



Cabinet of Ministers
Republic of Latvia

Latvian Financial Sector Update

No. 17 30 August 2019

Government of Latvia's response to the IMF Article IV Mission

Executive summary

We note the IMF's Staff Report for the 2019 Article IV Consultation and welcome its main considerations on how Latvia can continue to strengthen the anti-money laundering/counter-terrorism financing (AML/CFT) regime. The Selected Issues Paper accompanying the Staff Report, published on 7 August, provides a number of policy recommendations on key areas where the IMF believes that efforts need to focus going forward. We welcome the IMF's view and agree with its starting point: strengthening the effectiveness of the AML/CFT regime and refocusing the activities of banks with a strong foreign customer base have already provided Latvia with opportunities to improve the financial system.

As such, over the last two years and more notably since this government took office in January 2019, Latvia has been prioritising precisely these objectives. We have adopted, implemented and already seen the results of a far-reaching, comprehensive and unprecedented set of reforms that is supporting a stronger and more ambitious AML / CFT regime in Latvia.

The IMF's assessment is necessarily a snapshot of the progress achieved, having considered measures and results reported mostly by the first quarter of 2019, whereas the fight to combat ML / TF is an ongoing effort. For that reason, the Staff Report and the Special Issues Paper do not provide the most up-to-date picture of the status of the AML/CFT frameworks in Latvia. Recently, key reforms have happened since and a number of developments have taken place, both of which reinforce the effectiveness of ongoing and concerted efforts and bring to the spotlight further improvements not taken into account in this consultation.

The Latvian government has repeatedly expressed its commitment to tackling this threat to the integrity and stability of our financial system. For that reason, the paper below sets out a detailed take on the main conclusions of the IMF's assessment, including measures taken and implemented since the cut-off date used by the IMF's consultation and going forward. Notably:

- **De-risking and consolidating the banking sector** is indeed a critical part of Latvia's strategy. Changes to the AML / CFT Law prohibit companies from doing business / require them from ceasing to do so with shell companies. Since November 2017, Latvia has eliminated more than 17,600 shell companies previously serviced by Latvian banks; and their number continues to decrease as illustrated by drop from 2,421 to 1,829 between March and June this year alone. Latvian banks have had to reconsider their current business models and to draw up new business strategies reflecting the change of target market and target customers, as well as alternative business lines and services. The FCMC has been

conducting vigilant monitoring, including on-site inspections of the effectiveness of implementation of these plans.

- **Strengthening AML/CFT supervision** is an ongoing focus for the Latvian authorities. Changes to the AML/CFT legal framework have already strengthened the risk-based approach to supervision in all supervisory and control institutions, including the FCMC. Specific risk identification and profiling matrices are being used by the authorities to identify the highest risks to the sector and refocus resources on the riskiest supervised entities. Amendments have expanded the FCMC's objectives and more clearly set out its functions to recognise that the FCMC's role is both as prudential and AML/CFT supervisor.
- **Ensuring accurate beneficial ownership information** has been one of our key priorities. Latvia has vastly strengthened the transparency of information about ultimate beneficial owners (UBO) stored in the Enterprise Register ahead of January 2020, the mandatory date set by EU law. The UBO information in the Register is public since April 2019 and even before it has improved access to information to all obliged entities. Crucially, around 97% of companies established in Latvia have already disclosed their beneficial owners and this information is publicly available.

Emphasising the political commitment

Strengthening Latvia's AML/CFT frameworks is a matter of the utmost priority for the government and Prime Minister Krišjānis Kariņš. In the eight months since taking office, this government has sent a clear signal: "Latvia has zero tolerance for dirty money in our banking system".

In its recent Staff Report for the 2019 Article IV Consultation, the IMF concluded that significant gaps in implementing the AML/CFT framework had hampered its effectiveness in the past. Acknowledging that and with the orientation and in collaboration with international institutions, Latvia has since 2018 been addressing the deficiencies in the system and reforming the legal and supervisory AML/CFT frameworks.

We note that the IMF has concluded that significant efforts have been undertaken by Latvian authorities so far. We have been and remain resolutely committed to delivering the reforms identified by MONEYVAL in 2018 to restore the banking sector's financial integrity and reputation. Having already assessed internally the progress made ahead of the submission of our technical compliance report to MONEYVAL, we are well on track to achieve the objective set by MONEYVAL. For that reason, we are confident that Latvia will meet the conditions to remain off the list of jurisdictions with strategic AML/CFT deficiencies.

We have made meaningful progress in 10 of the 11 areas identified by MONEYVAL and have implemented most of its recommended actions. We made significant changes to the legislative framework, including the AML/CFT Law, the Law on Sanctions and the FCMC Act. Crucially, we have adopted measures to transpose the Fifth EU Anti-Money Laundering Directive ahead of its deadline in January 2020 to further drive a change of behaviour, governance and culture in the sector. Going forward, the government and all institutions and agencies involved in the implementation and application of the new framework are equally determined to ensure its effectiveness on the ground.

Take on the IMF's assessment

We welcome the conclusions of the Selected Issues Paper providing background to the Staff Report for the 2019 Article IV Consultation. We agree that the task ahead is challenging, which is why in February 2019 the government initiated a more intense

overhaul of financial sector regulation with the objective of further strengthening the response and capacity of our authorities to prevent money laundering and terrorism financing (ML/TF). The Article IV Mission considered the results of reforms mostly up until the first quarter of 2019. However, since then we have achieved further progress in the key areas identified by the IMF.

De-risking

IMF's assessment: "Underlying risks associated with shell companies and other high-risk entities could re-emerge. A very large number of shell companies whose accounts have been closed do not fall under the prohibition. The long-term effectiveness of the law is questionable, especially as banks may recalibrate their procedures to further narrow the banned company definition."

De-risking and consolidating the banking sector is indeed a critical part of Latvia's strategy to improve the supervisory system in Latvia both on technical compliance and on efficiency. Amendments to the AML/CFT Law adopted in May 2018 prohibit credit institutions and payment institutions from cooperating with shell companies if they have no economic operation and are registered in jurisdictions that do not impose a duty to submit financial reports. These changes also require financial institutions to cease existing business with such shell companies.

Such amendments mean that the law now captures the sorts of shell entities that were previously threatening the integrity of the Latvian banking system. Since November 2017, Latvia has eliminated more than 17,600 shell companies; recently the number of serviced shell companies has dropped further from 2,421 to 1,829 between March and June 2019. As a result, the share of non-EU deposits has decreased from 35.6% in 2015 to 7.7% in June 2019, greatly reducing the risk of money laundering associated with shell companies. The value of foreign deposits has shrunk from €8.1 billion in 2017 to €3.5 billion in June 2019 (39.7% to 21.3% in total deposits).

We are confident that banks will not be able to circumvent this prohibition: Latvian banks have had to reconsider their current business models and to draw up new business strategies reflecting the change of target market and target customers, as well as alternative business lines and services. The FCMC has evaluated these extensively to ensure that plans covered sufficient level of diversification of business and adequate link to preventing ML/TF risks. Since the law has been in place, the FCMC has also been conducting on-site inspections to monitor effective implementation of these plans; in the first half of 2019, the FCMC has already conducted 6 on-site targeted inspections. As a result, credit turnover for both enhanced due diligence customers and shell entities has decreased from 27.7% at the end of 2017 to 13.3% at the end of 2018, with further drop in share of credit turnover of legitimate shell companies to 8.8 % in Q2 of 2019. Hence, we do not share the IMF's view that risks associated with shell companies will re-emerge. Following changes to the Action Plan establishing the priorities for Latvian authorities in the field of AML/CFT in October 2018, the FCMC is now supervising the change of business models specifically of banks servicing non-resident clients by reducing the share of high-risk customers. Since then, a considerable decrease in concentration of foreign customer-base in credit institutions and the related cross-border movements of funds has been achieved. Risks in the credit sector have been significantly reduced. The euro has been fully established as the prevailing currency of the Latvian financial system and USD transactions have been reduced by 95%, hitting an all-time low level in the second half of 2018 and staying at this low level further on.

We also welcome the IMF's assessment of liquidity risk profiles of Latvian banks showing that our banks have large stocks of liquid assets and are well prepared to respond to cash shocks. The IMF concluded that our banks have the highest level of excess liquidity of any Eurozone Member State. The IMF confirms that Latvia's banking sector has a sufficient degree of resilience following efforts to de-risk by reducing non-resident deposits. This demonstrates that Latvia does not face new financial stability risks, which positions the government well to continue to successfully implement a more robust AML/CFT regime.

Supervision

IMF's assessment: "Supervisory action are missing critical aspects of a risk-based approach. The authorities may also need to provide more aid to both bank and non-bank financial institutions in developing their own risk assessments, mitigation measures and internal controls. Due to resource constraints, supervision has focused on targeted/thematic inspections and the FCMC has not conducted a full-scope inspection of all high-risk banks in the last three years."

Strengthening AML/CFT supervision is an ongoing priority for the Latvian authorities. In the last two years, the government followed international recommendations on how best the FCMC can execute its AML/CFT role, as well as strengthening its governance, objective and functions. In 2018, the FCMC's Compliance and Control Department (CCD) was separated from the Supervision Department. The FCMC tripled CCD staff from 6 in 2016 to 20 in 2018. In 2019, the CCD was strengthened with eight additional staff positions in order to ensure vigorous and risk-based compliance control of the financial sector under its supervision.

Changes to the AML/CFT legal framework have already strengthened the risk-based approach to supervision in all supervisory and control institutions, including the FCMC. Specific risk identification and profiling matrices have been developed and are being used by the authorities to identify the highest risks to the sector and refocus resources on the riskiest supervised entities.

In addition, in June 2019 the FCMC Law was reviewed and extensively amended. Explicitly preventing money laundering and financing of proliferation and terrorism in financial and capital markets is now one of the guiding principles of the FCMC's supervisory activities. Amendments have expanded the FCMC's objectives and more clearly set out its functions to recognise that the FCMC's role is both as prudential and AML/CFT supervisor. The governance, independence and democratic accountability of the FCMC was also reviewed and Saeima, the Parliament of Latvia, now appoints the board in its entirety. Such changes will be translated in a new leadership of the FCMC from October 2019, which will provide the opportunity to introduce renewed and stronger direction for the supervisor and to take forward a refocused mandate in a way that puts tackling ML/TF at the core of its activities.

In parallel, authorities have been empowered to – and have - increased the number of on-site inspections to implement targeted supervisory actions to ensure that all obliged entities effectively implement proper internal control systems. In particular, the FCMC is already supporting banks and non-banks institutions during these inspections by supporting with developing and verifying compliance and application of internal policies and procedures, including on identifying, on-boarding and scoring, as well as terminating cooperation with risky customers and reporting suspicious transactions. In addition, regular external audits of banks' compliance programs have been in place since 2017 to supplement the FCMC surveillance and conducted based on the FCMC determined tasks with full supervisory follow up to the findings.

Sanctions

IMF's assessment: "Sanctions may not be sufficiently effective, dissuasive, proportionate. Although the number of sanctions imposed has markedly increased in 2018, questions remain as to whether penalties are commensurate with the types of violations being identified."

Following amendments to the AML/CFT Law in November 2017, the sanctions regime has already been strengthened. We recognise that there is further room for improvement in streamlining the application and procedure but such changes have already led to significant increase in the effectiveness and deterrence nature of the regime.

Firstly, the full range of sanctions is now part of the toolbox of all supervisory and control authorities, including suspension of activity, revocation of licences and administrative requirements. Secondly, all authorities now have at their disposal the use of financial penalties, notably fines of up to €1,000,000 for natural persons and fines of up to 10% of

the total annual turnover or €5,000,000 to legal persons. Lastly, all supervisors have thoroughly reviewed the criteria for applying sanctions to ensure that they are addressing adequately violations of AML/CFT obligations.

For example, in 2018 this has resulted in the FCMC sanctioning three banks for a total of €3.9 million, with administrative requirements imposed to improve the internal control systems of banks. In 2019 so far, 7 administrative cases have been opened against 6 banks based on violations identified during on-site inspections, which demonstrates yet again the effectiveness of the AML/CFT supervision framework.

Beneficial ownership

IMF's assessment: "The effective implementation of recent updates to the AML/CFT framework intended to improve the availability of companies' beneficial ownership information should be a specific area of focus of AML/CFT supervision."

Ahead of the transposition of the EU's Fifth Anti-Money Laundering Directive, Latvia has vastly strengthened the transparency of information about ultimate beneficial owners (UBO) in Enterprise Register. The UBO information in the Register is public since April 2019 but already since the moment when the compilation of UBO data was introduced in Latvia it has improved access to information to all obliged entities. Crucially, around 97% of companies established in Latvia have already disclosed their beneficial owners by 1 August 2019 as required by law. The remaining 3% have had their rights to trade terminated because of non-compliance with the UBO reporting requirements.

Amendments to the AML/CFT law, which entered into force in July 2019, have empowered the FCMC to request quarterly reports from banks concerning beneficial owners. These reports show that as of Q2 2019 89% of the UBO of banks' customers are residents of Latvia, whereas the major shares from other countries include 2.8 % from Russia, 1.3 % from Lithuania, 1.2 % from Ukraine, 0.9 % from Estonia and 0.5 % from Germany.

In an effort to ensure accurate beneficial ownership information is provided to the FCMC, since March 2019 the FCMC has been engaging with all banks via a consistent questionnaire concerning their procedures and process for the identification and verification of UBO, as well as with a uniform set of guidelines to ensure how banks conduct such a process. This provides a significant stepping-stone to the effective implementation of the updates to the law.

Preventive measures and reporting

IMF's assessment: "The FIU and supervisory authorities should continue to work on ensuring an appropriate quality and amount of reporting of suspicious transactions. Special focus should be on ensuring effective implementation of preventive measures by higher risk entities. [This should be] accompanied by a more thorough understanding of the risks, stronger application of internal controls and more proactive guidance from regulatory authorities."

Amendments to the AML/CFT Law have already revised the obligations for firms and supervisory authorities to report and verify suspicious transactions. The concept of an unusual transaction will be abandoned from December 2019 and reporting will be mandatory only for suspicious transactions, to avoid confusion between the two concepts. Changes have also introduced a reporting requirement on threshold declarations from July 2019. In addition, the FIU has reviewed the typologies and indicators of suspicious transactions to ensure they are up-to-date.

To improve the effectiveness of implementing preventive measures and to support entities' understanding of risk factors and incentivise stronger application of internal controls, the FIU has throughout 2018-H1 2019 conducted a number of seminars and training sessions with both entities and supervisory authorities. The FIU has likewise developed guidelines and provided assistance via its website, as well as by holding individual meetings and consulting extensively with the entities submitting reports.

This has already resulted in an increase in quality of reporting of suspicious transactions: there has been an overall decrease of suspicious transaction reports (less 14% from 2017 to 2018) and more are being analysed by the FIU (48% in 2018 compared to 32% in 2017). This has led to an increase in the number of prosecutions and convictions following the FIU freezing. In 2018, the number of reports of suspicious transactions to the FIU totalled 6,617 and the FIU conducted financial intelligence analysis on 3,203 cases. In 470 cases, the FIU passed the information to Latvian law enforcement agencies or foreign FIUs.

Enforcement

IMF's assessment: "The FIU's operational and strategic analysis may still need improvement to better support enforcement actions. The FIU should continue to improve its analytical capabilities and ensure that financial intelligence generated by its operational analysis is useful to law enforcement in ML / TF investigations."

Since 2018, the FIU and law enforcement agencies (LEAs) have improved their coordination, especially in relation to the exchange of information and freezing orders. A number of guidelines, procedures and methodological materials have been developed by the FIU and crystallised in several successful cooperation and coordination meetings and discussions between the FIU and LEAs.

Particularly relevant has been the new procedure that the FIU has developed to be followed in each case when potential freezing of assets is involved. In such cases, the FIU must contact the LEA that may be investigating the particular criminal activity to inform of its plans to initiate the freezing procedure and to ensure that in case of freezing of assets there would be no risks that an investigation may be negatively affected by the FIU's activity. Among other things, this has resulted in introducing intelligence reports and statistics that are sent to LEAs in addition to case materials and a steep increase in the number of requests received from LEAs.

Such effective collaboration has already yielded significant results. In 2018, the total amount of assets frozen by the FIU exceeded €101 million, which is the highest result in the FIU's history in terms of amount of funds frozen in a single year. This means that the amount of assets frozen increased by 122% from 2017 to 2018. Demonstrating further the impact of the enhanced quality of the FIU's analysis, by May 2019 the FIU had already frozen €83.2 million in assets, five times the same period in 2018.

The number of FIU's criminal proceedings involving freezing of funds has increased, as well as the number of prosecutions (from 7 in 2017 to 16 in 2018) and the number of convictions made following freezing of funds (from 1 in 2017 to 4 in 2018). The number of cases of seizures has also increased from 3 in 2017 to 21 in 2018 and already 4 by May 2019.

To this has also contributed changes to the AML/CFT Law and Law on Sanctions, which have both empowered the FIU to adopt the necessary enforcement sanctions, including permanent freezing of financial means in cases of financing of terrorism or proliferation.

Looking ahead

We agree with the IMF on the need to demonstrate effectiveness of the enhanced AML/CFT regime. Since Saeima adopted the last package of measures in June 2019, the government and competent authorities have been focusing on continuing to ensure effective implementation of the reforms. We agree that our priority should now be on guaranteeing widespread, effective AML/CFT supervision within the FCMC – which we have set in motion with the reform of the FCMC, and monitoring risks associated with reorienting the business models and liquidity profiles of banks servicing foreign clients as well as those related to the non-bank financial sector more accurately and timely to consolidate understanding and analysis of the ML/TF threats and vulnerabilities in the system.

Crucially, the IMF notes in the Staff Report that Latvia’s efforts cannot be seen in isolation; instead, the reforms that the government is undertaking would “benefit from intensive regional cooperation”. Much stronger cooperation, coordination and trust are fundamental to address the magnitude of the challenge: financial crime remains complex, widespread and multifaceted, knowing no borders to threatening countries’ economy and stability. As Prime Minister Krišjānis Kariņš has advocated, the IMF encourages further coordination at EU level, for example by “establishing a European-level institution responsible for AML/CFT supervision”. The IMF reinforces our view that this is the way to ensure a consistent approach to cross-border risks and supervisory convergence on AML/CFT across the EU.

Contributing Institutions



Cabinet of Ministers
Republic of Latvia



State Chancellery
Republic of Latvia



Ministry of Finance
Republic of Latvia



Ministry of
Foreign Affairs
Republic of Latvia



Ministry of Justice
Republic of Latvia



Ministry of the Interior
Republic of Latvia



Register of Enterprises
Republic of Latvia



Office for Prevention of
Laundering of Proceeds
Derived from Criminal Activity



Financial and Capital
Market Commission

[See archive of all news here](#)

Subscribe to this newsletter www.financialsectornewsletter.lv