervised Latvia's adoption of its anti-bribery convention. The all-European inter-parliamentary organization Council of Europe focuses on democracy, human rights, and legal standards. It has a Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL), which has repeatedly inspected the Latvian banking system and issued major reports. Its next inspection is due in October 2017.

The Latvian authorities have invited all of these international organizations and willingly upgraded and harmonized their procedures to the highest ethical standard. Latvia has adopted all of the many legal measures these organizations have recommended. As a result, Latvia has promulgated dozens of laws and developed eminent legal standards and full-fledged defenses against money laundering. In parallel, the independent FCMC has been considerably strengthened with a big compliance department.

Three important AML principles are: 1) that the FCMC insists on knowing the beneficial owners of banks; 2) that banks have to impose the principle Know Your Customer (KYC) and know the origin of funds; and 3) that large cash payments are not permitted. Since 2015, the severe judgments that the FCMC have passed for prior breaches demonstrate that the rules are in place and effective. Latvia no longer appears to be a significant concern for money laundering.

A concern of a different nature has arisen. Latvian banks have been cut off from correspondent banking in US dollars. The last bank to offer such services was Deutsche Bank, which stopped doing so after a case of money laundering by the local Estonian management of Danske Bank came to light. This has contributed to a decline in non-resident banking by one quarter since the end of 2015, even though Latvia has eminent services and high legal standards for non-resident banking.

The International Monetary Fund (IMF) has drawn attention to this rising problem for a large number of small countries around the world. The US Federal banking regulators have also addressed this issue. But it is difficult to understand why this should apply to Latvia, a member of the EU, the EMU, and the OECD, supervised by the ECB, and with eminent legal standards. Latvia has complied with all conceivable standards and should be offered adequate correspondent banking.

1. Latvia's Successful Post-communist Economic Transformation

In July 1992, when I was a professor at the Stockholm School of Economics and Director of the Stockholm Institute of East European Economics, the center-right Swedish Prime Minister Carl Bildt asked me to go to Riga and evaluate Latvia's currency reform and macroeconomic policy. I was accompanied by my collaborator Dr. Ardo Hansson. Since 2012, he has been the governor of the Bank of Estonia.

We had two highly memorable meetings. One was with the young Chairman of the Bank of Latvia, Einars Repše. He understood macroeconomics, insisting on a balanced budget, a national currency, and strict monetary policy. He incessantly cited Baroness Margaret Thatcher's ideals for a free market, because after half a century of communist rule he wanted a free market. Repše was the chairman of the Bank of Latvia from 1991-2001, did many good things, and went on to become prime minister and finance minister.

Our other remarkable visit was to the newly established but already leading bank Parex. We met with one of the two co-founders, both from Riga. The bank's main slogan was: "We exchange all currencies and we ask no questions." It did not look like an ordinary bank.

We were convinced about the soundness of Latvia's fundamental economic policies and the competence of their key policymakers, so we argued strongly with Carl Bildt and IMF Managing Director Michel Camdessus for full Western support for Latvia,[1] which it got. Neither Bildt nor Camdessus needed any convincing. They knew the Latvian financial case was sound, but it needed empirical support.

Among the 30 post-communist economic countries, Latvia stands out as one of the greatest successes, together with its Baltic neighbors Estonia and Lithuania. These three countries pursued quite similar economic policies, which can be summarized as deregulation of markets and prices, swift macroeconomic stabilization, and early privatization. They all opted for early and radical market economic reforms from 1992.

Table 1 shows the main economic indicators for Latvia from 2000, and they are nothing but impressive.[2] From 2000-7, Latvia had an average economic growth of no less than 8.5 percent a year. Latvia's Gross Domestic Product (GDP) in US dollars increased more than four times from 2000 to 2008. Its investment ratio was as high as 41.5 percent of GDP in 2007. Its fiscal situation was equally outstanding. Public expenditures were capped at about one third of GDP, and the government budget was

[1] Anders Åslund, "Latvia: A Successful Currency Reform", *Östekonomisk Rapport*, vol. 4, no. 10, September 24, 1992.

[2] Table 1 is located on page 31.

almost balanced. Latvia's small public debt shrunk to 7 percent of GDP in 2007 and unemployment to 6 percent.

But it was too good to last. The statistics in Table 1 indicate the problems. Latvia was so promising but small and it attracted more foreign capital than it could absorb. Its economy overheated. Imports sharply exceeded exports in 2005-7, while wages rose more than the economy could bear, and the previously low inflation rose into double-digits in 2007. The government should have pursued a much stricter fiscal policy with a budget surplus during these years, but instead it increased expenditures with rising revenues, aggravating the over-heating with a pro-cyclical fiscal policy.

2. Fortuitous Resolution of the Financial Crisis of 2008

On September 15, 2008, the Lehman Brothers bankruptcy in the US led to the global financial crisis. International finance came to a sudden stop. Most countries faced a temporary liquidity freeze leading to a deterioration of their fiscal situation, and many ended up in fiscal crisis. Among the then-27 members of the European Union, all but Poland recorded an output contraction in 2009.

Estonia, Latvia, and Lithuania had experienced the greatest overheating before the crisis. They had large current account deficits and high inflation, with their economies operating beyond their actual capacity. Latvia was in the worst situation. The sudden stop of international finance caused a contraction in its output of 21 percent in three years (see Table 1).

In late 2008, the World Bank calculated in a baseline scenario that without any adjustment Latvia was heading to a budget deficit of 21.4 percent of GDP in 2010, with public expenditures of 58 percent of GDP.[3] But the Latvian government faced up to the severity of the crisis. It carried out a fiscal adjustment of 8.8 percent of GDP in 2009 and of 5.9 percent of GDP in 2010, amounting to a fiscal adjustment of 14.7 percent of GDP in the course of two years and a total of 17.5 percent of GDP in four years.[4] Latvia's public expenditures and revenues remain almost balanced at a level of 36-37 percent of GDP (Table 1).

As early as July 2009, the Latvian government had restored investment confidence. Although the budget deficit for that year was 8.9 percent of GDP, the policy action and direction were sufficient to convince the market. Funds started flowing into the country, and the Latvian recession lasted only two years.[5]

The reason why Latvia suffered an output fall of 21 percent in the course of three years in 2008–10 was external: a severe liquidity freeze. It could have been avoided if Latvia had been a member of the Eurozone, which would have allowed it to enjoy abundant liquidity from the European Central Bank (ECB). Having restored its public finances after two years, Latvia has geared up to solid economic growth of an average of 3.3 percent a year from 2011-16.

The first task in a financial crisis is to restore financial stability and market confidence. The Latvians succeeded because they concentrated the fiscal adjustments in the first year of combating the crisis. Thanks to their front-loaded fiscal adjustment,

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[3] World Bank, "Latvia: From Exuberance to Prudence. A Public Expenditure Review of Government Administration and the Social Sectors," Report no. 56747-LV, vol. 2, September 27, 2010, p. 21.
[4] Ibid.
[5] Anders Åslund and Valdis Dombrovskis, *How Latvia Came through the Financial Crisis*, Washington, DC: Peterson Institute for International Economics, 2011, pp. 102-110.

they did so in ten months from October 2008 until July 2009. The resulting market confidence has led to very low interest rates in Latvia, which stimulates investment and consumption and thus growth. One of the many advantages of a front-loaded fiscal adjustment is that a country obtains less public debt. Latvia's public debt declined from 43 percent of GDP in 2009 to 34 percent of GDP in 2016, far below the Maastricht ceiling of 60 percent of GDP (Table 1).

Politically, the population showed that it wanted to see the crisis resolved as soon as possible. The government concluded an early social compact with trade unions, the employers' association and pensioners' association in the midst of the crisis to get their support for public cuts. It closed half of the state agencies and sacked one third of the public employees, which turned out to be popular. It helped that the government hit the privileged with new taxes and pursued a political campaign against corruption and the oligarchs – rich business leaders with a great deal of political influence - two of Latvia's three dominant oligarchs were cut down politically. The proof of the success was that Prime Minister Valdis Dombrovskis was reelected twice after having taken the country out of the crisis.

Today, Latvia's main economic concerns do not revolve around the financial sector, which is widely considered of high quality. The key concern is that the population has declined from 2.4 million in 2000 to currently 2.0 million, mainly because of emigration. An additional issue is a relatively high unemployment at 8.34 percent (Eurostat June 2017), mostly because of a skills mismatch and demand, and the convergence with Western Europe has slowed down, and is not proceeding as fast as desired.

The key takeaway is that Latvians know how to resolve crises both politically and economically. When they face a big problem, they resolve it fast with the necessary radical measures.

3. Evolution of Latvia's Banking System

Banks have played an important role in Latvia's economic development. For hundreds of years, Riga was the dominant trading city on the Baltic Sea. After Latvia's renewed independence in 1991, it was natural that Riga would regain its role as the trading and financing hub of the Baltic states.

Einars Repše, who had become Chairman of Bank of Latvia in 1991, was the leading economic politician for a decade. Prime ministers and finance ministers were replaced almost every year, while Repše stayed put. Moreover, he had stronger views and principles than all the ministers. His economic ideas were clear and firm. He was a monetarist, who believed in a conservative monetary policy leading to stable prices, and he believed in an open economy. His ideal was Switzerland, and he desired that Latvia would develop into an international banking paradise characterized by the rule of law and monetary stability. About 60 banks swiftly sprang up. They thrived in an open and entrepreneurial climate. The Bank of Latvia was in charge of bank regulation.

Initially, this worked well, but Latvia has gone through three serious banking crises, in 1995, 1998-9, and in 2008-9. The crises have been very different, but each of them has led to consolidation and substantial improvement of the banking system.

The first banking crisis took place from February to May 1995. It was a typical financial stabilization crisis. The novel banks had learned to make money on inflation, but suddenly it was gone. Almost all post-communist countries experienced such a crisis. Latvia could learn from Estonia, which had gone through such crises in 1992 and 1994. In March 1995, Baltija Bank, the largest bank in the Baltics announced that it would merge with the sixth and eighth biggest banks in Latvia. It had been betting against the national currency prior to the introduction of the euro - the lat, attracting lat deposits at interest rates of up to 90 percent a year. It had pursued reckless expansion and thought it could overrule the Bank of Latvia.

This was a last-ditch effort to avoid a collapse of all the banks. The public understood what was going on, and a broad bank run on both resident and nonresident deposits in Latvian banks started. Initially, the Bank of Latvia offered liquidity support to the major banks, but soon it realized that this was not a *liquidity* but a *solvency* crisis. It started negotiating with the Baltija Bank management, which responded by stripping the bank of assets. In May, the two top managers of Baltija Bank were arrested and the bank was declared insolvent. [6]

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[6] Ardo H. Hansson and Triinu Tombak, "Banking Crises in the Baltic States: Causes, Solutions, and Lessons," in Mario I. Blejer and Marko Skreb, eds., *Financial Sector Transformation: Lessons from Economies in Transition*. New York: Cambridge University Press, 1999, 195–236; Alex Fleming and Samuel Talley, "The Latvian Banking Crisis, April, Washington, D.C.: World Bank, 1996; Imants Paeglis, "Troubling Bank Failures in Latvia and Lithuania," *Transition*, 2 (1996), 10: 14-17.

After some hesitation, the Bank of Latvia went for a radical solution. Revealing extensive fraud, it closed and bankrupted 15 commercial banks, accounting for 35-40 percent of the banking assets and 53 percent of household deposits in the country. The shareholders lost everything, and the depositors received only partial compensation, since they had taken obvious risks, betting on high interest rates. Banks were forced to accept truly hard budget constraints.[7] The banking crisis impeded Latvia's economic growth that had just turned positive in 1994, and in 1995 its GDP contracted by 2.1 percent,[8] but the harsh resolution cleansed the Latvian banking system.

After the Baltija Bank crisis stricter banking rules were adopted and implemented. The tough line that the Bank of Latvia took set a precedent that Latvia has followed: Resolve the crisis fast and do not waste public funds! In 1998, the Latvian Financial Intelligence Unit, which targets money laundering, was established, though it remained a small agency with limited powers subordinate to the general prosecutor's office.[9]

In 1997, the Latvian economy was finally taking off as GDP grew no less than 9.0 percent, but the Russian financial crash of 1998 hit Latvia, though the growth rate did not fall more than to 2.6 percent in 1999.[10] Latvia had caught up with the reform leaders in the Baltics and Central Europe and seemed unstoppable.[11] This crisis also put an end to Latvia's remaining dependence on the Russian market. Yet, asset values were depressed. At this time, Nordic banks, notably, Swedbank, SEB, and Nordea, decided to enter the Baltic bank markets, buying the biggest and best local banks.[12]

Since 1999, the Nordic banks have held most of the banking assets in the Baltic region, including in Latvia. They were praised for boosting technical and financial standards, and they have been happy with the business climate and profits in Latvia. By 2007, four banks accounted for three-quarters of Latvia's bank assets. They were three big Swedish banks, Swedbank, SEB and Nordea, but the second biggest bank was Latvian Parex Bank. The Scandinavian banks stayed on during the next crisis 2008-9. A Latvian complaint about the Scandinavian banks has been that they have been pro-cyclical. They poured too large funds into Latvia during the good years 2000-7, while they withdrew funds during the crisis in 2008-9.

In 2008, Latvia entered the bust of a classic boom-bust cycle.[13] The first movements of the global financial crisis in early 2007 affected Latvia through the restriction of

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[7] Ibid.
[8] IMF, World Economic Outlook Database, September 2017.
[9] "Latvian Bank Woes," OCCRP, October 30, 2011.
[10] IMF, World Economic Outlook Database, September 2017.
[11] Organization of Economic Cooperation and Development, *OECD Economic Surveys: The Baltic States.* Paris: OECD, 2000.
[12] "Latvian Bank Woes," OCCRP, October 30, 2011.
[13] The classical treatment is: Charles P. Kindleberger and Robert Aliber, *Manias, Panics, and Crashes*, 5th ed. Hoboken, NJ: Wiley, 2005.

credit issuance. With less credit, housing prices started falling and with them, consumer demand and investment did as well. In the second quarter of 2008, output began contracting so violently that it threatened the banks. With the bankruptcy of Lehman Brothers, liquidity froze and Latvia with its great dependence on foreign finance faced a sudden stop.

The prime victim of the sudden stop was Parex Bank, Latvia's largest, independent commercial bank, and the country's second largest bank, with one-fifth of all bank assets in the country. It could no longer finance itself on the European wholesale market, and it had syndicated loans falling due. The two owners of Parex Bank, Viktors Krasovickis and Valerijs Kargins, were well-connected and popular Latvian citizens. They had won the first private license in the Soviet Union to trade hard currency in 1990. It had been one of the early, highly entrepreneurial post-Soviet banks, with all the baggage, too. In 2005, it advertised in Russia that Riga was closer to Moscow than Switzerland and that everyone at Parex spoke Russian. In a last daring bid in the fall of 2008, its billboards in Stockholm offered 6.5 percent a year deposit rates in Swedish kronor.[14] Latvians were divided in their views of the two former owners, for a long time the richest men in Latvia. Some respected these self-made Latvian citizens, who could compete with big foreign banks. Others worried they would enrich themselves at the expense of Latvian taxpayers.

A run on deposits started at Parex Bank. It lost one quarter of its deposits from the end of August through November 2008. On November 8, the Latvian government announced it was buying 51 percent of Parex Bank from its owners for the symbolic amount of 2 lats (about 3 euros). Yet, the outflow of deposits did not stop. On November 15, the deposit run on Parex Bank turned into a run to exchange lat for euro and other foreign currencies. The air was full of rumors of imminent devaluation of the lat. On December 1, the authorities imposed a partial freeze on deposit withdrawals to conserve liquidity. The government had to recapitalize Parex at a total of 4.9 percent of GDP and 2.6 percent of GDP was needed in additional guarantees.[15]

The collapse of Parex Bank was the trigger that compelled the government to call in the IMF and the European Commission for emergency financing and urgently so. On December 18, the government concluded a standby stabilization agreement with the IMF, which was reinforced with even more EU funding and also large bilateral co-financing. In May 2010, the government decided to divide Parex Bank into two banks, a "bad bank" or resolution facility for non-performing loans and a normal bank. The bad bank was supposed to sell off impaired assets at a deliberate speed to receive decent returns to the state and then be closed down, while the good Parex Bank, renamed Citadele, was to be sold.

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[14] Robert Anderson, "Latvia's IMF Talks Stall over Bank Deal," *Financial Times*, December 2, 2008; Robert Anderson, "Latvia Nationalises Parex Bank As Depositors Withdraw Faith," *Financial Times*, December 4, 2008; Personal observation of the billboards in Stockholm.

[15] International Monetary Fund, Republic of Latvia, "Request for Stand-By Arrangement," December 19, 2008, 8. Accessed at www.imf.org on November 15, 2010.

The Latvian Privatization Agency carried out an international tender with support from Société Générale. The sale to private investors was done as planned in November 2014.[16] A group of international investors won the tender and bought 75 percent of the shares, while EBRD retained its share of 25 percent.[17]

[16] "Latvia Agrees Deal to Sell Citadele Bank for 74 Million Euros," Reuters, November 5, 2014.
[17] OECD, "Latvia: Review of the Financial System," Paris: OECD, April 2016, p. 19.

4. The Structure of the Latvian Banking System

Latvia has a strong central bank, the Bank of Latvia. The governor, his or her deputy and the members of the council hold office for six years. The Bank of Latvia has been strong and independent from the outset. Its first governor, Repše, held the job for a full decade until 2001, when he resigned to become prime minister. His successor, Ilmārs Rimšēvičs, has held the position since 2001. This stability has contributed to a firm monetary policy.

In its structure, the Latvian banking system is reminiscent of other banking systems in Central and Eastern Europe. Latvia's financial markets are extremely dominated by banks, which account for 90 percent of the assets of the financial system. Apart from a minor state-owned development finance institution, the whole financial system is private.

Although Latvia has had the ambition of developing a regional financial center, the ratio of banking assets to GDP is actually quite low at only 130 percent, to compare with an EU average of 350 percent. Nor does it have particularly large non-resident assets. The FCMC has defined 14 banks as specialized in non-resident banking and they account for less than 40 percent of total bank assets. Their share of total loans is even less than 25 percent, while their share of total deposits was more than 55 percent. The maturity of nonresident deposits is short with more than 85 percent being on-demand deposits held for business transactions. Around 80 percent of the total non-resident deposits pertains to business or individuals in former Soviet republics, who are the natural clients for both geographic and linguistic reasons.[18] After 2015, a sharp fall in non-resident funds of more than one-quarter has been reported.[19] The Latvian authorities require that banks with large non-resident business be subject to much stricter capital and liquidity requirements.

A 2016 OECD report notes: "Banks in Latvia can be classified into foreign (mainly Scandinavian) owned banks, which focus on servicing residents and dominate in the resident loans and deposits market and banks, and those which specialize in servicing non-residents, and which are mainly domestic private person-owned banks."[20] Latvian banks have a minimal presence overseas.

The Latvian banking system is characterized by strong transparency. The "FCMC verifies the identity of the shareholder of a financial institution. There is a legal duty to provide information to FCMC to enable this verification, and a founder should be financially stable, and if necessary, have to provide additional capital to the financial institution."[21]

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[18] OECD, "Latvia: Review of the Financial System," Paris: OECD, April 2016, p. 25

[19] Aaron Eglitis, "Ex-Soviet Cash Drain Deepens as Baltic Bank Rules Tighten," Bloomberg, February 22, 2017.

[20] OECD, "Latvia: Review of the Financial System," Paris: OECD, April 2016, pp. 13-14.

[21] OECD, "Latvia: Review of the Financial System," Paris: OECD, April 2016, pp. 13-16.

The concentration of the banking sector is limited. In 2014, the market share of the five largest banks was only 63.5 percent of assets, 76.3 percent of loans, and 64.7 percent of deposits. This is a market with healthy competition.[22]

Most big Latvian banks are owned by banks in neighboring Scandinavian countries. The four big Scandinavian banks are Swedbank, SEB, DNB, and Danske Bank, which hold more than half of the banking assets. There are five other foreign banks. Citadele Banka is owned by an American investor consortium led by Ripplewood Advisors. Expobank and Norvik Banka are owned by Russians. Regionala Investiciju Banka and Privatbank are owned by Ukrainians. Privatbank's parent company in Ukraine was taken over by the National Bank of Ukraine in December 2016.

Local banks remain comparatively strong, notably ABLV Bank, Rietumu Banka, Baltic International Bank, BlueOrange, Latvijas Pasta Banka, and Rigensis Bank.

As a result of bank closures and mergers, the number of banks in Latvia has declined gradually. It peaked at 61 banks in 1992. In 2016, the number of banks had declined to 23, of which 16 were registered as Latvian banks, while seven were branches of foreign banks. Further consolidation of the Latvian banking system is expected. Table 2 contains a list of the banks in Latvia today.[23]

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[22] OECD, "Latvia: Review of the Financial System," Paris: OECD, April 2016, p. 16.
[23] Table 2 is on pages 32-33.

5. Cases of Money Laundering

In the years, 2008-2015, a few prominent money laundering cases occurred in the Latvian banking system. They involved certain banks, but not all. Some were deeply involved in money laundering, while others had minor engagement.

Latvia became exposed to money laundering risks for many reasons. To begin with, it had carried out excellent market economic and judicial reforms. It was a very open economy with a large banking sector with many internationally-owned banks. In 2004, Latvia became a member of the European Union.

As Eriks Selga, a lawyer and scholar with the Foreign Policy Research Institute, has testified:

> After its economy had stabilized after the 2008 financial crisis, Latvia gained the reputation as a safe place to store money, attractive to investors from less stable Eurasian countries such as Russia and its neighbors. Together with low taxes and Russian-speaking financial professionals, Latvian banks are convenient for residents of the former USSR member countries. They are particularly appealing to elites and business owners seeking sanctuary from capricious governments. By moving their capital into more reputable Latvian banks, residents of less stable former Soviet nations ensure these funds are beyond the reach of their own states.[24]

The contrast to other countries in the eastern neighborhood mattered greatly. Property rights in former Soviet republics, such as Russia and Ukraine, are weak. All Russians and Ukrainians with significant wealth, regardless of how they have earned their money, keep their money abroad. Traditionally, the main conduit of money from Russia and Ukraine has been Cyprus because of an old Soviet double-taxation agreement that both countries maintained. The banking crisis in Cyprus in early 2013 led to substantial losses of offshore bank deposits. Press reports on the expected movement of Russian and Ukrainian funds to Latvia were later refuted by statistics from the Bank of Latvia.

In the years 2008-15, Latvia became subject to a few widely publicized cases of money laundering. On the one hand, Latvia had very attractive banking facilities and it was easy to move the money out of Latvia thanks to the country belonging to the European Union. Unfortunately, the nation had not developed sufficient defenses against money laundering as yet.

The cases of violations of money laundering regulations can roughly be divided into two groups. One group permitted or facilitated the laundering of money on behalf of customers. Some cases involved bad intent by the management and owners of the

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[24] Eriks Selga, "A Latvian Sock in the Laundromat? The Fight against Money Laundering," *Foreign Policy Research Institute*, April 28, 2017.

bank – in every case the result was serious enforcement measures such as bank closure, prison sentences, and major fines. The key cases were Trasta Komercbanka and Rietumu Banka. The other group consisted of banks whose policies, procedures and controls were considered to be inadequate by FCMC. No money laundering occurred but in the opinion of the regulator it could occur in the future if the deficiencies were not remedied. Those cases have resulted in supervised remediation plans and significant fines.

Sergei Magnitsky Case 2008

A well-investigated case is that of Sergei Magnitsky, who was murdered for defending the Western fund management company Hermitage Capital Management against a tax fraud of $230 million. Court records show that during two weeks in February of 2008, bank clients, mostly phantom companies, suspiciously wired this money into bank accounts in Ukraine, Kyrgyzstan, Moldova, Latvia, Lithuania, Estonia and Cyprus belonging to companies from the United Kingdom, British Virgin Islands, and Belize. Most of the money flew from Russia through Moldova and Cyprus to the United Kingdom and the British Virgin Islands. Of a total of $230 million, $63 million or about one quarter was reported to have gone through six Latvian banks,[25] but subsequent regulatory investigations cleared some of those banks of any involvement.[26]

Rietumu Banka, French Tax Evasion, 2008-12

On July 6, 2017, a Paris court fined the Latvian bank Rietumu Banka $91 million for facilitating tax evasion among French taxpayers. The presiding judge said that the proven amount of laundered money was $232 million, but investigators suspected that the actual amount of laundered money in 2008-12 was $964 million. Apart from the fines, most of the twelve defendants received suspended prison sentences of up to four years. Rietumu and the defendants were also sentenced to pay a combined $11.4 million to the government in damages.[27]

The Russian Laundromat, 2011-14

The most serious money-laundering story involving Latvia was the so-called Russian Laundromat, which was revealed by the international journalist syndicate the Organized Crime and Corruption Reporting Project (OCCRP) in 2014.[28] Between January 2011 and October 2014, $20.8 billion went from 19 Russian banks to 5,140 companies with accounts at 732 banks in 96 countries. "Organizers created a core of 21 companies based in the United Kingdom, Cyprus and New Zealand and run by

[25] Sanita Jemberga and Evita Purina, "U.S. Pressures Latvia to Clean up Its Non-Resident Banks, The Baltic Center for Investigatie Journalis,"Follow the Magnitsky Money," OCCRP, August 12, 2012.

[26] FCMC letter dated December 12, 2013.

[27] Philippe Sotto, "Latvian Bank Fined Heavily over Laundering Scheme in France," AP, July 6, 2017; "Latvian Bank Fined €80 Million for Money Laundering, Will Appeal. OCCRP, July 6, 2017.

[28] The Russian Laundromat Exposed, Organized Crime and Corruption Reporting Project, March 20, 2017.

hidden owners." Russian companies used these companies to move their money out of Russia. They used two banks as their immediate intermediary, Moldinconbank in Moldova and Trasta Komercbanka in Latvia. About $8 billion went through Moldinconbank. Nearly $13 billion was transferred to Trasta Komercbanka.[29]

The OCCRP website reported that all the money came from Russia and the ultimate culprits were the Russian owners of the 21 shell companies that made 26,746 payments through accounts with Trasta Komercbanka and Moldinconbank, who obviously cooperated. The banks that received these payments vary greatly. Among the top ten recipients, one was Moldinconbank , three were in Latvia, including Trasta Komercbanka, and the others were in Denmark, China, the United Kingdom, Russia, Greece and the United Arab Emirates.[30]

On March 3, 2016, the European Central Bank (ECB), now supervising the Latvian banking system, revoked the license of Trasta Komercbanka at the request of the Latvian Financial and Capital Market Commission (FCMC). The FCMC concluded that the bank had long committed serious violations of bank regulations, and Trasta Komercbanka had no critically important functions, so its closure would not impact the stability of Latvia's financial sector. [31]

The Big Moldovan Bank Robbery, 2014

One of the most spectacular bank coups in the former Soviet region was the looting of three Moldovan banks of $1 billion in one day in November 2014.[32] The central bank of Moldova hired the corporate investigations company, Kroll Inc., to trace the money and find out what had happened. Kroll's investigation is continuing with its fourth report issued to the National Bank of Moldova in April 2017.

Kroll's initial report contained a "data dump" that indicated that up to a fifth of the missing funds may have been routed through three Latvian banks. At least one of the banks has been cleared but the Kroll states that the investigation will continue for up to another two years.

Following its own investigation into the matter, the Latvian FCMC imposed varying fines for deficiencies in procedures and controls on the three banks [33] and on one for allowing suspicious payments.

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[29] "The Russian Laundromat Exposed," Organized Crime and Corruption Reporting Project, March 20, 2017.
[30] Max de Haldevang, "The Top 50 Global Banks Allegedly Involved in a $21 Billion Russian Money-Laundering Scheme," *Quartz*, March 21, 2017.
[31] "European Central Bank Revokes the Licence of Trasta Komercbanka," *Baltic News Network*, March 4, 2016; "Latvia: European Central Bank Revokes Trasta Komercbanka License," OCCRP, March, 2016
[32] Paul Radu, Mihai Munteanu, and Iggy Ostanin. "Grand Theft Moldova," OCCRP, July 24, 2015.
[33] FCMC Press Releases in English: December 11, 2015; May 26, 2016; July 25, 2017
http://www.fktk.lv/en/media-room/press-releases.html?start=40

North Korea Sanctions Violations, 2009-15

A close relative to laundering money is violating economic sanctions. Banks must protect against both as well as a host of other financial crimes. In June and July 2017, the FCMC determined that two banks did not know that they had several customers who had one or more customers in China and that those Chinese companies were doing business with North Korean companies. The FCMC also decided that three other small banks had procedures and controls that were inadequate to prevent the same situation from happening to them with customers' customers' business connections. Fines totaling 3,533,000 euros were assessed against the five banks.

"In the period from 2009 to 2015, on several occasions several customers of those banks, making use of off-shore companies and complicated chain transactions, transferred the funds from their bank accounts, to circumvent international sanctions requirements imposed against North Korea." FCMC Chairman Pēters Putniņš called these penalties "preventive," in that not all banks had completed these transactions.[34,35]

All these five cases pertain to the years 2008-15. It was in 2015 that Latvia really tightened all controls against money laundering and the FCMC has tightened its policy since Pēters Putniņš became chairman in February 2016. The FCMC can levy large fines and, since early 2016, it really does. Latvia appears to have gone through a qualitative paradigm shift. None of the people interviewed was aware of any case of money laundering after 2015.

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[34] FCMC, "FCMC in collaboration with U.S. law enforcement authorities identifies weaknesses and imposes monetary fines on three banks," Press Release, June 26, 2017. http://www.fktk.lv/en/media-room/press-releases/6429-fcmc-in-collaboration-with-u-s-law-enforcement-authorities-identifies-weaknesses-and-imposes-monetary-fines-on-three-banks.html

[35] FCMC, "FCMC in collaboration with U.S. law enforcement authorities identifies weaknesses," Press Release July 21, 2017, http://www.fktk.lv/en/media-room/press-releases/

6. Reforms Driven by International Integration

Latvia has opted for full integration with the West and complete institutional convergence. It has joined all major international organizations on offer: The International Monetary Fund (1992), the World Bank (1992), and the World Trade Organization (1999). The big step was that Latvia became a member of the European Union in 2004. Also in 2004, Latvia became a full member of NATO, the North-Atlantic Treaty Organization. Formally, this might not have meant much to Latvia's status, but for international investors it was a clear guarantee against external military threats.

The Latvian attitude to international organizations has been clear and consistent. It has desired as much engagement as possible in order to improve its national legislation and implementation. Rather than defending itself against criticism, Latvia's government has gratefully appreciated constructive criticism and conscientiously adopted the changes recommended.

Latvia's joining the EU had far-reaching implications. Latvia adopted the common European legal body, *acquis communautaire,* of some 250,000 pages. Latvia became subject to the verdicts of the European Court of Justice, becoming part of the European judicial space. The EU has substantial rules for the combat of money laundering. On May 20, 2015, the EU adopted the Fourth Anti-Money Laundering Directive, which is an extensive text of 35 pages.[36] In July 2016, the European Commission reinforced this directive. It lowered the threshold for identification from €250 to €150 and enhanced the powers of the national Financial Intelligence Units.[37] A fifth Anti-Money Laundering Directive will soon be adopted by the EU, further reinforcing the EU anti-money laundering regime.

After the 9/11 terrorist attacks on the world Trade Center and the Pentagon and the ensuing adoption of the US Patriot Act, the United States became deeply concerned about money laundering for terrorist funding, and it has been a driving force for anti-money laundering in Latvia. In April 2005, the US government announced such concerns about two Latvian banks, Multibanka and the tiny VEF bank.[38] In July 2006, the US Treasury passed its verdict with regard to Multibanka and the Latvian government:

> Multibanka has taken a number of important steps to address the reported money laundering risks highlighted in the previous notice of proposed rulemaking. Specifically, Multibanka has revised its policies, procedures and

[36] European Union, "Directive (EU) 2015/849 of the European Parliament and of the Council, On the Prevention of the Use of the Financial System for the Purposes of Monetary Laundering or Terrorist Financing," May 20, 2015. EU.
[37] European Commission, "Questions and Answers: Anti-Money Laundering Directive," Strasbourg, EU, July 5, 2016.
[38] "Latvian Bank Woes," OCCRP, October 30, 2011.

> internal controls; reviewed the entire portfolio of its accounts; retained an international accounting firm; and made organizational changes in the hiring of additional employees to assist with compliance.
>
> In addition to institutional reforms at Multibanka, the U.S. is encouraged by the efforts of the Latvian government in addressing the concerns highlighted last April. Latvia has made important strides in strengthening its anti-money laundering/counter-financing of terrorism (AML/CTF) regime, including passing legislation to significantly tighten controls and increase penalties on money laundering activity. Latvia has also banned the establishment of shell banks; introduced criminal liability for providing false information to banks; clarified the authority of Latvian financial institutions to demand customer disclosure regarding the source of funds; and allowed for the sharing of information between financial institutions on suspicious activities. These legislative, regulatory and law enforcement efforts over the last year demonstrate Latvia's commitment to combating illicit finance.[39]

In May 2010, Latvia's Financial and Capital Market Commission (FCMC) revoked VEF Banka's operating license, which satisfied the US Treasury.[40] These are good examples of how Latvia's cooperation with international partners has proceeded. In some cases, banks have reformed and fulfilled the new tightened requirements of dozens of Latvian laws on bank regulation. (Multibanka was sold and re-named Meridian Trade Bank.)

On 1 January 2014, Latvia adopted the euro and joined the Economic and Monetary Union (EMU), after a European Union (EU) assessment in June 2013 asserted that the country had met all convergence criteria necessary for euro adoption. Latvia's lat had been pegged to the euro for many years. The accession to the EMU was successful and went without problems. As a member of the Eurosystem, the Bank of Latvia participates in the formulation of the single monetary policy.

When Latvia joined the Eurozone, it also joined the European Banking Union, and it came under the supervision of the European Central Bank (ECB). In November 2014, the ECB established the Single Supervision Mechanism (SSM) for banks in the European Union, which became operational on January 1, 2016. It is the system of banking supervision in Europe.[41] It comprises the ECB and the national supervisory authorities of the participating countries. The three biggest Latvian banks are subject to ECB supervision, namely Swedbank, SEB Banka and ABLV Bank. The Latvian Financial and Capital Market Commission (FCMC), in cooperation with the ECB,

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[39] US Treasury FinCEN, "FinCEN Withdraws Finding on Latvia's Multibanka and Issues Final Rule Against Latvia's VEF Banka," July 12, 2006. https://www.fincen.gov/news/news-releases/fincen-withdraws-finding-latvias-multibanka-and-issues-final-rule-against

[40] US Treasury FinCEN, "FinCEN Withdraws Section 311 Actions Against Latvia's VEF Banka," July 26, 2011. https://www.fincen.gov/news/news-releases/fincen-withdraws-section-311-actions-against-latvias-vef-banka

[41] European Central Bank, "Single Supervisory Mechanism," https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html

supervises the other Latvian banks. The staff of the FCMC is involved in the work of the SSM joint supervision task forces of the ECB as well as in the development of supervisory practice. The ECB functions as a backbone and source of specialized knowledge for the FCMC.[42]

In July 2016, Latvia joined the Organization for Economic Cooperation and Development (OECD), which is the gold standard of legal development. Before Latvia could join the OECD, it had to adopt about 250 OECD legal instruments and be approved by 21 OECD committees. It did so at a record speed of three years.[43] The last hurdle for Latvia was to receive the approval from the OECD Working Group on Bribery and International Business Transactions on April 4, 2016. [44]

The OECD carried out a major study of Latvia's implementation of the OECD anti-bribery convention from 2014-16. These reports also looked into money laundering. The first report of 2014 was exploratory, clarifying the Latvian legislation and institutions and comparing them with the OECD Anti-Bribery Convention. [45] The second report of 2015 clarified what was missing in the Latvian system and how it needed to improve. The general verdict was that "Latvia has enacted a legal framework to address…money laundering risks. Of substantial concern, however, is that Latvia has not given sufficient resources or priority to ensure the effective implementation of this framework." [46] Specifically, the OECD experts found the Latvian definition of "politically-exposed persons" too narrow. They called for stricter due diligence and more enforcement. [47] The Latvian authorities took these recommendations to heart and had implemented all of them by 2016.

The all-European inter-parliamentary organization Council of Europe focuses on democracy, human rights, and legal standards. It has a Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL). It is a permanent monitoring body that has repeatedly inspected the Latvian banking system and issued major reports. In 2012, it issued its fourth report, a massive report on "Anti-Money Laundering and Combatting the Financing of Terrorism in Latvia" of 278 pages. [48] MONEYVAL has followed up with annual evaluation or progress reports. In July 2017, Latvia had fulfilled six of 14 recommendations from the fourth round of 2012 in full and three partially. At closer

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[42] FCMC, Annual Report and Activity Report of the Financial and Capital Market Commission for 2016, Riga, 2017, p. 10.
[43] OECD, "Latvia's Accession t the OECD," OECD, July 1, 2016.
[44] FCMC, "Annual Report and Activity Report of the Financial and Capital Market Commission for 2016," Riga, 2017, p. 11.
[45] OECD, "Phase 1 Report on Implementing the OECD Anti-Bribery Convention in Latvia," Paris: OECD, June 2014.
[46] OECD, "Phase 2 Report on Implementing the OECD Anti-Bribery Convention in Latvia," Paris: OECD, October 2015, p. 27.
[47] Ibid., pp. 29-30, 63-64.
[48] Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval), "Anti-Money Laundering and Combatting the Financing of Terrorism in Latvia," Strasbourg: Council of Europe, July 5, 2012.

look, however, it turns out that none of the unfulfilled recommendations actually concerns money laundering. Essentially, they are about transparency and regulations of the parliamentarians, who are unwilling to give up any privileges.[49] A new round of MONEYVAL inspection shall be carried out in October 2017.

[49] Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval), "Fourth Evaluation Round, Latvia," Strasbourg: Council of Europe, August 1, 2017.

7. Development of Latvia's Financial Market Regulation and Supervision

During Latvia's first decade as a once-again independent country, the Bank of Latvia was in charge of bank regulation. On July 1, 2001, the Financial and Capital Market Commission (FCMC) was set up as an autonomous public institution. It regulates and monitors the function of the financial and capital market participants.

The FCMC has a legal position that is reminiscent of the central bank. It is governed by a board with five members. The parliament appoints the chairperson and his or her deputy for a period of six years after a joint proposal by the minister of finance and the government of the Bank of Latvia. By law, nobody is allowed to interfere in its decisions. The FCMC has independent financing as well, being paid by fees from financial market participants. Its budget is ample so that it can pay excellent salaries and attract experienced and qualified staff, as well as training them. [50] In 2016, the FCMC had a large staff of 166. It has increased significantly from 35 in 2014. Their qualifications are high, and the staff turnover was only 3 percent in 2016, reflecting real stability.[51]

The vision of the FCMC is a "sound Latvian financial market integrated into the European Union single market, associated with professional, rigorous and fair supervision." The FCMC is committed to the values of accountability, openness and transparency.[52]

According to EU stipulations, each EU country also needs a parallel Financial Investigation Union (FIU). In Latvia it is called the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity. It was founded in 1998. It is a specially created State authority that operates under the supervision of the Prosecutor's Office. It collects information from all market participants, and processes, and analyses reports on unusual and suspicious financial transactions and prepares prosecution.[53]

Until 2014, complaints were frequent that the FIU had insufficient resources and investigated too few of the complaints that led to investigations, but that year the number of investigated cases shot up. The number of reported suspicious transactions rose sharply until 2008, but then they fell and remained at that lower

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[50] OECD, "Latvia: Review of the Financial System," Paris: OECD, April 2016, pp. 22-23.

[51] FCMC, "Annual Report and Activity Report of the Financial and Capital Market Commission for 2016," Riga, 2017, p. 75.

[52] FCMC, "Annual Report and Activity Report of the Financial and Capital Market Commission for 2016," Riga, 2017, p. 5.

[53] Office for Prevention of Laundering of Proceeds Derived from Criminal Activity (FIU Latvia), "About Institution,"
http://www.kd.gov.lv/index.php/en/about-us/about-institution

level until 2014. The number of new criminal cases that were opened tripled from 2011 (32) to 94 cases in 2014.[54]

In 2016, the powers of the FCMC were substantially increased:

- A robust Compliance Control Department with five divisions was established within the FCMC in order to strengthen the supervision with regard to AML/CTF, effectively quintupling the number of staff.
- The EU's Fourth AML Directive was implemented.[55]
- Three independent US consulting companies carried out a review of Latvia's banks' anti-money laundering programs according to US Federal Financial Institutions Council standards.
- Regulations on risk scoring and enhanced customer due diligence were strengthened.
- Subsequent to amendments to the AML/CTF law, the definition of politically exposed persons was extended.
- The staff was increased and training improved.
- Not only bank owners, but also high-risk customers are obliged to sign a declaration identifying the real beneficiary owners.

The FCMC carried out on-site inspections of 22 of the 23 banks and foreign branches.[56] The board of the FCMC meets almost one a week and it made major decisions in 2016:

- It imposed penalties of €5.9 million on four banks for having failed to comply with the requirements laid down in the Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) rules, including one of the Scandinavian banks.[57]
- At the initiation of the FCMC, the ECB passed the decision to withdraw the license of Trasta Komercbanka on March 3, 2016.
- In September 2016, the FCMC decided to ban the Estonian Versobank from providing financial services in Latvia.

The FCMC imposed its first fines in July 2014, and the initial fines were quite small. In 2015 and 2016, the fines have risen to one or two millions of euros, and the FCMC is also issuing a number of warnings.[58]

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[54] Office for Prevention of Laundering of Proceeds Derived from Criminal Activity, "Report for 2014." Riga. http://www.kd.gov.lv/images/Downloads/about/reports/KD%202014g_atskaite-EN-rw.pdf
[55] FCMC, "Annual Report and Activity Report of the Financial and Capital Market Commission for 2016," Riga, 2017, p. 75.
[56] FCMC, "Annual Report and Activity Report of the Financial and Capital Market Commission for 2016," Riga, 2017, pp. 10-13.
[57] FCMC, "Sanctions Imposed by FCMC," Riga, September 1, 2017.
[58] FCMC, "Sanctions Imposed by FCMC," Riga, September 1, 2017.

In other cases, banks have been deprived of their licenses or never been given a license, as was the case when GE sold GE Money bank to the private Russian bank Otkrytie,[59] which was taken over by the Central Bank of Russia in August 2017.

The big events in the last decade have been when banks have lost their licenses. At the end of 2008, Parex Bank was nationalized. In May 2010, VEF Banka had its license revoked. In May 2012, the FCMC withdrew the banking license from Latvijas Krajbanka after its mother company had collapsed from looting in Lithuania. Finally, in March 2016, the ECB deprived Trasta Komercbanka of its license.

In March 2017, the director of compliance control at the FCMC, Maija Treija, spoke up. She stated that since the clampdown in mid-2015 the FCMC had cleaned up Latvia.[60] In June 2016, the IMF mission passed its positive judgment that the "authorities' recent actions to combat financial fraud and mitigate AML/CTF risks are commendable."[61]

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[59] "Latvian Bank Woes," OCCRP, October 30, 2011.
[60] Minna Knus-Galan, "Regulator Says Latvia Finally Cleaning up Bad Banks," YLE, March 20, 2017.
[61] IMF, "Republic of Latvia: 2016 Article IV Consultation," IMF Country Report no. 16/171, June 2016..

8. Problems with Correspondent Banking

Correspondent banking is something that most of us take as a given, that a bank in one country can wire money to a bank in another country. Until the global financial crisis of 2008-9, this was more a matter of status than profit for banks. Since 2008, however, many factors have changed.

After the big global banks were charged tens of billions of dollars in fines, they all asked 'What regulatory risks are we taking?' The revenues from correspondent banking relationships are small, but the fines might be large, so the big international banks are adopting a risk-adverse approach. This is particularly true for banks operating with US dollars because of the high US fines for malfeasance.

As a consequence, the big international banks have cut out one country after the other from their correspondent banking relations. Previously, this attracted little attention because other banks were always ready to transfer money. The big international banks point out that they are not charitable foundations. Their task is not to serve the small and powerless but to make money for their shareholders. New banking regulations have rendered the compliance costs for business with small and poor countries excessive. In recent years, all the big international banks have refused to deal with dozens of mostly small and poor countries, as the de-globalization of international finance proceeds.

Few have noticed that even a decent EU country such as Latvia has become victim of this international withdrawal of correspondent banking relations. In 2014, JPMorgan ceased providing dollar-clearing services to Latvia. In 2015, Commerzbank stopped doing so, leaving Deutsche Bank as the sole bank accepting correspondent bank relations with Latvia in US dollars.[62]

In early 2017, it emerged that the local management of Danske Bank, in neighboring country Estonia, were carrying out money laundering with Azerbaijan.[63] Deutsche Bank reacted by cutting off all banks from correspondent banking in Estonia and Latvia, even though the Latvian banks were not found to be involved, but did not cut off Lithuania. This did not seem fair or reasonable, but those were not Deutsche Bank's concerns. Estonia and Latvia are small, so why bother? Latvia's FCMC issued a sad but understanding statement: "A decision by Deutsche Bank to discontinue handling of US dollar settlements in Latvian commercial banks is no surprise neither to the financial market participants nor the FCMC. The decision was based on the change of business strategy for interbank markets in several countries and it was in no way attributable to the assessment of [the] Latvian banking sector." For the time

[62] Luke Harding and Nick Hopkins, "Bank that Lent $300m to Trump Linked to Russian Money Laundering Scam," *Guardian*, March 21, 2017.
[63] Luke Harding, Caelainn Barr and Dina Nagapetyants, "UK at Centre of Secret $3bn Azerbaijani Money Laundering and Lobbying Scheme," *Guardian*, September 4, 2017.

being, increased usage of euro is the main response.[64] This is a serious concern for Latvian banks, which are in effect subject to collective punishment. Moreover, that this sophisticated money laundering did not go through Latvia indicates that the Latvian defenses against money laundering have become quite formidable.

The withdrawal of correspondent banking relationships has become a serious concern throughout the world. It has attracted great attention from the IMF, which has focused on Arab countries, Sub-Saharan Africa, Caribbean islands, Pacific islands, and former Soviet republics.[65] Half of the countries in the world might now be excluded from correspondent banking, but both the countries and the withdrawing international banks are quiet about it, because they do not want to arouse unnecessary negative public relations.

In June 2016, the IMF published a discussion note, arguing that this was a case for policy action. Yet, it did not present any clear policy.[66]

The US regulators are sympathetic but also offer no solutions. As Thomas Curry, Comptroller of the Currency, commented to the Association of Certified Anti-Money Laundering Specialists Annual Conference on September 28, 2016, when trying to discourage indiscriminate de-risking:

> "A joint fact sheet published recently by the U.S. Treasury reminds us that the global financial system, trade, and economic development rely on foreign correspondent banking relationships."[67]

The other authors of the fact sheet include the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation.

Another issue that was raised in conversations in Riga was whether correspondent banking is best resolved on a jurisdiction basis or on an individual bank basis. Each bank in the US makes its own decisions about correspondent relationships and those decisions are influenced by its regulator. The typical clearing bank for US dollars claims that it must avoid risk that is criticized by bank examiners, but the regulators state that correspondent account decisions are made independently by the bank. In effect, both parties disclaim any responsibility for changing the present situation.

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[64] FCMC, FCMC Opinion on Deutsche Bank Decision to Discontinue Handling of US Dollar Settlements in Latvian Commercial Banks, Riga, Riga, April 7, 2017.

[65] International Monetary Fund, "Recent Trends in Correspondent Banking Relationships – Further Considerations," March 16, 2017.

[66] Michaela Erbenova, et al. "The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action," IMF Staff Discussion Note, June 2016, p. 36.

[67] See "U.S. Department of the Treasury and Federal Banking Agencies Joint Fact Sheet on Foreign Correspondent Banking: Approach to BSA/AL and OFAC Sanctions Supervision and Enforcement." August 30, 2016 (http://www.occ.gov/topics/compliance-bsa/foreign-correspondent-banking-fact-sheet.pdf).

Conclusions

Latvia has carried out impressive democracy, rule of law, and market economy reforms. It has been quite successful in controlling corruption. Authoritative group Transparency International ranks Latvia 44 on its Corruption Perception Index for 2016, which puts it ahead of no less than 8 out of 28 EU countries, including the old members Spain, Portugal, Italy, and Greece.[68] Since its independence in 1991, Latvia has carried out a vigorous policy in nearly all relevant regards. It has done astoundingly well in terms of macroeconomic stability and economic growth, democracy and rule of law.

Taking its cue from other successful financial centers, such as Switzerland, Singapore and Hong Kong, Latvia has attempted to become a regional financial center. It is attractive to businesses in countries farther to the east that have less rule of law or property rights. Significant amounts of financing have arrived in Latvia, but in comparison with other European countries with similar ideas, such as Switzerland, Ireland, Luxembourg, Cyprus, and Malta, the flows have been quite limited. Since 2005, money laundering has risen as a concern, first raised by the US Treasury. The Latvian authorities dealt with these concerns early on and forcefully.

To begin with, the problem appeared limited, but from 2014 after a few cases of serious money laundering were revealed, the Latvian authorities have focused on these concerns. They have done whatever it takes to root out money laundering. In 2004, Latvia became a member of the European Union, after having fulfilled all its many legal, democratic, and economic demands. It started working with the US Treasury in 2005, which has been satisfied. In 2014, Latvia adopted the euro, became a member of the ECB, and it became subject to ECB bank inspection. In parallel, the OECD checked Latvia's legal and financial standards, and so did the Council of Europe. Latvia has complied with all their demands and implemented them, most effectively in the period 2014-16.

Today, Latvia has a highly effective, qualified, and sufficiently large regulator in the Financial and Capital Market Commission (FCMC) which has closed down failing banks, fined banks that have violated the rules, and warned other banks. All people interviewed claim that the Latvian FCMC is a top-notch financial regulator. The problems of money laundering have hopefully been left behind in the past.

Since 2012, the Basel Institute on Governance, an independent non-governmental organization (NGO), has ranked countries once a year with regard to the risk for money laundering/terrorist financing, that is, their quality of governance. Out of a

[68] Transparency International, Corruption Perception Index 2016, https://www.transparency.org/news/feature/corruption_perceptions_index_2016

total of 147 countries, Latvia ranked no. 14 from the top in 2017. Among the EU countries, only nine scored better, and none were big countries.[69]

The problem is that Latvia, a highly-respected member of the European Union, is left with minimal correspondent banking relations. Neither the ECB nor the IMF can sort out this problem because it stems from the relationships and understandings between the large banks with operations in the US and the Federal and state bank regulators.

[69] The Baltic Course, "Latvia Ranks 14 in Basel Anti-Laundering Index," Riga, August 31, 2017. http://www.baltic-course.com/eng/analytics/?doc=132755, Andisw Sedlenieks, "The Move Upward in a Prestigious Rating," *Diena*, August 31, 2017.

Table 1:

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
National Accounts																		
GDP growth (% change)	5.4	6.5	7.1	8.4	8.3	10.7	11.9	9.9	-3.6	-14.3	-3.8	6.4	4.0	2.6	2.1	2.7	2.0	3.0
GDP in current US dollars	7.9	8.4	9.6	11.8	14.4	16.9	21.5	30.9	35.8	26.2	23.8	28.5	28.1	30.3	31.4	27.0	27.7	27.8
Total Investment (% of GDP)	24.7	28.2	28.3	30.2	33.0	35.2	39.2	41.5	35.1	22.0	19.3	25.2	26.2	23.9	23.2	22.1	19.8	20.7
Public Finances																		
General Government Revenue (% of GDP)	33.7	32.4	31.8	31.4	32.5	33.5	33.4	33.7	33.5	35.8	36.5	35.6	37.3	36.8	36.1	36.2	36.3	37.1
General Government Expenditures (% of GDP)	36.2	34.4	34.3	33.0	33.5	34.5	33.9	33.1	36.6	42.8	43.0	38.7	37.3	37.3	37.8	37.7	36.7	38.3
Budget Balance (% of GDP)	-2.5	-2.0	-2.5	-1.6	-1.0	-1.0	-0.5	0.6	-3.2	-7.0	-6.5	-3.1	0.1	-0.6	-1.7	-1.5	-0.4	-1.2
Public Debt (% of GDP)	12.1	13.9	13.1	13.9	13.8	11.2	9.2	7.2	16.2	32.5	40.3	37.5	36.7	35.8	38.5	34.8	34.3	33.7
Inflation (CPI, end of year)	1.7	3.2	1.5	3.6	7.3	7.1	6.7	14.0	10.4	-1.4	2.4	3.9	1.6	-0.4	0.3	0.4	2.1	1.5
Foreign Account																		
Imports of goods and services (% change)	2.7	15.6	2.7	11.9	21.0	20.1	21.4	17.3	-10.7	-31.7	12.4	22.0	5.4	-0.2	0.5	2.1	4.4	4.5
Exports of goods and services (% change)	14.4	9.0	5.0	4.0	13.7	23.6	7.5	13.8	2.4	-12.9	13.4	12.0	9.8	1.1	3.9	2.6	2.6	2.5
Labor																		
Unemployment (% of labor force)	14.3	13.5	12.5	11.6	11.8	10.1	7.0	6.1	7.7	17.6	19.5	16.2	15.0	11.9	10.8	9.9	9.6	9.4
Population (million people)	2.4	2.4	2.3	2.3	2.3	2.3	2.2	2.2	2.2	2.2	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0

Source: IMF World Economic Outlook Database (2017).

Table 2: Current List of Banks (Latvian Joint Stock Companies):

	Ultimate Beneficial Owner	Millions of Euros on 31 Dec 2016 *Group Capital*	*/ Group Total Assets*
Swedbank	Swedish	712	5,242
SEB banka	Swedish	434	3,524
Rietumu banka	Latvian (50%+), Irish (33%)	433	3,786
ABLV Bank	Latvian	318	3,655
DNB Banka*	Norwegian	302	2,259
Citadele Banka	American (75%), EBRD (25%)	254	3,350
Norvik Banka	British (naturalized Russian)	102	1,002
Rigensis Bank	Russian	62	341
BlueOrange Bank	Latvian	58	653
Expobank	Russian	57	379
PrivatBank	Ukrainian	48	279
Baltic International Bank	Latvian	38	308
Reģionālā investīciju banka	Ukrainian/Latvian	35	636
Latvijas pasta banka	Latvian	30	205
Bank M2M Europe	In transition	19	176
Meridian Trade Bank	Latvian	16	303

Foreign Branches:

Svenska Handelsbanken	Swedish
Danske Bank	Danish
Nordea Bank*	Swedish
OP Corporate Bank (fka Pohjola Bank)	Finnish

Bigbank	Estonian
Scania Finans Aktiebolag (finance company)	Swedish

Aktsiaselts Eesti Krediidipank (Estonian) - branch in Latvia ceased operation on 14 June 2017

*Consolidation pending:
http://www.nordea.lv/about+nordea/news+archive/2017/15092017/1785142.html

Ownership of Total Latvian Bank Capital**

43% Sweden
18% Latvia
11% Norway
5% USA
4% United Kingdom
4% Russia
3% Ukraine
12% Other investors

**FCMC, "Latvian Banking Sector Performance 2016", February 21

Interviews

Governor of the Bank of Estonia, Dr. Ardo Hansson, Tallinn, May 12.

Former Prime Minister Valdis Dombrovskis, now Vice President of the European Commission, Brussels, May 29.

Martins Kazaks, chief economist of Swedbank in Latvia, Stockholm, June 13.

Latvian Ambassador to the US Andris Teikmanis, Washington, July 5.

Deputy Governor of the Bank of Lithuania Marius Jurgilas, Dubrovnik, July 10.

European Director of the IMF Poul Thomsen, Dubrovnik, July 11.

Sanda Liepiņa, Chairman of the Board at the Association of the Latvian Commercial Banks, Kristīne Mennika, Head of Strategic Communications at the Association of the Latvian Commercial Banks, Riga, September 11.

Andris Strazds, Adviser at Bank of Latvia, Riga, September 11

Līga Kļaviņa, Deputy State Secretary on Financial Policy Issues at Ministry of Finance, Aija Zitcere, Director of Financial Market Policy Department at Ministry of Finance, Riga, September 11

Igors Rodins, Partner, Deloitte, Riga, September 11

Mārtiņš Āboliņš, economist at Citadele Bank, Riga, September 12

Vjačeslavs Dombrovskis, Chairman of the Board at public think tank CERTUS, Riga, September 12

Vadims Reinfelds, Deputy CEO and Deputy Chairman of the Board of ABLV Bank, AS, and Jānis Butkevičs, Member of the Council of ABLV Bank, AS, Riga, September 12