

by ALEXANDER WELSCHER

Little Places, Big Money – and a dubious reputation

First Latvia, now Estonia: The Baltic banking sector has recently been seriously shaken by new money laundering scandals. While they are by no means the first ones, these major cases are a blow to the financial sector and the image of the region. Or maybe not?

Hardly anyone is likely to envy Karsten Dybvad for his new job. Only one day after his 62nd birthday, the current head of the Confederation of Danish Industry was nominated in November to be the new chairman of Danske Bank. Supported by the bank's largest shareholders, Dybvad is set to take the helm as main supervisor at Denmark's biggest lender, which finds itself at the centre of one of Europe's biggest ever money laundering scandals.

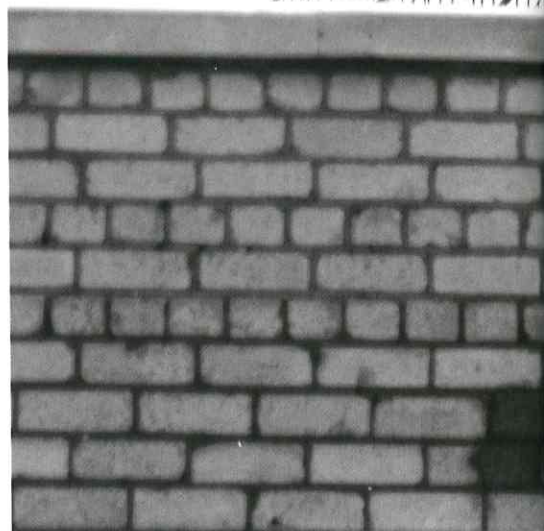
Dybvad's appointment came after an internal inquiry at Danske found that €200 billion in payments had been moved through its Estonian branch between 2007 and 2015. Of the approx. 15,000 accounts under investigation so far, some 6,200 are considered suspicious, according to the 87-page report published in mid-September. In light of the money-laundering claims, the value of Danske shares plummeted to hit a year-low at the end of October, also because the bank is now the subject of criminal investigations – and could face hefty fines.

Cleaning up the Estonian laundromat

The sheer scale of Danske's dirty money scandal also cast a shadow over the financial system that acted as a gateway into the European financial system. What has happened in Estonia has kept the general public, policy makers, financial authorities and courts busy for months. Not least because of the vast amounts of money involved: The sum that flowed through Danske's tiny Estonian branch via a total of around

9.5 million payments almost equalled the Baltic State's GDP in the nine-year period under scrutiny. In addition, there are also suggestions that some of the local staff colluded and assisted with the illegal activities identified in the publicly available report.

The revelation and related media investigations have sparked heated discussions over whether the supervisory authorities – in spite of vast amounts of evidence – have been too slow to react and the applied measures were sufficient. The European Commission has called for a probe into the regulatory failures and chided Denmark and Estonia over failing to completely enshrine the fourth EU anti-





money laundering directive into national law. Often regarded as one of the most exemplary members of the EU and euro zone, the dirty money scandal might be a serious backlash for Estonia's financial system and cause problems of both a prestigious and political nature.

"Estonia has definitely lost credibility here", says Morten Hansen, head of the Economics Department at the Stockholm School of Economics in Riga. His stance is echoed by Jan Körnert, professor of economics at the University of Greifswald with a research interest also in the Baltic banking sector. The German academic, however, sees the money laundering scandal more as an "industry-specific issue"

with a more direct negative impact on the reputation of the banking sector and Danske. Körnert believes that outside financial circles, the scandal might have even remained unnoticed in large parts of the population of unaffected Western European countries such as Germany.

Something is rotten in the state of Denmark – or Estonia?

While the Danish government and central bank have stated the scandal risks damaging the entire country's reputation, the money laundering incident has so far drawn mixed reactions in Estonia. For Erki Kilu, head of the Estonian Banking Association, the Danske case has badly



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damaged Estonia's banking reputation, while former Estonian President Toomas Hendrik Ilves, whose tenure ran almost synchronously with the laundering scandal, laments that his country is being made the scapegoat. He told the Danish paper *Weekendavisen* that Estonia did its job in supervising the bank activities but now is a very convenient fall guy for the Danish lender in the whole affair, since it fits the narrative of a little Eastern European country that does not control anything.

Others see the money laundering scandal less of a blow to Estonia's international prestige. "I would not be too concerned now that Estonia has experienced a significant

amount of damage here compared with other countries where the very same problem exists", claimed Katri Raik, director of the Estonian Foreign Policy Institute at the International Center for Defense and Security, at a discussion in the Estonian parliament. In her opinion, the international focus is rather on Danske Bank, Denmark and the phenomenon of money laundering in general. Similarly, the Estonian daily *Eesti Päevaleht* referred to a popular saying from Shakespeare's famous play *Hamlet*: "Something is rotten in the state of Denmark", it wrote in an editorial.

Latvian banking sector in hot water

One of these other countries mentioned by Raik is right next door. Being the regional financial centre, neighbouring Latvia has seen several banking scandals in the last couple of decades. Only few of them, however, have shaken Latvia's financial system like the ones that evolved in early spring this year. With ABLV, one of the biggest lenders went into self-liquidation after U.S. authorities accused it of having "institutionalized money laundering as a pillar of the bank's business practices" and sanctions busting by helping to finance North Korea's nuclear weapons programme.

Separately, the country's central bank chief and ECB policy maker Ilmars Rimševics was suspended from his post and faces criminal proceedings due to corruption suspicions. In a case without precedent, repercussions from the scandal are also being felt at the ECB, which asked the European Court of Justice to clarify whether Latvia violated EU law by enforcing security measures against its council member Rimševics before the end of the criminal proceedings.

Both cases have caused considerable turbulence that could damage Latvia's standing in the euro zone and its credibility as a financial hub. "It is clear that much has happened this year and that the reputation of the financial sector has been significantly affected", Reinis Rubenis,



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CEO of Swedbank Latvia, told the Latvian news agency Leta. Even though Latvia's biggest bank is not drawn into the money laundering scandals that have tainted some of its peers, the retail bank still feels the consequences of recent events. "There is no direct impact on Swedbank, but the reputation risks, of course, are leaving their mark." The wave of negative press in the international media seems not just to have spill-over effects on individual banks in Latvia and Estonia, but also in Lithuania. "The Baltic states are considered a single market. Therefore, we cannot ignore what is happening to the north of the Lithuanian border", Vitas Vasiliauskas, governor of Lithuania's central bank, told the main Baltic news agency BNS. "All these actions affect the reputation of the Baltic states' banking sector one way or another."

However, it must be said that Lithuanian banks are no strangers to controversy either, with Snoras and Ukio Bankas having their banking licenses

withdrawn some years ago. The latter now also features in new accusations of money laundering of up to \$405 million against Nordea Bank that are supposed to have been moved to the lender via Danske's Estonian branch and Ukio Bankas. Unlike Latvia and Estonia, the Lithuanian banking system still has access to US dollar correspondent banking.

Tempting lure of easy money

The new major scandals have raised further pre-existing questions about banking practices in the Baltics. In all three countries, the commercial banking sector is mainly dominated by domestic clients serving Nordic banks alongside a number of privately-owned local lenders that act as a gateway for cash from Russia and other CIS countries by offering Swiss-style confidentiality. For a long time, concerns have centred on these boutique banks' push to cater to these so-called non-resident clients – an issue often highlighted as a source of risk by international authorities but long ignored by local supervisors.

The specialisation in flexible and secretive financial services has grown to become a lucrative multibillion-euro business. The sector flourished especially in Latvia which earned a dubious, partly self-imposed reputation as the Baltic Switzerland, while in Estonia and Lithuania the non-resident catering did not develop on such a large scale. Even though many of the deposits were perfectly legitimate, the line between legitimate non-residential business and money laundering seemed to be thin.

"Many local banks simply have not been able to keep their hand out of the cookie jar." This is how the economist Hansen explains the numerous money laundering scandals that Latvia, in particular, has witnessed. Given previous egregious incidents, the latest illicit money case with ABLV for him does not have much of an effect on the reputation of the Latvian banking sector. "What was there left to harm? How much lower could we get?". Hansen cynically highlights the big



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challenges facing the Baltic state in repairing its tarnished image. "To those who deal with it, Latvia was already known as being rather dodgy in sections of the banking system. Not all of it – and this is important", he underlines, in reference to the retail banking system.

Being now a board member of Latvia's central bank, Mārtiņš Kazāks is more diplomatic in his assessment. For him, the ABLV case has "undoubtedly had some impact" on Latvia's reputation as a financial and banking centre. Similarly to Hansen, the former chief economist at the Latvian subsidiary of Swedbank sees it

as an "industry-specific issue of quite a few banks". Kazāks stresses that the risks have been contained and did not spill over into everyday economic activity or affect overall financial stability, and he points to the rather weak links between the non-resident client banks and the wider domestic economy.

Blowing the whistle on money laundering

In the wake of the Danske Bank scandal and ABLV's forced collapse, financial watchdogs in Tallinn, Riga and elsewhere are now stepping

up their scrutiny of banks' dealings with their customers. First and foremost, US authorities have built up relentless pressure to make the regulators start seriously clamping down on the stream of dodgy millions from the East. One of the main reasons for this is the heightened tensions between Russia and the West. "Geopolitics and the interpretation of anti-money laundering and counter-terrorist financing have changed", Kazāks explains. Worries have increased that shadowy banking activities can assist those looking to evade sanctions or finance terrorism.

After years of massive illicit flows and international criticism of lax controls, the Latvian government has now finally committed to reducing non-resident banking drastically. In record time, action was taken to strengthen the supervision and long overdue efforts to clean up the sector – with the aim of reducing the dependency of the financial institutions on dubious cash sources from non-EU countries and eliminate the associated problems of money laundering and sanctions busting.

Whether the much hyped improvements will materialise can only be seen next year. What is undisputed amongst local experts and international observers is that the further development of the banking sector will mainly depend on how successfully the government implements the recommendations of Moneyval, the anti-money laundering body of the Council of Europe. Being already subject to an enhanced follow-up procedure, a negative evaluation in 2019 could result in Latvia being blacklisted as a noncompliant jurisdiction.

„It is essential for the Latvian economy to reduce risks in the financial sector. Determined action from all involved institutions will increase the reputation of the Latvian financial sector“, emphasizes Kazāks. „It is by no means easy, but these changes should have a positive long-term impact both for the financial sector and overall economic growth.“

Situation and reputation not as bad after all?

This possible worst-case scenario and other uncertainties have not prevented US private equity fund management company Blackstone from investing €1 billion in Luminor bank, the third largest financial services provider in the Baltic banking market. For many industry experts, this decision is proof of the confidence in the region and its economic potential, which was also confirmed by international rating agencies. In generally upbeat assessments, Fitch reaffirmed Latvia's 'A' rating in October and upped Estonia's rating to 'AA'.

The scores achieved by the Baltic States in the Basel Anti-Money Laundering Index 2018 were similarly positive. Despite the Danske scandal, Estonia is even considered to be the country with the second lowest risk of money laundering and financing terrorism in the world, according to the independent annual ranking. Lithuania ranks in third place, while Latvia comes in at 14th.

Whether this will impress Danske's new chairman Karsten Dybvad remains to be seen. In late April, the Danish lender declared it would align its remaining Baltic operations with the aim of focusing on customers in the Nordic region, especially in its home market. Prior to that, it sold its retail operations in Latvia and Lithuania back in 2016. It is not yet clear what will happen to the scandal-ridden Estonian branch that Danske acquired when it made its move into Estonia in 2007 by buying Finland's third-largest bank Sampo.

In any case, it appears that it will take time for the dust to settle for Danske Bank, and to restore credibility and public confidence. Asked by the Danish business newspaper Børsen what his primary task as new chairman of the scandal-ridden bank will be, Dybvad answered that his main job will be to restore one thing: trust, trust and once more trust. The same goes for the Baltic banking sector. It is not an easy task.