

Latvian Banking: Recent Reforms, Sustainable Solutions

By Joshua Kirschenbaum

Introduction

Latvia's non-resident banking sector, which caters to clients from Russia and other countries of the Commonwealth of Independent States (CIS), has finally become politically untenable. After years of scandals and massive illicit flows through Latvia, the government has concluded that the non-resident banking sector as currently constituted poses a threat to Latvian national security. The precipitating event was the targeting in February 2018 of Latvia's third-largest bank, ABLV, by the U.S. Treasury Department, which found that ABLV had "institutionalized money laundering as a pillar of the bank's business practices."¹ Days later, Latvia's central bank governor was detained on corruption charges.² Led by Prime Minister Maris Kucinskis and Finance Minister Dana Reizniece-Ozola, both of the ruling Union of Greens and Farmers party, Latvia has committed to reduce non-resident banking drastically.

To that end, on April 26 Latvia's parliament, the Saeima, took the dramatic step of amending the anti-money laundering (AML) law to prohibit Latvian banks from maintaining accounts for shell companies.³ The law,

shepherded through the Saeima by Member of Parliament Veiko Spolitis of the center-right Unity Party, passed easily, 57-17, with the pro-Russian Harmony Party opposed.⁴ Reformers took advantage of the narrow window prior to the Saeima's summer recess and the fall elections to take a bold step, one that communicates unequivocally to illicit financial facilitators and their accomplices that they are no longer welcome.⁵ Now comes the hard part.

The United States and the European Union should continue to support those in Latvia who are prepared to bring the non-resident banking business under control once and for all. To get reform right, though, Latvia must proceed in a methodical, thorough manner. There is a real risk that, in a moment of panic followed by a moment of relief, Latvian reformers will unintentionally squander this political opportunity. A lasting solution will require deeply rooted institutional changes, increased enforcement resources, and sustained political commitment to ensure that the dominance of the non-resident banks is eliminated and never renewed.

1 "FinCEN Names ABLV Bank of Latvia an Institution of Primary Money Laundering Concern and Proposes Section 311 Special Measure," Financial Crimes Enforcement Network, February 13, 2018, <https://www.fincen.gov/news/news-releases/fincen-names-ablv-bank-latvia-institution-primary-money-laundering-concern-and>.

2 "Banker Finds He Has 'Even More Enemies Than I Thought'," *New York Times*, April 23, 2018, <https://www.nytimes.com/2018/04/23/world/europe/latvia-rimsejcs-banking-bribery.html>.

3 "Saeima imposes the ban on servicing shell companies," Latvian Cabinet of Ministers, April 27, 2018, <https://www.mk.gov.lv/en/aktualitates/saeima-imposes-ban-servicing-shell-companies> and legislative text at <http://titania.saeima.lv/LIVS12/saeimalivs12.nsf/0/344AEAC6259D2156C225827A004A1632>.

4 "Saeima bans banks from servicing shell companies," *Latvian Public Broadcasting*, April 26, 2018, <https://eng.lsm.lv/article/economy/banks/saeima-bans-banks-from-servicing-shell-companies.a276351/>.

5 It is noteworthy that, beyond the adoption of the shell company ban in the wake of the ABLV action, the Saeima has been studying possible amendments to the anti-money laundering law since 2017. In Brussels, a Latvian Member of the European Parliament, Krisjanis Karins, was an architect of the European Union's 5th Anti-Money Laundering Directive, adopted in April 2018. The new directive will strengthen beneficial ownership registries, provide for better exchange of information across member states, create centralized registers of bank account, and establish ownership of trusts. See "Statement By First Vice-President Timmermans, Vice-President Dombrovskis and Commissioner Jourovà on the adoption by the European Parliament of the 5th Anti-Money Laundering Directive," European Commission, April 19, 2018, http://europa.eu/rapid/press-release_STATEMENT-18-3429_en.htm.



History of the Non-Resident Banking Sector

After the dissolution of the Soviet Union, Latvia positioned itself as an offshore financial hub for the Russia/CIS region, with a large Russian-speaking population, geographic proximity to Russia, and, beginning in 2004, European Union membership.⁶ Latvian-headquartered banks tend to cater to this non-resident Russia/CIS business (there are currently about a dozen in the sector).⁷ Large Scandinavian commercial banks dominate Latvia's domestic banking market for household and business customers.

The Treasury Department targeted two Latvian non-resident banks, VEF and Multibanka, for money laundering under Section 311 of the USA PATRIOT Act as early as 2005.⁸ When Parex Bank collapsed in 2008 amid the global financial crisis, it was the leading bank in the non-resident business (although it had a substantial number of domestic clients too).⁹ That year Latvia began a process of reforming its AML regime.¹⁰ It has been reforming the reforms ever since.

From 2011 to 2015, non-resident deposits grew consistently, sometimes at a rate as high as 25–30 percent per year.¹¹ For many years, the total amount of non-resi-

6 Leonid Bershidsky, "How Latvia Built Its Post-Soviet Money Pipeline," *Bloomberg*, March 9, 2018, <https://www.bloomberg.com/view/articles/2018-03-09/latvia-s-post-soviet-money-pipeline-is-closing>.

7 "Credit Institutions: Banks," Financial and Capital Market Commission, <http://www.fktk.lv/en/market/credit-institutions/banks1.html>. The term "non-resident banking" refers to the provision of bank accounts to customers based in a foreign country. The term more familiar to readers may be "offshore banking." The two concepts are similar, although "offshore banking" more often refers to a legal framework in which banks operate under a special license regime that authorizes the provision of services to foreign customers. The more general term "non-resident" banking is often used when there is not a distinct offshore licensing regime in place, as is true in Latvia.

8 "Imposition of Special Measure Against Multibanka," Financial Crimes Enforcement Network, April 26, 2005, <https://www.fincen.gov/sites/default/files/shared/nprmultibanka.pdf>; "Imposition of Special Measure Against VEF Banka, Financial Crimes Enforcement Network, April 26, 2005, <https://www.fincen.gov/sites/default/files/shared/nprvefbanka.pdf>.

9 Neil Buckley, "Latvia: a banking scandal on the Baltic," *Financial Times*, February 23, 2018, <https://www.ft.com/content/e7b586c4-1883-11e8-9376-4a6390addb44>.

10 "FinCEN Withdraws Finding on Latvia's Multibanka and Issues Final Rule Against Latvia's VEF Banka," Financial Crimes Enforcement Network, July 12, 2006, <https://www.fincen.gov/news/news-releases/fincen-withdraws-finding-latvias-multibanka-and-issues-final-rule-against>.

11 "Latvia: Review of the Financial System," Organization for Economic Co-operation and Development, April 2016, <https://www.oecd.org/finance/Latvia-financial-markets-2016.pdf>.

dent deposits in the banking system hovered around 50 percent,¹² although at banks specializing in this business, the ratio was typically above 90 percent.¹³ As Marc Galeotti, a scholar of Russian organized crime, explained in a prescient 2014 article, the light fines imposed by the regulator, and the inflow of non-resident deposits from Cyprus following the latter's 2013 banking crisis, demonstrated a clear lack of commitment to grapple with the problem.¹⁴ And so the problem only got worse. Latvian banks catering to non-resident customers continued to play a key role in the biggest illicit financial scandals connected to Russia and the CIS more broadly in recent years. Although they are too numerous to document exhaustively here, some of the highlights include:

“ Latvian banks catering to non-resident customers continued to play a key role in the biggest illicit financial scandals connected to Russia and the CIS more broadly.”

- The \$20 billion Russian Laundromat¹⁵
- The \$3 billion Azerbaijani Laundromat¹⁶
- The \$1 billion Moldovan bank heist¹⁷
- The \$1 billion Kazakh bank fraud¹⁸

12 "Non-Resident Deposits with Banks in Latvia," Financial and Capital Market Commission, December 28, 2015, http://www.fktk.lv/attachments/article/5477/Nerezid_inogr_3-ENG.pdf.

13 Gatis Eglitis, Balazs Forgo, Radoslav Krastev, Ingrid Toming, and Christian Weise, "Assessing business practices in Latvia's financial sector," *ECFIN Country Focus*, April 2014, http://ec.europa.eu/economy_finance/publications/country_focus/2014/pdf/cf_vol11_issue6_en.pdf.

14 Andrew Bowen and Marc Galeotti, "Latvia and Money Laundering: An Examination of Regulatory and Institutional Effectiveness in Combating Money Laundering," *Central European Journal of International and Security Studies*, December 13, 2014, <https://www.cejiss.org/static/data/uploaded/1425903244760326/Article%2001.pdf>.

15 "The Russian Laundromat Exposed," OCCRP, March 20, 2017, <https://www.occrp.org/en/laundromat/the-russian-laundromat-exposed/>.

16 "The Azerbaijani Laundromat," OCCRP, <https://www.occrp.org/en/azerbajjanilaundromat/> and "Massive Azerbaijan 'Laundromat' Scheme Had a Latvian Connection," *Latvian Public Broadcasting*, September 4, 2017, <https://eng.lsm.lv/article/economy/banks/massive-azerbajjan-laundromat-scheme-had-a-latvian-connection.a248989/>.

17 Tim Whewell, "The great Moldovan Bank Robbery," *BBC*, June 18, 2015, <http://www.bbc.com/news/magazine-33166383>.

18 Stolen Asset Recovery Initiative, <http://star.worldbank.org/corruption-cases/node/19048>.

- The \$230 million Russian tax fraud uncovered by Sergei Magnitsky¹⁹
- The \$10 billion Russian “mirror trading” scheme²⁰
- The \$5.5 billion asset-stripping of Ukraine’s largest bank²¹
- Public corruption involving the transit of natural gas through Ukraine²²
- Fines against the second- and third-largest non-resident banks, Norvik and Rietumu, for AML failures that allowed their customers to “circumvent international sanctions [against] North Korea”²³

Latvia’s non-resident banks function largely as a pass-through for money from Russia and other CIS countries, a waystation that the funds must transit on the way to their final destination. The evidence for this is simple – there are only about €8 billion in non-resident deposits in Latvian banks, and the banking system holds about €25 billion in deposits.²⁴ For the sake of

19 “Latvia to check for bank links with Magnitsky case,” *Reuters*, October 3, 2012, <https://www.reuters.com/article/us-latvia-magnitsky/latvia-to-check-for-bank-links-with-magnitsky-case-idUSBRE89200620121003>.

20 “Final Notice,” Financial Conduct Authority, January 30, 2017, <https://www.fca.org.uk/publication/final-notice/deutsche-bank-2017.pdf>.

21 Lucy Fitzgeorge-Parker, “Kroll report backs PrivatBank fraud claims,” *Euromoney*, February 7, 2018, <https://www.euromoney.com/article/b16t91sb61gicj/kroll-report-backs-privatbank-fraud-claims>.

22 Sanita Jemberga, “How Americans Took Down a Latvian Laundromat,” *Re:Baltica*, March 7, 2018, <https://en.rebaltica.lv/2018/03/how-americans-took-down-a-latvian-laundromat/>; Stephen Grey, Tom Bergin, Sevġil Musaieva, and Jacks Stubbs, “Special Report: How a 29-year-old Ukrainian Made a Killing on Russian Gas,” *Reuters*, December 11, 2014, <https://www.reuters.com/article/us-russia-capitalism-kurchenko-specialre/special-report-how-a-29-year-old-ukrainian-made-a-killing-on-russian-gas-idUSKBN0JP1KO20141212m>; and Olena Goncharova, “Ukraine: Kyiv Court Seizes Billionaire Kurchenko’s 14 Offshore Accounts,” OCCRP, October 29, 2015, <https://www.occrp.org/en/component/content/article?id=4545:ukraine-kyiv-court-seizes-billionaire-kurchenko-s-14-offshore-accounts>.

23 “FCMC in collaboration with U.S. law enforcement authorities identifies weaknesses and imposes monetary fines on JSC ‘NORVIK BANKA’ and JSC ‘Rietumu Banka’, Financial and Capital Market Commission, July 21, 2017, <http://www.fktk.lv/en/media-room/press-releases/6479-fcmc-in-collaboration-with-u-s-law-enforcement-authorities-identifies-weaknesses-and-imposes-monetary-fines-on-jsc-norvik-banka-and-jsc-rietumu-banka.html>; Minna Knus-Galan, “Regular says Latvia Finally Cleaning Up Bad Banks,” OCCRP, March 20, 2017, <https://www.occrp.org/en/laundromat/regulator-says-latvia-finally-cleaning-up-bad-banks/>.

24 “Latvian Banking Sector Shrank in 2017,” *Latvian Public Broadcasting*, March 30, 2018, <https://eng.lsm.lv/article/economy/banks/latvian-banking-sector-shrank-in-2017.a273168/>; “MFI Balance Sheet and Monetary Statistics,” Latvijas Banka, May 2, 2018, <https://www.bank.lv/en/statistics/stat-data/monetary-statistics/mfi-balance-sheet-and-monetary-statistics>; and “Financial Stability Report 2017,” Latvijas Banka, July 18, 2017, https://www.bank.lv/images/stories/pielikumi/publikacijas/FSR_2017_EN.pdf.

comparison, Swiss banks hold around \$1.7 trillion in deposits.²⁵ It seems likely that most of the money that passes through Latvian non-resident banks ends up in one of three types of places: a premier jurisdiction such as Luxembourg, Switzerland, the United Kingdom, or the United States; another offshore hub; or on a round trip back to Russia and the CIS. The function of Latvia’s non-resident banks is to get the money out of Russia and the CIS, clean it, and detach it from its origin. It is, in other words, to convert the money from “Russian” to “European.”

The Pressure Builds

As Latvia prepared to enter the eurozone in 2014 and bid to join the Organization for Economic Cooperation and Development (OECD) in 2016, the pressure on the non-resident banking sector continued to rise. The International Monetary Fund expressed concern in 2012.²⁶ The European Commission published a 2014 report highlighting the risks, warning, “This business model needs strong policies to guard against money laundering [...] Financial transactions in non-resident banking may be more complex and difficult to investigate [...] This lower degree of transparency [...] requires specific supervisory actions by the authorities and adequate response by banks active in this sector.”²⁷ The OECD echoed those concerns in a 2015 report, casting doubt on Latvia’s prospects for accession to the organization.²⁸

Ainars Latkovskis, the head of the parliamentary defense committee, described the message he and the Foreign Ministry received from the U.S. Departments of State and Treasury at the start of 2016: “Although your country is small, and your administration is small, the

25 “Annual Banking Statistics: Amounts Due in Respect of Customer Deposits,” Swiss National Bank, September 28, 2017, <https://data.snb.ch/en/warehouse>.

26 “IMF Warns Latvia about Non-Resident Use of Bank Deposits,” *Reuters*, November 26, 2012, <https://www.reuters.com/article/latvia-banks-imf-idUSL5E8MQ7US20121126>.

27 Gatis Eglitis, Balazs Forgo, Radoslav Krastev, Ingrid Toming, and Christian Weise, “Assessing Business Practices in Latvia’s Financial Sector,” *ECFIN Country Focus*, April 2014, http://ec.europa.eu/economy_finance/publications/country_focus/2014/pdf/cf_vol11_issue6_en.pdf.

28 “Phase 2 Report on Implementing the OECD Anti-Bribery Convention in Latvia,” Organization for Economic Co-operation and Development, October 2015, <http://www.oecd.org/corruption/anti-bribery/Latvia-Phase-2-Report-ENG.pdf>.

amount of dollars going through your financial system is 1 percent of all U.S. dollar transactions in the world [...] You must be able to control it. How you do it is up to you.”²⁹

In February 2016, the chairman of the FCMC, Latvia’s primary financial regulator, was fired and replaced by his deputy, Peters Putnins. Observers generally perceived Putnins to be more aggressive in tackling financial crime, and he fulfilled those expectations.³⁰ Putnins immediately set about imposing more, and larger, fines for AML violations throughout 2016 and 2017.³¹ Only one month into Putnins’s tenure, the FCMC’s request that the European Central Bank revoke the license of Trasta Komerbanka – one of the most egregious offenders among the non-resident banks – was granted, although the bank was apparently insolvent.³² In June 2016, the OECD welcomed Latvia into its ranks and explicitly acknowledged Latvia’s progress in combating money laundering.³³

These measures by the FCMC, and the increased scrutiny of the banks’ operations, did have some positive effect. Non-resident deposits had declined from a peak of nearly 60 percent to 40 percent of total deposits by early 2018.³⁴ Equally important, annual U.S. dollar transaction flows involving Latvian banks declined from \$269 billion in 2014 to around \$100 billion 2017.³⁵ The decline in dollar flows likely reflects both a drop in non-

resident activity and money laundering on the one hand and a shift in remaining activity to euros on the other.

Yet the newly invigorated FCMC was never in a position to deter the politically powerful, highly profitable non-resident banks. The regulator generally levied fines of 1 or 2 million euros, and never more than 3 million. It has a compliance staff of only twenty people charged with monitoring the entire financial sector, not just the dozen or so non-resident banks.³⁶ The remote prospect of criminal prosecution in Latvia was likewise not a deterrent. Responding to the ongoing high-risk activity of the non-resident banks, U.S. banks in the past few years closed their correspondent accounts, thereby limiting their direct exposure to the sector.³⁷

Reform Too Slow, National Security at Risk

The Section 311 action against ABLV on February 13, 2018 was different. It targeted the third-largest bank in Latvia, and the largest Latvia-based institution, whose owners are two of the richest people in the country. It also came at a moment of heightened tension between Russia and the West. As Finance Minister Reizniece-Ozola acknowledged while describing past efforts to reform the financial sector, “The situation has changed due to geopolitical tension. It’s not the pace that suits our strategic partner. We are fully dedicated to reduce the high-risk business.”³⁸ The detention of Central Bank Governor Ilmars Rimsevics days later by the national anti-corruption bureau, reportedly on suspicion of having solicited bribes from Trasta Komerbanka, com-

29 Sanita Jemberga and Evita Purina, “U.S. Pressures Latvia to Clean Up Its Non-Resident Banks,” *Re:Baltica*, February 2, 2016, <https://en.rebaltica.lv/2016/02/u-s-pressures-latvia-to-clean-up-its-non-resident-banks/>.

30 Mike Collier, “Latvia Makes it into OECD Thanks to Crackdown on Non-Resident Banks,” *bne IntelliNews*, May 27, 2016, <http://www.intellinews.com/latvia-makes-it-into-oecd-thanks-to-crackdown-on-non-resident-banks-98445/>.

31 “Sanctions Imposed by FCMC,” Financial and Capital Market Commission, March 7, 2016, <http://www.fktk.lv/en/market/credit-institutions/2014-10-23-sanctions-imposed-by-fcmc.html>.

32 “Latvia’s Trastas Komerbanka Loses License over Alleged Money Laundering,” *bne IntelliNews*, March 4, 2016, <http://www.intellinews.com/index.php/latvia-s-trasta-komerbanka-loses-licence-over-alleged-money-laundering-92073/?source=baltic-states>.

33 “Accession: Latvia Invited to Join OECD,” Organization for Economic Cooperation and Development, May 11, 2016, <http://www.oecd.org/latvia/accession-latvia-invited-to-join-oecd.htm>.

34 “Latvia Aims to Halve Foreign Deposits, but Slowly: PM,” *Reuters*, February 23, 2018, <https://www.reuters.com/article/us-latvia-banking-kucinskis/latvia-aims-to-halve-foreign-deposits-but-slowly-pm-idUSKCN1G71RG>.

35 Aaron Eglitis, “Latvia Wants Clampdown on Banks to Reopen U.S. Dollar System,” *Bloomberg*, April 26, 2018, <https://www.bloomberg.com/news/articles/2018-04-26/latvian-leader-wants-bank-clampdown-to-reopen-u-s-dollar-system>.

36 “Compliance Control Department set up in FCMC,” Financial and Capital Market Commission, June 16, 2016, <http://www.fktk.lv/en/publications/press-releases/5798-compliance-control-department-set-up-in-fcmc.html>.

37 Although the non-resident banks generally lost direct correspondent account access, the Latvian branches of Scandinavian banks retained direct correspondent access. Citadele, a Latvia-based bank that also conducts a significant amount of non-resident activity but has a strong reputation, also lists a U.S. correspondent account. See “Deutsche Bank Pulls Dollar Clearing from Latvian Banks,” *Latvian Public Broadcasting*, April 7, 2017, <https://eng.lsm.lv/article/economy/deutsche-bank-pulls-dollar-clearing-from-latvian-banks.a231649/>; <https://www.swedbank.lv/about/swedbank/contacts/corbanks?language=ENG>; <https://www.seb.lt/en/private/daily-banking/bank-account-and-transfers/list-nostro-correspondents>; and <https://www.citadele.lv/en/contacts/correspondent-banks/>.

38 Richard Milne, “Latvia Vows to Crack Down on Unscrupulous Banking,” *Financial Times*, March 18, 2018, <https://www.ft.com/content/dbba8922-2a72-11e8-9b4b-bc4b9f08f381>.

pounded the sense of crisis.³⁹

To make matters worse, Latvia is in the midst of an evaluation by Moneyval, the anti-money laundering body of the Council of Europe.⁴⁰ A negative report could result in referral to the Financial Action Task Force, an inter-governmental organization that sets global AML standards and has the ability to blacklist noncompliant jurisdictions.⁴¹ While Latvia demonstrates a high degree of compliance with formal AML regulatory standards, this evaluation marks the first time that Latvia will be assessed – under new procedures – for the efficacy of its AML regime in practice. Days after the Section 311 action, Prime Minister Kucinskis announced that Latvia would gradually reduce the level of non-resident deposits in the banking system from 40 percent to 20 percent. “It has to be carried out in several stages both by strengthening supervision and by setting new targets so that there are no unnecessary shocks.”⁴²

A few weeks later, Prime Minister Kucinskis adopted a tougher tone. “Our ultimate goal is to eradicate any suspicious transactions,” he said. “We don’t want the banks who are just using Latvia or its vulnerabilities to make money. This is definitely not the future we have envisaged for ourselves.”⁴³ The prime minister, the finance minister, and the chairman of the FCMC all issued statements in mid-March vowing to lower the level of non-resident deposits to the much more ambitious

target of 5 percent, and to do so quickly.⁴⁴ The sense of urgency was now palpable, as evidenced by Chairman Putnins’s declaration:

“The share of non-resident business Latvian banks should have now [is] around 5 percent. That is today our requirement, considering the changes in the global financial system and the national security aspects. Latvian banks should revise their strategies, develop different business models and look for new business niches. There is no other possibility. There is no time. It is important to be aware that non-resident business has always been a high-risk zone.”⁴⁵

It appears that two things happened between the February and March statements. First, non-resident money began to flee spontaneously in response to the Section 311 action, the changed political climate in Latvia, and uncertainty about what might happen next. Recent press reports peg the level of non-resident deposits at somewhere between 25 percent to the low 30s.⁴⁶ Settling for 20 percent would have looked like – and indeed would have been – a lackadaisical effort, as so much money had already left absent any measures on the part of the Latvian government.

Second, and more importantly, Latvia’s government understood that the United States had grown impatient with the never-ending reforms stretching over a decade and ending, inevitably, in yet another money laundering scandal. Given current relations with Russia, the non-resident sector had morphed from distasteful to dangerous. Prime Minister Kucinskis did not mince words. “As

39 “Rimsevics Claims Bribe was from Trasta komercbanka, and Martinsons Worked as Mediator,” *Baltic News Network*, February 26, 2018, <http://bnn-news.com/rimsevics-claims-bribe-was-from-trasta-komercbanka-and-martinsons-worked-as-mediator-180558>.

40 “Prime Minister: We have until July to clean up Latvian banking sector,” *Latvian Public Broadcasting*, April 24, 2018, <https://eng.lsm.lv/article/society/crime/prime-minister-we-have-until-july-to-clean-up-latvian-banking-sector.a276080/>; “At a Glance,” Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism - MONEYVAL, Council of Europe, <https://www.coe.int/en/web/moneyval>.

41 “Who We Are,” Financial Action Task Force, <http://www.fatf-gafi.org/about/>.

42 “Latvia Aims to Halve Foreign Deposits, but Slowly: PM,” *Reuters*, February 23, 2018, <https://www.reuters.com/article/us-latvia-banking-kucinskis/latvia-aims-to-halve-foreign-deposits-but-slowly-pm-idUSKCN1G71RG>.

43 John O’Donnell and Gederts Gelzis, “Latvia PM Pledges Tighter Bank Controls to Defuse U.S. Standoff,” *Reuters*, March 8, 2018, <https://www.reuters.com/article/us-latvia-banking-government/latvia-pm-pledges-tighter-bank-controls-to-defuse-u-s-standoff-idUSKCN1GK158>.

44 Aaron Eglitis, “Latvia to Cut Shell-Company Dealings After U.S. Security Warning,” *Bloomberg*, March 19, 2018, <https://www.bloomberg.com/news/articles/2018-03-19/latvia-to-cut-shell-company-dealings-after-u-s-security-warning>; and Richard Milne, “Latvia Vows to Crack Down on Unscrupulous Banking,” *Financial Times*, March 18, 2018, <https://www.ft.com/content/dbba8922-2a72-11e8-9b4b-bc4b9f08f381>.

45 “Non-resident Business in Latvian Banks Should be around 5% - Financial Watchdog,” *The Baltic Times*, March 16, 2018, <https://www.baltictimes.com/non-resident-business-in-latvian-banks-should-be-around-5-financial-watchdog/>.

46 Maris Kluga, “OECD to Audit Latvia’s Finance Watchdogs,” *Latijas Radio Zinu*, April 25, 2018, <https://eng.lsm.lv/article/economy/economy/oecd-to-audit-latvias-finance-watchdogs.a276259/>; “PM: Shell company ban could sink 0.5% of GDP,” *LTV*, April 5, 2018, <https://eng.lsm.lv/article/economy/economy/pm-shell-company-ban-could-sink-0.5-of-gdp.a273787/>; and Richard Milne, “Latvia vows to crack down on unscrupulous banking,” *Financial Times*, March 18, 2018, <https://www.ft.com/content/dbba8922-2a72-11e8-9b4b-bc4b9f08f381>.

a border state, NATO member state, and with our geopolitical situation, we can't allow this volume of risky money. [Non-resident deposits] will be reduced to the level of 5 percent [within] two or three months."⁴⁷

Policymakers briefly flirted with the idea of levying a fee on shell company deposits in an attempt to disincentivize a high-risk business model.⁴⁸ This idea was dropped in favor of a statutory ban on financial institutions maintaining an account for a shell company customer, the logic being that much of the illicit activity in the non-resident sector utilizes shell companies to provide anonymity or obscure the true purpose of transactions. The government rolled out a proposal on March 24.⁴⁹ Both the Association of Latvian Commercial Banks and Delna, Transparency International's Latvian chapter, supported the ban.⁵⁰ The bill sailed through the Saeima and, once signed by President Raimonds Vejonis, will take effect immediately. Passage of the law is a bold, dramatic gesture. It is the first ban of its kind anywhere in the world, and it is designed to demonstrate to the United States whose side Latvia is on. It will calm the panic.

What the New Law Does

A determined financial facilitator can evade the new shell company ban. However, the reality that sophisticated actors will evade the law is not an argument against it. All regulation is susceptible to evasion, and no single safeguard is sufficient in isolation. Moreover, the importance of this law is more political than regula-

47 Aaron Eglitis, "Latvia to Cut Shell-Company Dealings After U.S. Security Warning," *Bloomberg*, March 19, 2018, <https://www.bloomberg.com/news/articles/2018-03-19/latvia-to-cut-shell-company-dealings-after-u-s-security-warning>.

48 John O'Donnell and Gederts Gelzis, "Exclusive: Russian Billions Slip through Latvia's Loose Net," *Reuters*, March 16, 2018, <https://www.reuters.com/article/us-latvia-banking-reform-exclusive/exclusive-russian-billions-slip-through-latvias-loose-net-idUSKCN1GS0KE>.

49 Mike Collier, "Latvian Government Tries to Spread the Word on Shell Company Ban," *Latvian Public Broadcasting*, March 24, 2018, <https://eng.lsm.lv/article/economy/banks/latvian-government-tries-to-spread-the-word-on-shell-company-ban.a272512/>.

50 "Latvian Government Mulls Ban on Doing Business with Shell Companies," *bn IntelNews*, March 23, 2018, <http://www.intelnews.com/latvian-government-mulls-ban-on-doing-business-with-shell-companies-138777/>; "Six Recommendations for the Government of Latvia to Increase Transparency of the Financial System," Delna, March 6, 2018, <http://delna.lv/wp-content/uploads/2018/03/6-recommendations-TI-LV-2018-2.pdf>.

tory.

The new law amends the existing AML statute to prohibit Latvian financial institutions from maintaining a shell company account.⁵¹ What, exactly, is a shell company under the AML law? Any entity that meets at least two of the following three criteria:⁵²

- The entity cannot provide documentary evidence that it conducts actual economic activity
- The entity is formed in a jurisdiction that does not require the submission of annual financial statements to the state
- The entity does not maintain physical premises in its country of registration

Sophisticated money launderers are able to provide documentation of economic activity (e.g. imports or exports of goods) and of the maintenance of a physical place of operation. By contrast, a multinational corporation establishing a foreign legal entity to channel investment into Latvia could theoretically run afoul of the ban. Ironically, legitimate shell companies will acknowledge their shell character, their purely legal and financial (as opposed to economic) purpose, and their lack of a physical location. Shell companies used for illicit purposes, on the other hand, will often masquerade as entities conducting real business (which may or may not in fact be true) and maintaining a physical presence abroad. Presumably, the FCMC will adopt an interpretation of the law that excludes shell companies used for the purpose of facilitating investment into the real economy by legitimate businesses.

The final requirement, that a company file annual financial reports with the government of the country in which it is registered, will not be a major hurdle for illicit financial facilitators. According to the FCMC, the United Kingdom is the most common jurisdiction of

51 The law does not prohibit anonymous companies, per se. AML rules already require Latvian banks to determine the beneficial owners of legal entity account holders. Rather, the new law prohibits shell company accounts even when their ownership is known to the bank.

52 Law on the Prevention Money Laundering and Terrorism Financing, <http://www.fktk.lv/en/law/general/laws/4260-2010-04-01-law-on-the-prevention-of.html>.

incorporation for shell companies banking in Latvia.⁵³ The U.K. requires the filing of annual financial reports with Companies House, the British national corporate registry.⁵⁴

The law and the broader political climate in Latvia are likely to lead to account closures and a shift in the business model of some of the banks away from non-resident deposits in the short term. The banks appear to be on the retreat and downsizing, for now.⁵⁵ Unfortunately, the benefits of the new law will likely fade over time. The ban matters more for its politics and its empowerment of reformers than for its ability to prevent illicit financial activity over the long term. The trick is to prevent the resurrection of an out-of-control banking sector after memories have faded. The non-resident money escaping to friendlier climes today can just as easily reverse its flow once the winds shift tomorrow.

Lasting Reform: Recommendations

If Latvia chooses to offer non-resident banking services to clients from Russia and the CIS, then the country needs a non-resident banking sector that regulators and law enforcement have tamed. Only the prospect of discovery and punishment will deter the return of widespread illicit financial activity at Latvian banks. To that end, a sustainable, long-term solution requires empowered regulators and law enforcement agencies, a smaller non-resident banking sector, and a political commitment to put national security over profits.

The first thing the Saeima can do is increase the resources of the FCMC immediately. After the targeting of ABLV, the State Department pointedly issued a statement of solidarity with the government of Latvia

and mentioned the FCMC by name.⁵⁶ Twenty compliance staff, though, is inadequate to supervise domestic commercial banks, non-resident banks, and a variety of other institutions. If Latvia wants the economic benefits of serving as an offshore financial hub, it needs to invest the resources to supervise the industry responsibly.

Second, the FCMC must be empowered politically to impose larger fines (it has the statutory authority to do so) and to refer recalcitrant institutions to the European Central Bank for the revocation of their licenses.

Next, the government should explore ways to bring about an orderly and transparent consolidation of the non-resident banking sector. Even an expanded FCMC will not be able to supervise twelve non-resident banks. And, if Latvia only wants clean, transparent non-resident business, twelve banks will be more than the market can bear for the foreseeable future.

Fourth, in order to support the efforts of the FCMC and of law enforcement, Latvia should finalize its recent efforts to strengthen the Financial Intelligence Unit (FIU), beginning with new leadership. The FIU collects reports of suspicious transactions from banks, analyzes the information, and disseminates it to law enforcement agencies and regulators. The government announced on May 10 that it had selected Ilze Zlotina as the new head of the FIU, replacing the previous director, who served for twenty years.⁵⁷ Zlotina will hopefully bring new energy and a renewed sense of mission to the agency; more resources are also required. An effective FIU, in turn, will augment the efforts of law enforcement investigators and the FCMC to combat financial crime.

Fifth, the government of Latvia needs to enhance its in-house capacity to detect and disrupt illicit financial activity. The Finance Ministry recently announced an agreement to host U.S. Treasury officials who will pro-

53 "Most Shell Companies Served by Latvian Banks are Incorporated in UK - Regulator," *Baltic Times*, March 28, 2018, https://www.baltictimes.com/most_shell_companies_served_by_latvian_banks_are_incorporated_in_uk_-_regulator/.

54 "Accounts and tax returns for private limited companies," <https://www.gov.uk/prepare-file-annual-accounts-for-limited-company>.

55 John Mulligan, "Desmond-backed Bank to Cull 'Prohibited Risk' clients," *Independent* (Ireland), April 7, 2018, <https://www.independent.ie/business/irish/desmondbacked-bank-to-cull-prohibited-risk-clients-36782681.html>.

56 "Recent Actions Regarding Latvia's Banking Sector," U.S. Department of State, February 20, 2018, <https://www.state.gov/r/pa/prs/ps/2018/02/278505.htm>.

57 "Latvia's Prime Minister Appoints New Head of Control Service," *Baltic News Network*, May 10, 2018, <http://bnn-news.com/latvia-s-prime-minister-appoints-new-head-of-control-service-184436>.

vide technical assistance to the FIU.⁵⁸ Such technical assistance should be expanded via Treasury or the International Monetary Fund to the FCMC and via the Justice Department to Latvian law enforcement and prosecutors.

Finally, Latvia must tackle corruption and inefficiency in the government as a whole and in the judicial system in particular. This, of course, is a perennial, and easier said than done. That does not make fighting corruption and inefficiency any less vital. The plodding pace of the justice system (as in the prosecution of Ventspils mayor Aivars Lembergs for corruption and money laundering, beset by delays)⁵⁹ and the limited number of high-profile cases mean that bankers and money launderers alike are not particularly scared of facing serious prison time. One idea under discussion is the creation of a specialized white collar or commercial court that would have expertise in complex financial cases.

The prospects that all or much of this could happen are actually fairly bright. Unlike in Cyprus, where the problem is far more intractable, Latvia's economy is not especially dependent on money from Russia and the CIS. A small number of businessmen have grown very wealthy from non-resident banking, and the sector does indeed employ a sizeable number of people. Yet Latvia can stand to let it go. Prime Minister Kucinskis estimated that the desired reduction in the non-resident sector could shave 0.5 percent off of GDP this year in an economy growing at 3.5–4 percent annually.⁶⁰ Latvia has answered the question of whether the political will to tackle the non-resident sector head-on exists. It does. Success or failure will hinge on something more prosaic – execution.

58 Piotr Skolimowski, "Latvia Secures U.S. Help to Clean Up Its Scandal-Tainted Banks," *Bloomberg*, April 22, 2018, <https://www.bloomberg.com/news/articles/2018-04-22/latvia-secures-u-s-help-to-clean-up-its-scandal-tainted-banks>.

59 "One Day in a Courtroom with Aivars Lemergs," *Baltic News Network*, March 14, 2018, <http://bnn-news.com/one-day-in-a-courtroom-with-aivars-lembergs-181698>.

60 "Latvian Parliament Bans Banks from Dealing with Shell Companies," *bne IntelliNews*, April 26, 2018, <http://www.intellinews.com/latvian-parliament-bans-banks-from-dealing-with-shell-companies-140712/>.

Correction: An earlier version of this article incorrectly stated that in order for an entity to be considered a shell company under AML law it needed to meet at least one of three criteria. This was subsequently changed to "two of three criteria" to accurately reflect the law – August 2, 2018.

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