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ECFIN Country Focus

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Assessing business practices in Latvia's financial sector

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HIGHLIGHTS IN THIS ISSUE:

- *Latvia's non-resident banking is thriving once again as the economic situation improves.*
- *Existing competitive advantages in this sector have been recently augmented by changes in the administrative environment, including the corporate tax regime.*
- *The business model is not without risks: non-resident financial flows are potentially volatile and prone to money laundering risks, while changes in the tax code could lead to ambiguous business practices.*
- *Strong regulatory and supervisory vigilance needs to be maintained.*

Summary

The financial sector received specific attention when assessing Latvia's readiness to join the euro area, as well as in the context of the post-programme surveillance.[1] The main concern is that some particular features of the Latvian financial sector could lead to negative spill-overs to the euro area, either because the sector might prove to be unstable and require external help or because of ambiguous business practices in this sector. The areas giving rise to concern include non-resident banking, money laundering and recent changes in the corporate tax code. This Country Focus analyses these elements and discusses whether they pose risks to financial stability.

The most prominent issue in the discussion on Latvia's financial sector is non-resident banking, in which Latvia has a long tradition and enjoys several competitive advantages. After waning due to the crisis in 2008-2009, this business is thriving again. Data for 2014 show that non-resident deposits account for nearly half of all deposits in the banking system or 40% of GDP. Non-resident banking enjoys a supportive administrative environment, including an extension of temporary residence permits to investors from the Commonwealth of Independent States (CIS) in exchange for investments,[2] a network of double-taxation agreements with Russia and other CIS countries, and a favourable corporate tax regime. However, while the expansion of non-resident deposits is associated with an accumulation of liquid foreign assets, which somewhat reduce the risks of domestic spill-overs, the increasing size of the sector might represent a source of vulnerability to external shocks.

In addition, this business model needs strong policies to guard against money laundering, even if the threat is not necessarily linked with or restricted to non-resident banking. Financial transactions in non-resident banking may be more complex and difficult to investigate, while banks' business relations can be volatile, short-term, and exposed to different cycles across regions. This lower degree of transparency and predictability requires specific supervisory actions by the authorities and adequate response by banks active in this sector.

Finally, Latvia is implementing a liberal corporate tax policy that favours the establishment of international holdings, aiming to benefit from large cross-border corporate income transfers. These recent tax changes may further increase the importance of non-resident financing and result in a wider use of aggressive tax planning and evasion practices.

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Non-resident banking in Latvia

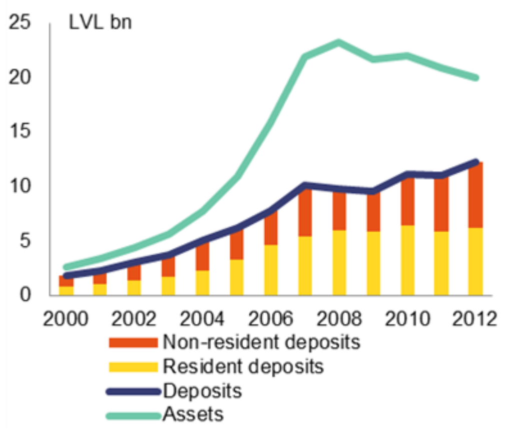
The profile of Latvia's banking sector

Latvia's banking sector is relatively modest with an assets-to-GDP ratio of 130% of GDP, compared to the EU average of 352% and far below the levels of popular EU non-resident hubs.

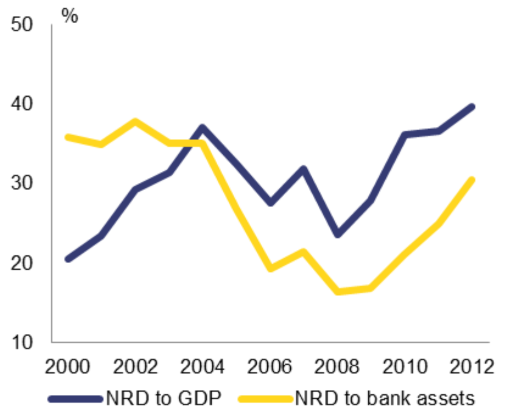
The Latvian banking sector experienced very rapid growth before the crisis of 2008-2010, surging from 57% of GDP in 2000 to 149% in 2007. A particular feature of the sector is the significant role played by non-resident deposits, which are as important as resident deposits (Graph 1). Relative to GDP, they are now higher than before the crisis, while they are still lower relative to bank assets (Graph 2). Despite the drop in the nominal stock of total bank assets during the crisis, their share in GDP peaked at 172% at the end of 2010, but subsided to about 130% of GDP at the end of 2012 due to deleveraging. Still, the ratio of bank assets to GDP is rather low compared with the EU average of 352% and far below the levels of popular EU non-resident hubs like Luxemburg, Cyprus, Malta, and Ireland, where total bank assets exceeded 700% of GDP at end-2012 (Graph 3). Similarly, the ratio of non-resident deposits to GDP, which stabilised at 50% in 2013, is significantly lower than respective ratios in other EU countries (Graph 4).

It appears that relocations of financial flows from Cyprus to Latvia have been relatively small.

Graph 1: Latvian bank indicators



Graph 2: Non-resident deposits (NRD)



Source: Bank of Latvia

The Latvian banking sector comprises 20 banks and 8 branches of foreign banks. The local credit market is dominated by Scandinavian-owned banks, which rely on cheap funding from parent banks and resident deposits, and domestically-owned banks that are largely dependent on non-resident deposits and mostly specialise in financial services to non-residents.

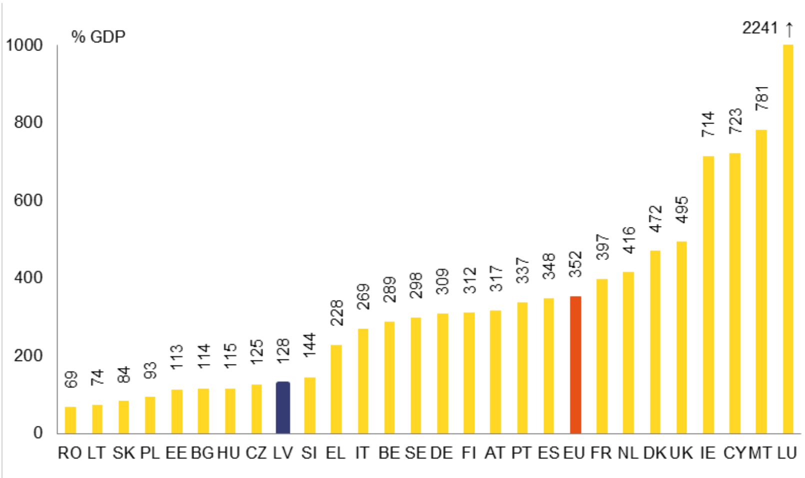
Two thirds of assets and deposits of the non-resident banking segment are controlled by three banks – ABLV, Rietumu, and the state-owned Citadele.

At end-2012, the Latvian Financial and Capital Market Commission (FCMC) defined 14 banks as specialised in non-resident banking.[3] Their assets accounted for about 40% of total bank assets but their share in total loans was less than 25%, according to individual bank statistics reported by the Latvian association of commercial banks (ACBL). However, their share in total deposits was much higher (more than 55%). Two thirds of assets and deposits of the non-resident banking segment are controlled by three banks: ABLV, Rietumu, and the state-owned Citadele. In the case of ABLV and Rietumu, more than 90% of their assets and liabilities are linked to non-resident deposits.

Non-resident liabilities have expanded by more than 150% or about EUR 5 billion since mid-2009 and the trend is continuing. The increase in foreign liabilities has been matched by a corresponding expansion of foreign assets, which represent 62% of all assets held by banks with a non-resident business model. According to FCMC data, foreign assets are distributed among liquid and geographically-diversified deposits with foreign financial institutions (ca. EUR 3 billion), loans to non-residents (ca. EUR 2.1 billion) and foreign securities (ca. EUR 2 billion). Loans to non-residents are skewed toward CIS countries; more than half of these loans have a residual maturity of less than a year. Domestic assets, which exceed EUR 4.3 billion, consist primarily of loans to the domestic economy.

■ *The maturity of non-resident deposits, mostly from CIS countries, is very short, with more than 85% being on-demand, implying a particularly high liquidity risk.*

Graph 3: Bank assets, end-2012

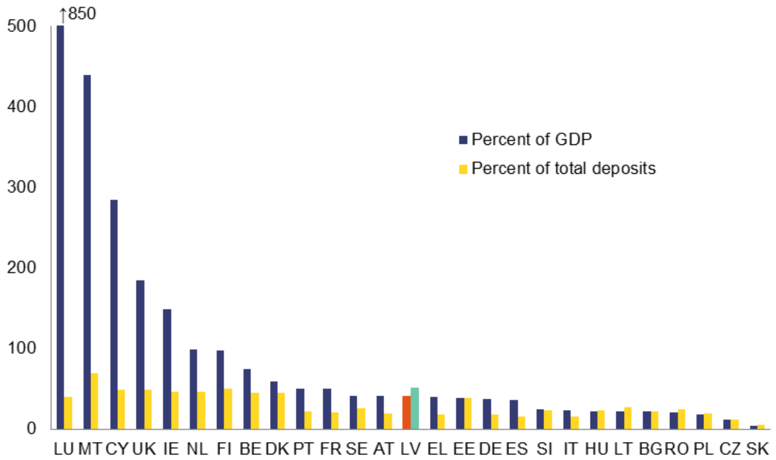


Source: European Banking Federation, Eurostat

According to the FCMC, the maturity of non-resident deposits is very short, with more than 85% being on-demand, primarily held for corporate transaction purposes (trade, insurance, salary payments). In November 2013, only 14% of non-resident deposits, which are mostly in USD, appeared as CIS deposits, while around 34% were booked as deposits from the EU, in particular the UK and Cyprus, and the remaining half were attributed to the Channel Islands, British Virgin Islands, Belize and other territories. However, according to the FCMC 2013 estimates based on the indicated place of residency of the beneficial owners, around 80% of total non-resident deposits are de facto attributable to CIS businesses and individuals.

■ *Problems in the non-resident banking sector could create significant challenges for Latvia, as was evidenced by costly failures of Parex and Krajbanka banks.*

Graph 4: Non-resident deposits, end-2012



Source: National central banks

The growth rate of the non-resident banking sector seems to have moderated in 2013 due mainly to the depreciation of the US dollar, which forms a substantial share of the banks' balance sheets. The prospects of large relocations of financial assets from Cyprus to Latvia do not seem to have materialised. Some non-resident banks reported an increased interest in moving accounts from Cyprus. However, the percentage of refusals has also risen due to tighter compliance requirements of the Latvian banks.

Potential risks linked to non-resident banking

There seem to be significant country-specific advantages for Latvia to continue growing as a popular non-resident banking destination for CIS customers: language, geographical proximity to the CIS region, EU membership, low fees for labour-intensive compliance checks and long working hours adjusted to customer demand, double-taxation treaties with Russia and other CIS countries, low administrative costs for company and tax registrations, an favourable corporate tax law for holding companies and repatriation of profits, as well as an extension of residence permits in exchange for investments.[4] The introduction of the euro in 2014 may also have a positive impact, as Latvian banks will have, inter alia, access to Eurosystem liquidity instruments. According to the FCMC, exports of financial services have maintained a share of at least 1% of GDP since the mid-1990s. The additional impact on other sectors, like legal services, tourism, construction and sale of up-market real estate, should also be recognised.

However, engagement in non-resident banking entails significant risks, as Latvia itself has seen costly bankruptcies of two banks focusing on non-resident banking in the past five years. In 2008 the collapse of the second largest bank Parex triggered a deposit outflow and necessitated a request for international financial assistance. In late 2011, Latvijas Krajbanka, a subsidiary of the Lithuanian Snoras Bank, went bankrupt, as the main stakeholder was accused of fraud and illegal withdrawal of funds. The cross-border nature of the business on the asset and liabilities side increases classical banking risks through a number of channels:

- *While financial supervision has been tightened, monitoring of non-resident banking activities is inherently more challenging due to the dynamic cross-border nature of transactions.*

First, although lending appears to be less important for banks with non-resident business model, the cross-border nature of loans makes the assessment and monitoring of **credit risk** more difficult due to geographic distance, language and cultural barriers, and a differing business and regulatory framework. In particular, the legal and regulatory environment in CIS countries may be weaker than in most EU countries, thus requiring more thorough checks of borrowers' creditworthiness and enforceability of collateral.

Second, the **liquidity risk** is inherently higher as the mostly on-demand non-resident deposits are a more volatile source of funding than longer-term resident-deposits. This is partly because the clientele is relatively concentrated (large deposits) and the depositors are typically very flexible entities that can easily relocate their activities. These risks were evidenced during the crisis in 2008-2009, when the non-resident banking sector experienced large and fast deposit outflows. Thus, risks on the liabilities side are even more important for banks engaging in non-resident banking than the usual risks on the assets side.

Third, banks with a non-resident business model are exposed to **market risk** as they address the higher (funding) liquidity risk by keeping a high share of liquid assets. In particular, a large security portfolio may lead to significant losses in case of adverse shocks on the bond markets. However, these risks are mitigated by large cash holdings and a recent (and likely increasing) tendency to move towards euro operations.

Fourth, non-resident banking may also lead to some **contagion risks** for the Latvian economy, e.g. through loss of some domestic deposits if a bank fails or by creating asset or credit bubbles. However, this risk is mitigated by the relatively low involvement of the non-resident banks in domestic activities.

- *Contagion risks for the Latvian economy are mitigated by the relatively low involvement of the non-resident banks in domestic activities.*

Fifth, as regards **reputational risk**, ensuring compliance with anti-money laundering rules may be more challenging for non-resident banks as verifying clients' background and business activities could prove difficult. Criminal groups and corrupt officials may use elaborate off-shore services to hide true beneficiaries or create fraudulent business transactions.

Sixth, a specific risk relates to **USD correspondent accounts**. These are essential to allow daily operations to be conducted in US dollars. Only a handful of large international banks service USD payments of Latvian non-resident banks and they might reconsider their co-operation if Latvian banks' activities were deemed suspicious or for any other reason.[5] However, this risk is partly mitigated by Latvia's euro adoption, as 'hard' currency liquidity is now ensured within the Eurosystem, which might also encourage non-resident depositors to increase the share of euro transactions.

Seventh, the **recapitalisation risk** is also higher for individually-owned non-resident banks than for subsidiaries or branches of large Scandinavian banks, which have demonstrated their strong commitment during the crisis in 2008-2010. Capital increases may also prove unstable if the source of financing comes from loans between related entities as was the case with Snoras bank in Lithuania.

Are the risks under control?

There seem to be three ways of limiting the risks associated with non-resident banking:

a) **Limiting the size of this business relative to the financial sector and GDP**: this may, however, impinge on principles of equal treatment and free movement of capital in the Single Market. Also, non-resident banking does not play a particularly strong role relative to GDP.

b) **Separating non-resident banking from the domestic economy to minimise negative spill-overs should things go wrong**: as outlined above, there seems to be a relatively clear distinction in the Latvian banking sector, with mainly Scandinavian-owned banks serving the domestic market and domestically-owned banks focusing on non-resident banking. This should help to limit spill-overs, as well as a repetition of Parex- and Krajbanka-like bank failures.

c) **Specific regulatory oversight**: several measures have been taken, which should be reviewed regularly and developed further as warranted. However, it is important to recognize the dynamic nature of non-resident banking, which limits finding permanent solutions.

Capital adequacy and liquidity ratios have been raised for non-resident banks.

The structure of assets in the sector suggests that the higher liquidity risk of the non-resident bank business model is well managed. Additional **liquidity requirements** were introduced by the FCMC in March 2013: depending on the exposure of a bank to non-resident deposits, the ratio of high-quality liquid assets to the estimated value of 30-day cash outflow is set at a daily-average of 40% to 60%. The biggest non-resident banks have also been issuing significant amounts of bonds and subordinate debt to diminish reliance on short-term deposits, as well as limiting CIS lending activities.

As far as solvency is concerned, the **capital adequacy ratio** (capital vs. risk-weighted assets) of around 17% since mid-2013 is more than double the minimum capital requirement of 8%. Thus, significant capital buffers have been built up. However, banks with a non-resident business model may be more exposed to mispricing risks, as their leverage ratio (assets to equity) is above 13, which compares with a ratio of below 8 for the resident banks. The high leverage is partly explained by the large share of high-quality foreign assets in the balance sheets of non-resident banks, mostly claims on foreign financial institutions and investments in foreign securities, so as to manage risks from the large share of on-demand deposits. In addition, the FCMC has already started to apply differentiated capital adequacy requirements to non-resident banks, which should correspond better to their specific risk profiles.

Non-resident banks pay into the Deposit Guarantee Fund substantially more in relation to the insured value of deposits than domestic-oriented banks.

The FCMC also performs regular **on- and off-site analysis** of the dynamics and quality of non-resident loan portfolios (loan days in arrears, loan-to-value and coverage ratios, structure of loan portfolio), and analyses Credit Committee and Internal Control files to check internal risk assessment procedures. This allows closer monitoring of collateral enforceability and application of anti-money laundering procedures. Moreover, the FCMC regularly performs verification of the availability of correspondent account balances. In addition, balance sheet stress tests, including macro-prudential tests, were carried out in 2013 and amendments were proposed to the Deposit Guarantee Law and the resolution and recovery framework.

ABLV – the biggest non-resident bank – will be subject to the Single Supervisory Mechanism.

While all banks pay the same percentage into the **Deposit Guarantee Fund** relative to the total value of deposits, non-resident banks pay effectively significantly more in relation to the insured value of deposits than domestic-oriented banks. Only about 30% of their deposit value is insured, as their client base is dominated by big depositors, whose deposit amounts vastly exceed the insured EUR 100000. For this reason, ABLV, the largest bank with a non-resident business model, moved part of its deposits to a subsidiary in Luxembourg, where respective charges are lower, while most of the labour-intensive work related to service of deposits and compliance checks remains in Latvia.

Although several important changes have been made in the regulatory framework, the authorities will have to remain vigilant and may need to consider additional regulatory measures to further reduce financial risks from the non-resident banking sector. This may include an enhanced monitoring of pledged assets and origin of financing in cases of capital hikes, regular reporting of specific financial ratios, a more systematic use of stress tests and pre-defined actions if certain benchmarks are reached.

The FCMC is also studying the supervisory experience of other small EU countries that attract a lot of non-resident deposits, for example Luxembourg. While both countries benefit from a marginal involvement of non-resident banks in the domestic economy, other features highlighted in a recent ECFIN country focus,[6] which make Luxembourg's financial sector less vulnerable to risks associated with large foreign deposits, are more country-specific, namely strong international banks' standing behind the local subsidiaries and branches, long-lasting experience of the supervisor, and a credible and efficient Deposit Guarantee Scheme.

Latvia's anti money laundering framework: tight enough?

Latvia's anti-money laundering legislative framework complies with international norms. However it needs to be supplemented by consistent implementation, jointly with the banks.

In 2005, some US banks threatened to close correspondent accounts of Latvian banks due to suspicious transactions. In April 2005, the US government had announced concerns about two banks under the auspices of the US Patriot Act, while 13 of 23 Latvian banks were under intensified supervision by the FCMC due to deficiencies in anti-money laundering (AML) systems. Up to now, a strong incentive for AML compliance stems from the need to maintain USD correspondent account relationships, as much of non-resident deposits and assets are in US dollars.

The need to build further expertise and improve institutional capacity for fighting financial crimes remains a long-term challenge due to the dynamic nature of investigating and prosecuting complex international financial schemes.

While the US actions in 2005 led to stricter AML regulations, some Latvian banks may have been used as intermediaries in a number of international money laundering and tax evasion cases, casting doubts on the overall efficiency of money laundering controls. For example, Latvian banks have featured in the Magnitsky affair in 2007, in the case of inflated fuel-sales to Moscow's main airport in 2008-2010, in the 2008 Ukraine Faina ship case involving arms sales, and the 2011 “oil rig case”, where Ukraine's state oil company "Chornomornaftogaz" bought oil rigs at hugely inflated prices. Also, Kirgizstan launched court proceedings against the owner of Latvia’s Baltic International Bank for his alleged role in helping the son of deposed dictator Bakyev steal public funds through Manas bank in 2010.

In July 2012, the MONEYVAL Committee, set up by the Council of Europe to ensure that its member states have in place effective systems to counter money laundering and comply with the relevant international standards, published an evaluation report on Latvia. It concluded that Latvia's legislation and institutional setup are largely compliant with the international AML standards: of the 48 recommendations that apply to Latvia, the country "complies" with 15, "largely complies" with 19 and "partially complies" with the remaining 14.

There are relatively few court cases and actual convictions.

Nevertheless, as highlighted in the 2013 Convergence Report on Latvia, a determined and effective implementation of AML rules remains key. The MONEYVAL report points to significant weaknesses as regards implementation, including too-demanding proofs needed for prosecuting offences, weaknesses in customer due diligence assessments ("Know Your Customer" principle, including identification of the true beneficial owners), questionable effectiveness of the sanction regime, and inadequate training and capacities of institutions dealing with financial crimes. For example, banks reported more than 18 000 unusual or suspicious transactions in 2013, based on the set of indicators in the Cabinet of Ministers' Regulation on such transactions. However, the latter indicators do not adequately reflect additional circumstances and the Financial Intelligence Unit (FIU) receives a significant number of reports with little analytical value.

As part of the Post Programme Surveillance,[7] the authorities have been encouraged by the Commission to devote more financial and human resources to tackling complex financial crimes, especially in view of the very few related convictions in the last two decades. In many cases, the knowledge and skills of relevant authorities may not be adequate to successfully investigate, prosecute and punish such schemes, which often involve international dimensions. In addition, institutions like the State Police Economic Crimes Unit and the Financial Police have difficulties in attracting experienced and well-qualified staff.

In response to the MONEYVAL report and in view of concerns raised in the euro accession process, the Cabinet of Ministers approved an Action Plan for implementing its recommendations in March 2013. The FIU and the FCMC are tasked with monitoring its implementation by institutions directly or indirectly involved in fighting financial crimes, as well as advancing relevant legislative changes. Constructively, the authorities have allocated significant additional resources in the 2014 budget for AML institutions and the FIU is supported by additional staff, IT and logistical upgrades. Also, the FIU is working with the banks to improve the analytical value of reporting of "suspicious transactions" and comprehensive training programmes on AML issues are organised for investigators, prosecutors, judges and other involved staff.

Encouragingly, the main non-resident banks seem to be devoting significant attention to “Know Your Customer”-compliance checks and regularly invite professional expertise to review their risk assessment procedures, so as to eliminate any risks to their “bread-and-butter” USD transactions. Also, the Latvian Private Banking Association, which comprises the main banks engaged in non-resident banking business, appears to be supporting efforts to train and assist their members in properly applying AML procedures.

Generous corporate taxation amendments may attract holding registrations, primarily from CIS countries, and part of the huge financial flows of international holding companies.

Corporate tax regime: supporting ambiguous tax practices?

One notable development that may provide a further boost to the non-resident banking sector relates to the December 2011 corporate tax amendments on dividend, interest, and royalties' taxation, which may be attractive for the establishment of international holding structures, mostly from CIS countries. In harmonising the corporate tax regime with the EU Parent-Subsidiary Directive (for which the transition period expired in July 2013), since January 2013, Latvian companies are no longer taxed on dividends received from non-resident entities. Nor is withholding tax applicable to dividends paid to non-resident companies, except for companies residing in low tax or tax free territories (a list of 65 territories set by the Cabinet of Ministers),[8] which will continue being subject to 15% withholding tax. Similarly, since January 2013, gains realized by Latvian companies from the sale of shares are no longer taxed and, since July 2013 and January 2014, the interest and royalty payments made by a company residing in Latvia to non-resident entity are exempt from enterprise income tax, except for payments to low tax or tax free territories.

There is a risk that Latvia may be used as a hub for aggressive tax planning and evasion practices, including profit-shifting.

In effect, the Latvian amendments lead to a more liberal tax regime than required by the respective Directives (2011/96 and 2003/49). Unlike other EU countries with competitive holding company regimes, Latvia does not impose any conditions regarding the holding period (e.g., minimum two years), holding capital (e.g., minimum 25% equity), or the nature of the business required to qualify for withholding tax exemptions. Thus, for instance, even income from a 1% holding in a company’s capital held for one month (speculative income) is tax-exempt. Although the authorities make no specific reference to international holding companies, many local analysts and non-resident banks interpret these changes as an attempt to attract holding registrations primarily from CIS countries and to compete with other popular European countries with favourable international holding laws, such as Cyprus, Ireland, Luxembourg, Malta and the Netherlands.

Ambiguous tax practices need to be addressed at the EU level.

Overall, with a relatively low 15% corporate profit tax rate, 52 agreements for avoiding double taxation (including agreements with all major CIS economies), widespread proficiency in the Russian language, and low charges for banking, accounting and legal services, there are indeed good prospects for Latvia to attract corporate registrations from the CIS region. Since Latvia is already a transport and logistical hub for many CIS companies trading with the EU, attracting holding registrations and providing administrative and financial services for such entities can be a lucrative supplement to the local cluster of non-resident financial services.

However, it may also turn out that well-established holding jurisdictions, like Luxembourg and the Netherlands, will maintain their high attractiveness when compared to Latvia. Some EU countries have no restrictions for dealings with low tax or tax-free territories and the effective corporate tax paid can be lower than Latvia’s 15% rate due to various exemptions and arrangements with tax authorities. Some jurisdictions allow financial statements to be prepared according to international accounting standards (IFRS) and in English, whereas annual tax returns can be filed in major foreign currencies to avoid exchange rate fluctuations. The traditional jurisdictions also have a large pool of experienced lawyers, accountants and tax experts to service the sometimes sizeable activities of holding companies and rely on efficient and business-friendly legal systems.

Given the still relatively limited size of the Latvian banking sector and the weak links between non-resident banking and the domestic economy, a liberal holding jurisdiction seems to carry more prospects than risks for Latvia as long as financial supervision stays effective. From a broader perspective, increased incentives for aggressive tax planning and profit shifting may weaken the Internal Market. However, tackling such developments, evident in several EU Member States, is a task at European and wider international levels.

Conclusion

Latvia's banking sector is relatively modest in size compared to other well-established EU financial centres and its non-resident banking business is still relatively small, albeit growing strongly. While there have been no large-scale relocations of CIS-owned financing to Latvia following the financial sector challenges in Cyprus, the non-resident banking business is once again thriving after the drop during the crisis years. Riga has become a Baltic financial centre, servicing mostly medium-sized CIS businesses and rich individuals. Non-resident banking was supported in recent years by administrative changes - selling of residence permits, agreements to avoid double taxation, corporate act changes -, and will be helped by euro adoption and historic and linguistic links with the region. Since these factors are likely to attract new CIS business registrations and financial flows, banks' fee-based incomes and the state's tax revenue could grow substantially.

As part of the 2009-2012 financial assistance and in view of joining the euro area, the financial supervision of non-resident banking has been considerably strengthened and the resources for relevant supervisory institutions, in particular the financial regulator, have increased. This shift in regulatory policy is, on the one hand, due to costly lessons learnt, most notably with the Parex and Krajbanka failures, and, on the other hand, it brings Latvia's institutional setting in line with a general trend of a gradual tightening of tax avoidance and money laundering loopholes at EU and international levels. The non-resident banks are also addressing risks by, inter alia, accumulating liquid foreign assets, issuing significant amounts of bonds and subordinate debt to diminish reliance on short-term deposits, limiting CIS lending activities, and updating their anti-money-laundering procedures.

Nevertheless, the supervision of this banking segment poses continuous challenges and the authorities will have to remain vigilant, primarily due to the dynamic cross-border nature of banks' activities. It cannot be excluded that additional regulatory measures will need to be introduced to further address evolving risks. The ECB's Single Supervisory Mechanism, to which the biggest non-resident bank ABLV will be subject, may also bring in new supervisory approaches.

The recent anti-money laundering efforts, partly due to pressure from outside, also seem notable. However, even if the legislative framework complies with international norms, it needs to be consistently implemented, jointly with the banks. The need to improve the institutional capacity remains a long-term challenge due to the complexities of investigating and prosecuting money laundering. In many cases, the knowledge and skills of enforcement agencies and the judiciary need to be upgraded and salaries must be competitive.

Lastly, the recent corporate tax changes aimed at attracting CIS holding registrations may further increase the importance of CIS capital in Latvia's banking sector and may possibly lead to wider use of aggressive tax planning and evasion schemes. Even though the authorities have put in place a comprehensive black-list of low tax or tax free territories, such lists may not be effective, as they regularly leave loopholes and other EU countries can be used for repatriation of profits to non-EU "tax havens". With potential gains higher than risks for individual host countries like Latvia, aggressive tax planning practices must be tackled at the EU level.

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[1] For more information on the assessment of Latvia's readiness to join the euro area, see European Commission (2013). Commission services are conducting post-programme surveillance, i.e. a more intense monitoring than the regular country work, until 75% of the EU loan has been repaid. For more information on the programme see European Commission (2012) and http://ec.europa.eu/economy_finance/assistance_eu_ms/latvia/index_en.htm

[2] It is assumed that deposits of foreign customers receiving residence permits are still accounted as non-resident deposits in the banking system, although it cannot be excluded that part of such deposits is or will be transferred to the resident segment.

[3] The definition is based on the criterion of having non-resident deposits in excess of 20% of the total value of bank assets. Branches are not analysed on the basis of this criterion but, excluding the branches of Nordea Bank Finland and Danske Bank, which are supposedly not focused on non-resident services, the aggregated market share of the remaining 6 branches is less than 1%. However, the distinction between resident and non-resident entities is often difficult as non-residents can gain resident status e.g. physical persons through acquiring a residence permit and legal persons through registering a company.

[4] Having fulfilled one of the following criteria, an investor may apply for a residence permit that is valid for a period of 5 years: opening a subordinated term deposit or bonds worth more than EUR 300000 for 5 or more years; investing in real estate value to the tune of EUR 143000 in Riga and EUR 72000 in regions; or investing in a business establishment (ranging from EUR 35000 to more than EUR 150000 depending on the number of work places created, the taxes paid, the turnover)

[5] According to media reports (Bloomberg on 2 January 2014), JPMorgan stopped clearing dollar transfers for Latvian lenders at the end of 2013, leaving Deutsche Bank and Commerzbank as the only corresponding banks. The FCMC attributed JPMorgan's decision to a modified strategy of the bank on the worldwide interbank market, rather than Latvia-specific factors.

[6] Country Focus: "Luxembourg's financial centre and its deposits" by Markus Wintersteller, Volume 10, December 2013

[7] See the third review report of June 2013 under the Post Programme Surveillance, page 6 http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/pdf/lv_efc_note_3rd_pps_mission_en.pdf

[8] The rules set up a list of countries and territories to which tax-free transfers are not allowed due to risks of money laundering, financing of terrorism, and tax evasion. These restrictions are based on internationally-recognised blacklists and, since 2013, comprise 65 countries and territories (see http://likumi.lv/doc.php?id=25839).