

SERIOUS AND ORGANISED CRIME**Date Posted: 10-Aug-2007**

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The Baltic connection - Money laundering in the Baltic region**Key Points**

- The Latvian financial sector has repeatedly been singled out as an area of concern by anti-money laundering agencies.
- The financial regulatory regimes in the Baltic countries have continuously been improved, partially as a result of foreign pressure.
- Recent cases indicate the region remains vulnerable to money laundering relating to political corruption, internet-based financial crimes organised from Russia and domestic gangs involved in drug trafficking.
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The Baltic countries have long been utilised for money laundering by both domestic and foreign organised crime groups. Klas Karrstrand and Michael Jonsson analyse the background of the problem and current trends.

The Baltic countries have long been used by both domestic and foreign organised crime groups to launder the proceeds of crime. Part of the problem stems from the rapid expansion of the banking sector in the early 1990s, which was followed by banking crises partially caused by corruption, subsequent consolidation of the banking industry and gradual improvements of the regulatory regimes against money laundering. Political corruption and tax evasion in the region as well as organised crime, such as drug trafficking and other forms of smuggling, are the prominent sources for money laundering. Demonstrating the region's susceptibility to the phenomenon, Latvia has repeatedly been designated as a major money laundering country by the US Department of State, including in its 2007 International Narcotics Control Strategy (INCS) report.

Estonia and Lithuania were not designated as such, but also appear to have problems with money laundering. Andrei Kozlov, the head of the Russian Central Bank, who was murdered in Moscow in September 2006, warned before his death that major money laundering schemes were underway in Estonia. According to *The Baltic Times* in October 2006, Kozlov visited Estonia a few months before his murder, demanding to close down several accounts in two banks after billions of roubles had been moved from Russia to offshore companies via these banks in Estonia. No charges were brought against the banks in question. Baltic financial institutions have also allegedly been used as conduits for the proceeds of financial crimes carried out in Western countries, but organised from countries in Eastern Europe or the former Soviet Union.

Nonetheless, Latvia remains the primary centre for money laundering in the Baltic region. Recently, Latvian authorities with US assistance have been successful in pursuing money launderers and the country currently seems to be at an important crossroads in its fight against financial crimes.

The Baltic banking industry

Many of the current problems with money laundering in the Baltic countries have their roots in the early 1990s, when the banking sector was privatised. This led to a rapid increase in the number of commercial banks. Banking regulations were overall lax and very weak on anti-money laundering. In Latvia, 59 new commercial banks had been created by 1994, controlling some 85 per cent of total assets. The biggest of those, Bank Baltija, grew very rapidly from total assets of USD25 million in 1993 to almost USD500 million in early 1995. The bank attracted some 200,000 customers by offering interest rates on deposits as high as 90 per cent a year, at a time when other banks in Latvia offered 18 to 52 per cent. These returns were largely achieved by using deposits to finance the initially very profitable east-west trade in Russian commodities. However, the profit margins decreased as Russian commodity prices rose, and by mid-1995 Bank Baltija was declared to be insolvent and was revealed to have a negative net worth of USD320 million, equivalent of seven per cent of the Latvian GDP at the time. This, together with various overall phenomena in the banking industry such as the lack of confidence in the Latvian financial system, the inherent risks of trade financing, currency risks and general lack of technical expertise during early parts of the economic transition process triggered a banking crisis during which seven of the 20 biggest banks in Latvia collapsed during mid-1995. Estonia and Lithuania took a more gradualist approach to banking reform, but also experienced banking crises, in 1992 and late 1995, respectively.

The ill-managed and ill-supervised Latvian banking sector quickly became a part of the capital flight, tax evasion and money laundering schemes from the former Soviet Union countries. The money-moving schemes were mostly set up to avoid the attention of Russian tax authorities and in some cases law enforcement. As foreign currency transactions are limited and strictly regulated in most former Soviet Union countries, some Latvian banks that accept rouble transactions have been used for money laundering schemes. In the case of Russia, hard currency transactions abroad must be registered at the Russian central bank and properly taxed. To avoid taxation, the money is instead wired in roubles to Latvian banks as 'payments' for various fictional services of fictional companies in Latvia. The money is then either parked in Latvian accounts or wired elsewhere, often to an offshore account or shelf

company in a tax haven.

This could in part explain the lively economic interactions seen in official statistics in foreign direct investments (FDI) between Latvia, Estonia and jurisdictions with preferential tax and bank secrecy laws such as Cyprus and Switzerland. National balance of payments sheets indicate that money flows out of Russia, through the Baltic countries, to tax havens and then back to Russia, having been laundered during the transit.

Although claims such as these are very difficult to verify, Latvia's balance of payments for 2006 reveals some fairly strange patterns. It is, for example, hard to imagine what real economic phenomenon would explain the fact that Latvia sends three times as much FDI to Malta as to nearby Finland, 16 times as much to Cyprus and almost 100 times as much to Switzerland. Money invested in Cyprus, which is the third largest recipient of Latvian FDI and the main provider of FDI to Russia, has been steadily increasing. Latvia also receives sizeable incoming FDI flows from jurisdictions such as the Bahamas, Guernsey, Liberia, the British Virgin Islands and Jersey. Such hard-to-explain patterns of FDI flows suggest that sizeable money laundering may be involved.

Dirty money

The banking sector is not the only industry used to launder money in the region. The real estate sector in all three Baltic countries, but especially in Latvia, has also been increasingly used for money laundering. Latvian police sources told *Jane's* they estimate that up to 80 per cent of the proceeds of drug trafficking in the country has been reintegrated into the real estate market, and note a worrying trend of contract killings of real estate traders. An overwhelming majority of recent major political corruption scandals have involved the real estate market, where prices are booming and rose over 60 per cent last year, according to the *Wall Street Journal*, making real estate pricier than in Vienna and Frankfurt. Latvian Minister of Finance Oskars Spurzins commented on this in March, arguing the so-called shadow economy and especially the legalisation of grey money constitutes "a highly credible reason for the overheating of the real estate market".

The proceeds of predicate offences carried out in the Baltic countries are also laundered in the region. The problem stems from political corruption and business activities as well as unlawful influence on politics by a few oligarchs. One possible example of this is the case of Aivars Lembergs, one of the handful of Latvian business tycoons with great influence on Latvian politics, who was detained in March this year and now faces charges of money laundering, bribery and tax violation. The Latvian prosecutor has spent years gathering material for the case, which includes investigations of a Swiss company from which Lembergs has allegedly received dividends. Lembergs, who denies all charges, was released to house arrest on 10 July and is awaiting trial. The arrest and the forthcoming court case have also sparked rumours that other oligarchs may be facing a similar fate within the foreseeable future.

Baltic financial institutions have also been used as conduits for the proceeds of internet-based financial crimes masterminded from Russia. In mid-2006, a major internet attack was directed at Nordea, one of four major banks in Sweden. After obtaining passwords from numerous bank customers, the perpetrators logged into the victims' bank accounts via the internet and transferred money to accomplices based in Sweden. These accomplices had bank accounts in Sweden, but were recruited via a Russian-language webpage, ostensibly with the purpose of helping an import-export company avoid tax payments. The accomplices withdrew the stolen money transferred to their accounts and sent them via money transmitters such as Western Union to various locations in Eastern Europe.

So far, two people have been convicted of sending stolen money to Estonia, but a record 160 people currently face charges of money laundering in Sweden for the Nordea case, allegedly transferring money to countries such as Estonia, Latvia, Lithuania, Belarus and Moldova. In total, upwards of USD1.5 million was stolen from accounts with Nordea, but had the perpetrators not used a sequenced approach - whereby early, smaller withdrawals alerted the bank's security staff, who could later prevent other numerous transfers from being completed - it seems likely the total amount could have been significantly greater.

According to police representatives, the masterminds behind the attacks were based in Russia. The attack also followed a pattern similar to that of an earlier attack carried out against an Australian bank in 2006 and a British bank in 2004. Another such case involves Joe Lopez, a Florida businessman who was defrauded of some USD90,000 that was sent to an account in the biggest Latvian bank. There have also been cases of extortion based on the threat of denial-of-service attacks against online betting agencies and poker companies. Among the victims was the Multibet.com web agency in Australia which, according to its owner Terry Lillis, was asked to send USD20,000 to a Latvian bank account early 2004.

Countering money laundering

The anti-money laundering and combating the financing of terrorism (AML/CFT) regimes in the Baltic countries have rapidly developed since 1997-1999, when the first laws were passed and the financial intelligence units created. Since then, more stringent regulations have been continuously demanded by the EU and the US. According to evaluations of the Baltic countries' AML/CFT regimes carried out by the Council of Europe's experts on anti-money laundering (Moneyval), this legislation typically looked fairly acceptable on paper, but was unsatisfactorily implemented. The financial intelligence units were generally seen as earnest and ambitious, but co-operation with other law enforcement agencies was lacking and very few investigations initiated on the basis of financial intelligence. Much of the laundered money came from predicate offences such as drug trafficking and financial crimes, but initial investigations focused more on small-scale tax evasion cases. The banking sector often remained vulnerable if somewhat regulated, whereas the surprisingly numerous bureaux de change and casinos provided very few or no suspicious activity reports at all. According to the latest evaluation, adopted by Moneyval in December 2006, Lithuania's AML/CFT regulations are quite sound on paper, but "the few measurable results remain modest".

Starting from 2005, increased pressure from US authorities led to a crackdown on Latvian banks and their many accounts with unknown beneficiary owners. The campaign was largely a reaction to the designation of two Latvian banks, VEF Banka and

Multibanka, as banks of "primary money laundering concern" by the Financial Crimes Enforcement Network of the Department of the Treasury in April 2005. The yearly INCS reports of the US Department of State have consequently pointed to Latvia as the worst among the Baltic countries in terms of its financial system's exposure to money laundering. Part of the problem, as pointed out in the INCS reports, seems to be the high proportion of foreign deposits in Latvian banks. Demands were raised that all banks should close down accounts for which the beneficiary owners were not known. Consequently, a major withdrawal of foreign funds from Latvian bank accounts took place after the announcement and as many as 10,000 accounts were closed down in Latvian banks. Together with the application of stricter know-your-customer regulations, this eventually led to Multibanka being taken off the Financial Crimes Enforcement Network list in July 2006. VEF Banka remains on the list and consequently cannot have correspondent banking relations with US banks, nor make transactions in US dollars.

In addition, the Latvian Corruption Prevention and Combating Bureau (Korupcijas novēršanas un apkarošanas birojs: KNAB) was created in 2002, largely as a response to Western allegations of corruption. KNAB has since then been successful, although not without causing a certain amount of friction between the agency and government politicians.

Recent trends

In 2006, the case of Ogres Komercbanka provided a strong reminder that although things may be moving in the right direction, all is not well in the Latvian financial sector. Ogres Komercbanka was one of the smallest banks in Latvia. In 2006, the Latvian bank regulator, the Financial and Capital Market Committee (FCMC), discovered that LVL100 million (USD196 million) was missing from the bank. According to the FCMC, the bank had tried to cover it up by forging documents proving the assets were held in correspondent accounts in other banks. Although the bank denied the money had gone missing, it has been liquidated following a petition filed by the FCMC and accepted by the Riga district court in December 2006.

Even as measures are implemented to restrict money laundering, other groups make the laundering process more diverse and difficult to track. Recent information from Scandinavian law enforcement agencies suggests motorcycle gangs based in Sweden are making inroads into the Baltic criminal market. The two dominating groups in Scandinavia, Hell's Angels and Bandidos, have been active in the Nordic countries for several decades, have consolidated their position in Sweden and now seem set to expand eastwards, according to police reports. A Swedish police source told *Jane's* that members of motorcycle gangs have made connections with Baltic criminals and created businesses locally. The Swedish police suspects the motorcycle gangs are seeking access to the products of illegal laboratories in Estonia and Lithuania and to use their businesses for money laundering. In the past, there have been reports of Balkan organised crime groups reconnoitring in the Baltic countries, but Baltic law enforcement officials tell *Jane's* they believe these groups have slim chances of succeeding with this endeavour. The current strategy of outlaw motorcycle gangs seems to be working in co-operation with local criminal groups, as engaging in organised crime without their consent has proved difficult.

An analogy for this relationship already exists between Finnish professional criminals and their Estonian counterparts. Synthetic drugs are being produced in Estonia and controlled by Estonian groups as well as the smuggling to Finland, while the retail trade is left to Finnish criminals. According to a 2006 report by the Finnish criminologist Mika Junninen, Finnish professional criminals use Estonia as a safe haven for laundering or hiding money from the Finnish authorities through the use of front companies based in Estonia.

CONCLUSION

Such trends make countering money laundering more difficult. What is significant about Latvia and, to some extent, the other Baltic countries is the extent to which the country seems to have become somewhat of a hub for both domestic and international money laundering operations.

Nonetheless, developments in countering money laundering in the Baltic countries has progressed swiftly over the last decade, moving from rudimentary laws and law enforcement units being created in the late 1990s towards more stringent and aggressive implementation of these laws. Many of these changes have taken place as a result of EU and US pressures. In this regard, the Baltic countries are not that different from numerous countries around the world.

However, the political will to actually enforce AML/CFT regulations has also been questioned frequently, suspicions that seem to be borne out by the experience of Latvia. Consistent US pressure on Latvia has yielded some palpable results, but recently there have been clear signs of resistance from Latvian officials.

If any lessons can be drawn from the Baltic cases, it may be that whereas promoting stricter AML/CFT regulations on paper is a necessary first step, having an autonomous anti-corruption agency, such as Latvia's KNAB, and international actors consistently applying pressure may be necessary to achieve significant results.

In light of the swift changes in AML/CFT regulations in recent years, using several different policy tools towards the same goal now seems to be making some headway against, not only terrorist financing, but money laundering as well.

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