Delna
SABIEDRĪBA PAR ATKLĀTĪBU
TRANSPARENCY INTERNATIONAL
LATVIJAS NODAĻA

# SIX RECOMMENDATIONS FOR THE GOVERNMENT OF LATVIA TO INCREASE TRANSPARENCY OF THE FINANCIAL SYSTEM

1. **Prohibit for banks to serve shell companies.**
2. **Free access to the register of beneficial owners in Latvia.**
3. **Decrease of the threshold of identification of beneficial owners from 25% to 10% of shares or voting shares in a company, or introduction of sector-specific thresholds, with a separate threshold applying to politically exposed persons.**
4. **Introduction of a mechanism for identifying nominee directors in the register of beneficial owners.**
5. **Development of licencing rules for company service providers in the non-financial sector.**
6. **Prohibition for company service providers in the non-financial sector to service legal entities that facilitate the anonymity of beneficial owners and money laundering.**

Public discussions about Latvia's international reputation over the past few weeks have shifted the focus of attention away from the main problems caused by Latvian banks serving high-risk customers. The statements by the Prime Minister and the Minister of Finance to significantly reduce risky non-resident deposits is a positive step but the proposal to introduce a fee for cooperation with shell companies is a dangerous move. The Latvian government must adopt radical decisions that promote transparency and sustainable development of the financial system.

During the last decade the Latvian banking sector was exploited from several individuals and entities to facilitate the laundering and movement of at least 20 billion EUR of illicit funds amount equal to 70% of Latvia's GDP. This has been demonstrated by the so called Russian Laundromat scheme, Moldovan Bank Robbery, breaching of North Korea sanctions etc. Improvements happened mainly due to external pressure (EU, U.S.A., OECD).

The offshore service providers industry has flourished hand in hand with the development of Latvia's offshore banking. As of today, there is ample evidence that unregulated company service providers have been one major drivers behind the creation of anonymous shell companies and the attraction of risky customers to Latvian banks relying on their services.

What Latvia needs is not just a mere "strengthening" of the AML regime, it needs a complete overhaul. A ban of servicing shell companies, would be the best government response now. From a systemic point of view high-risk client servicing is not sustainable and doesn't contribute to development, welfare or international reputation. According to data by Association of Latvian Commercial Banks in the 2nd quarter of 2017 non-resident deposits constituted 41,1% of all deposits. Most of them are short term and benefit almost only the bank owners and does not compensate the reputation risks.

Illegal financial flows through Latvia enable threats to national and international security. Kleptocratic regimes use money laundering to concentrate financial resources in democratic countries and can use them to strengthen the power of their non-democratic regimes and

gain influence, e.g., by implementing information war activities. Given Latvia's geopolitical reality and external threats, Latvia must pay special attention to these issues in internal policy.

The Financial and Capital Market Commission (FCMC) has been talking about the risks associated with non-resident business for many years [1], but money laundering continued. The reputation can be improved by government's choice to facilitate transparency of the financial and business system.

The government should prohibit banks from servicing shell companies, strengthen beneficial ownership regulation, provide free access to the beneficial ownership register and regulate company service providers that attract customers to banks.

The FCMC audit would allow to identify and address potential problems in the institution and would promote public trust in the regulator and the government. An analysis should be done of transparency provisions, integrity framework and balance between FCMC's mandate, independence and accountability. Similar assessment should be done in the Bank of Latvia.

***Transparency International Latvia*** **suggests six recommendations to increase the transparency of the financial system:**

1. Prohibition for banks to serve shell companies. Shell companies are legal entities that do not carry out actual economic activity; they are of small or of no economic value and have only a *mailbox* rather than real business premises. By using networks of shell companies, money launderers and corrupt networks can hide the proceeds of their crimes. The Latvian government must act proactively and impose sanctions on banks for co-operation with shell structures, in line with the criteria defined by Article 15.1 of the Law on Prevention of Money Laundering and Terrorist Financing (PMLTF).

2. Free access to the register of beneficial owners in Latvia. Any fee, regardless of its size, creates a barrier to the public's rights and ability to receive information on who really owns or controls companies in Latvia. In 2016, the United Kingdom abolished the fee for access to its company register. As a result, the number of searches in the register has risen from 6 million to 2 billion a year.

3. Decrease of the threshold of identification of beneficial owners from 25% to 10% of shares or voting shares in a company, or introduction of sector-specific thresholds, with a separate threshold applying to politically exposed persons. By reducing the threshold, the disclosure obligation of beneficial owners would apply to any natural person who holds, directly or indirectly, 10% of the shares or voting shares in a company. In a 2016 Impact assessment on the 5$^{th}$ AML Directive, the European Commission stated [2] that the 25% threshold is too high and can be easily circumvented by those looking to stay under the radar. At such a threshold, 1 out of 10 British companies claimed that they did not have a beneficial owner or "person of significant control". There is precedent for setting the threshold at 10%. For the purposes of the United States Foreign Account Tax Compliance Act (FATCA), a substantial US owner of a company is considered any US person who owns, directly or indirectly, more than 10% of the stock of the corporation by vote or value. Precedents for even lower thresholds exist as well. Several EITI (Extractive Industries Transparency Initiative countries had a pilot BO project for extractive companies where four countries had no threshold at all and three used a threshold of 5%. In the US, the Securities and Exchange Commission requires all individuals to disclose their status as a beneficial owner when they reach directly or indirectly the threshold of 5%. One of the main arguments against lowering the threshold is that companies would find it very difficult to identify their beneficial owners, but analysis by Global Witness shows that this is not the case in the United Kingdom: "in

only 2% of cases did companies say they were struggling to identify a beneficial owner or collect the right information.

4. Introduction of a mechanism for identifying nominee directors in the register of beneficial owners. According to current Latvia's AML Law, in case a beneficial owner cannot be identified using the primary criteria of ownership and control, then the person with the highest management role in the given entity can be identified as the beneficial owner instead. This is a serious loophole which allows 'nominee directors' (individuals often nominated by offshore law firms who have no real control over the firm in question) to be listed as beneficial owners of a company. The presence of nominee directors and shareholders should be considered a red flag during anti-money laundering risk assessments, so measures need to be implemented to ensure that nominee directors are always identified and titled as such. This has also been agreed in the negotiations on the new European Anti-Money Laundering Directive (5AMLD) in December 2017. [3]

5. Development of licensing rules for company service providers in the non-financial sector that attract customers to banks (mainly entities under Article 3, paragraphs 4, 5, 3 of the PMLTF). These firms should be subject to a 'fit and proper test' (a series of checks to make sure they meet the requirements with Latvia's AML laws) at the time of licensing and over the period for which they hold a license, applying similar standards of integrity as for financial institutions. Branches and subsidiaries of Latvian TCSPs operating abroad should also be subjected to the same checks and integrity requirements. The rules would strengthen the sector's supervision and raise awareness of the regulation of money laundering and possible risks.

6. Prohibition for company service providers in the non-financial sector to service legal entities that facilitate the anonymity of beneficial owners and money laundering. Penalties for breach of the prohibition may also include the loss of the license.

[1] http://www.fktk.lv/lv/mediju-telpa/pazinojumi-masu-informacijas-l/arhivs/2012/1779-2012-
[2] http://eur-lex.europa.eu/legal-content/EN/%20TXT/?uri=CELEX%3A52016SC0223
[3] http://data.consilium.europa.eu/doc/document/ST-15849-2017-INIT/en/pdf (p.18)

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