



LICENSING COMMITTEE OF LATVIJAS BANKA

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**Assessment of money laundering and
terrorism and proliferation financing
(ML/TF/PF) and sanctions risks in the
currency cash exchange sector**

2020

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Summary

The risk of ML/TF in the sector of capital companies exchanging currency cash has been assessed as medium high. The risk of proliferation financing has been assessed as low. The risk of failure to comply with international and national sanctions of the Republic of Latvia (hereinafter, the sanctions risk) has been assessed as medium high.

Risk factors:

Sector size:

The value of foreign currencies purchased and sold by capital companies exchanging currency cash (34 capital companies, excluding the credit institutions purchasing and selling currency cash) in Latvia has been gradually declining over the last three years: 320 million euro in 2017 and just 264 million euro in 2019.

At the same time, the turnover of capital companies having received Latvijas Banka licences for purchasing and selling foreign currency cash in their financial statements constitutes about 1% of the total value of the purchased and sold foreign currencies¹. Consequently, the total annual turnover of the currency cash exchange market in Latvia can be estimated at about 2.6 million euro.

For comparison: the total annual turnover of credit institutions in Latvia exceeds 700 million euro, which suggests that the share of currency cash exchange capital companies in Latvia's overall financial market is small.

The capital companies operating in the currency cash exchange market are mostly small businesses and only some of the largest companies employ more than 10 people. Consequently, a large part of the capital companies operating in the sector may find it difficult to ensure effective compliance with the requirements set by legal acts in the field of AML/CTF/CPF and compliance with the restrictions imposed by sanctions because of their limited resources, thereby resulting in increased vulnerability.

Transaction specifics:

Mostly, transactions are relatively small, with the average transaction value slightly below EUR 400. They are spot transactions and can be easily substituted by going to another service provider. Considering the above, the market is dominated by occasional transactions, business relationships are rare and only four capital companies have reported that such relationships have been established.

At the same time, more than 97% of the transactions carried out by the capital companies are anonymous and the companies do not identify the customer (average value of an anonymous transaction is slightly over EUR 300, while a legal obligation of customer due diligence is triggered at the amount of transaction or the total of several seemingly related transactions exceeding the threshold of EUR 1500).

From the perspective of AML/CFT/CFP as well as compliance with the restrictions imposed by sanctions, anonymous cash transactions constitute an increased vulnerability.

¹ The turnover of currency cash exchange consists of the exchange rate difference and commissions.

Traditionally, the most widely used foreign currency is USD (41% of the total value in 2019), followed by GBP and RUB (23% and 14% of the total value in 2019 respectively). 1% of the total value is also exceeded by the Scandinavian currencies, Polish zloty and Swiss franc.

Customer due diligence:

Customer due diligence in the currency cash exchange sector can be a challenge because of poor availability and reliability of information. An excessively time-consuming or detailed customer due diligence process involves a likely risk that the customer might cancel the transaction and go to another currency exchange office, including a possibility that the transaction amount could be split into parts to reduce the amount of information to be provided or to avoid providing information altogether. Consequently, all the required customer due diligence information has to be collected at the moment of the transaction.

Capital companies are mostly small businesses (for more than 2/3 of the capital companies the annual turnover in 2018 was below EUR 100 000.00), they do not have the capacity to put in place automated customer transaction monitoring systems, especially because, considering that most transactions are anonymous, the practical benefit of such systems would be low. Capital companies also often do not use even the simplest electronic data processing alternatives for customer risk evaluation or transaction monitoring. As a result, customer due diligence is based on information provided by customers before each transaction; in the case of occasional transactions, meaningful verification of such information is virtually impossible, particularly as regards natural persons. Monitoring of each individual occasional transaction that would help verify the truthfulness of the provided information also is not feasible, as suggested by the analysis of the value of such transactions and regularity.

Mostly information provided by the customer and public registers that can be easily checked is used for verification of beneficial owners and the status of a politically exposed person within the sector. It has to be noted that part of the capital companies do not have any electronic aids (a computer or a tablet) on-site, which makes customer due diligence even more difficult, as it has to be performed remotely by calling the person empowered with taking the respective customer due diligence decision on the phone. Overall, it has to be concluded that implementation of a meaningful customer due diligence process is difficult for capital companies, which overall increases the sector's vulnerability.

Capital companies' understanding of prevention of money laundering and terrorism and proliferation financing as well as compliance with the restrictions imposed by sanctions:

In most cases, inspections of capital companies (particularly, of the smallest capital companies) have identified breaches stemming from insufficient knowledge in the field of AML/CFT/CFP and compliance with the restrictions imposed by sanctions. In 2019 overall, more than a half of all inspections found that the knowledge of capital company staff in the field of AML/CFT/CFP and compliance with the restrictions imposed by sanctions was insufficient.

Threats of terrorist and proliferation financing:

According to the State Security Service, the terrorist threat level in Latvia remains low². No cases of terrorist financing or proliferation financing in Latvia or via Latvia in cash, including by means of currency exchange, have been observed.

It has to be remembered, however, that euro is a global and easily convertible currency, hence the need to use currency exchange services in order to finance terrorism would be lower. This is especially important with regard to local and lone terrorists who do not require currency conversion. At the same time, converts travelling to conflict zones might want to exchange foreign currency cash, for example, to USD which is considered a globally more widely-spread currency or to the currency of a conflict zone country or a neighbouring country.

According to the State Security Service Guidelines for the Prevention of Terrorism Financing and Proliferation³, mostly formal financial network ensuring cash transfers is used for proliferation financing, in order to give an impression of a legal operation and not to stand out from other transactions. Although cash can be potentially used as a means of concealing the origin of funds, including through exchanging currency, there is no reason to believe that this is practised in Latvia.

Risk assessment

Cash, anonymous transactions, spot transactions, market competition and open market (customers can freely choose not to complete the transaction and go to another currency exchange office) pose a significant vulnerability to the sector.

Vulnerability is managed by establishing a binding transaction value threshold for the sector triggering an obligation to perform customer due diligence in order to reduce the amount of anonymous transactions and by monitoring transactions.

Despite the measures taken to reduce the vulnerabilities of the sector, anonymous occasional transactions still account for a considerable part of all transactions, while the average transaction value of slightly above EUR 300 is a relatively small amount that a typical traveller wishing to exchange currency could require.

At the same time, anonymous transactions make it impossible to draw any conclusions as to the purpose of transactions. In light of the above-mentioned, including the comparatively small share of the sector in the overall financial domain, the sector's:

- money laundering risk is assessed as **medium high**, mainly on account of the considerable share of anonymous transactions;
- terrorist financing risk is assessed as medium, mainly on account of the considerable share of anonymous transactions and relatively low level of threat posed by potential converts or local terrorists, including with a legal origin of funds, and potential transit of cash from abroad through Latvia.
- proliferation financing risk is assessed as low. The level of threat in the currency cash exchange sector is low and the established threshold for triggering

² See Guidelines for the Prevention of Terrorism Financing and Proliferation for the Subjects of the LPMLTF and Supervisory Authorities. Available at: https://eng.fid.gov.lv/images/Downloads/materials/TF_PF_vadlinijas_ENG.PDF

³ See Guidelines for the Prevention of Terrorism Financing and Proliferation for the Subjects of the LPMLTF and Supervisory Authorities. Available at: https://fid.gov.lv/images/Downloads/materials/proliferation/TF_un_PF_nov_vadlinijas.pdf

customer due diligence limits the possibilities of anonymously exchanging significant amounts of cash.

Assessment of the risk of failure to comply with the restrictions imposed by sanctions

The Law on International Sanctions and National Sanctions of the Republic of Latvia (hereinafter, the Sanctions Law) establishes an obligation to comply with sanctions. At the same time, the Sanctions Law does not set any minimum requirements for compliance with the Law. Compliance of the participants of the cash currency exchange sector with the minimum requirements laid down by the Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing (hereinafter, LPMLTPF) leaves a significant vulnerability, as even a simple customer check against the list of sanctions is impossible in case of anonymous transactions. Therefore, the risk of failure to enforce sanctions is assessed as medium high.

I Profile of the currency cash exchange sector

According to legislation, only capital companies having received a licence for purchasing and selling cash foreign currencies from Latvijas Banka and credit institutions may engage in the currency cash exchange business. In credit institutions, currency cash exchange services are not separated from other services; therefore, the supervision of these services is carried out within the general credit institution supervision framework by the Finance and Capital Market Commission (hereinafter, the FCMC). Consequently, the present sectoral risk assessment does not cover the currency cash exchange operations carried out by credit institutions.

The operation of capital companies in the field of currency cash exchange in Latvia is governed by Articles 10 and 11 of the Law on Latvijas Banka and Latvijas Banka's Regulation No. 36 "Regulation for Purchasing and Selling Cash Foreign Currency" of 13 May 2009 (hereinafter, Latvijas Banka's Regulation No. 36) issued on the basis of Article 11 of the said Law.

Licences granted by Latvijas Banka provide capital companies with the rights to exchange cash currency only. Latvijas Banka does not grant licences for non-cash currency exchange.

Pursuant to Latvijas Banka's Regulation No. 36, open-ended licences are granted to each currency exchange office (location), which means that a single capital company may have several licences. The respective Latvijas Banka's Regulation permits the use of automated currency exchange machines (at an already existing currency exchange location or by obtaining a separate licence for a new location), yet there were no such machines installed as at the end of 2019. The Regulation permits online selling of foreign currencies, using the mail delivery services. As at the end of 2019, such service was available from one capital company.

Currency cash exchange services may be provided by both capital companies registered in the Republic of Latvia as well as capital companies registered in other countries of the European Economic Area. Physical persons may not provide currency cash exchange services.

As at the end of 2019, currency cash exchange services were provided only by capital companies registered in the Republic of Latvia (only residents), including:

- two capital companies have legal persons registered abroad as participants;
- three capital companies have foreign participants which are not legal persons.

Table 1

Number of service providers and licensed currency exchange offices (locations) as at the end of the reporting year

	<i>2014</i>	<i>2015</i>	<i>2016</i>	<i>2017</i>	<i>2018</i>	<i>2019</i>
Capital companies	58	51	42	39	36	34
Number of licensed offices (locations)	106	89	74	70	66	64

The number of capital companies providing currency cash exchange services has been decreasing year by year since the introduction of the euro as well as on account of the growing opportunities and popularity of non-cash payments (see Table 1). At the same time, in light of the tightening of regulatory requirements, particularly in association

with AML/CTF/CPF and compliance with the restrictions imposed by sanctions, the slightly downward trend in the number of capital companies operating in this particular area can be expected to continue.

The same tendency can be observed with regard to the value of the purchased and sold foreign currency cash, which continues to decrease (see Table 2).

Table 2

Total value of foreign currencies purchased and sold by capital companies exchanging currency cash (in millions of euro)

	2014	2015	2016	2017	2018	2019
Purchased	314.1	239.3	210.5	215.8	211.2	177.8
Sold	163.4	110.5	108.3	104.6	88.4	86.5
Total	477.6	349.8	318.8	320.4	299.6	264.4

Looking at the overall market, it has to be additionally borne in mind that, according to the information provided by the Financial Intelligence Unit, the total amounts of 2018 and 2019 included transactions between market participants in the amount of 10 million euro and 12.1 million euro respectively.

In 2019, approximately 700 thousand currency cash exchange transactions were carried out by all capital companies. More than 97% of those transactions did not involve any customer screening actions, including customer identification. Such anonymous transactions accounted for about 78% of the total value of foreign currency cash exchanged by capital companies in 2019.

A survey of capital companies (hereinafter, the survey) was conducted at the end of 2018 and the beginning of 2019, with the participation of most capital companies, including all the largest capital companies. Moreover, the collection of quarterly statistical data from the capital companies also started in 2019 (data available as of the second quarter of 2019). The above data were, to the maximum possible extent, used in the 2019 assessment of money laundering and terrorism and proliferation financing (ML/TF/PF) and sanctions risks in the currency cash exchange sector.

The data provided by capital companies reveal a comparatively low average value of transactions at capital companies, with the average transaction value exceeding EUR 500 only in a few of them (see Table 3). The average value of all transactions in the sector overall amounted to about EUR 385 in 2019, whereas the average value of anonymous transactions was about EUR 305.

Table 3

Capital companies according to the average value per transaction⁴

Range	2017	2018	2019
EUR 0.00–EUR 199.99	6	6	12
EUR 200.00–EUR 499.99	14	15	17
EUR 500.00 and more	9	8	5

⁴ Data for 2017 and 2018 in Tables No. 3, 4, 5 and 6 are based on the survey responses from 29 respondent capital companies; for 2019, the statistical data provided by all capital companies for the second, third and fourth quarters of the reporting period were used.

The significant predominance of anonymous transactions (see Table 4) confirms that the role of these transactions in the market is negligible. Some capital companies even do not have a single transaction involving customer due diligence, which in separate cases (when the average transactions value is bigger) is suspicious, potentially suggesting that transactions might have been deliberately split into several small transactions in order to avoid customer due diligence. The existing transaction value threshold triggering an obligation to perform customer due diligence was introduced at the end of 2017 (the previous threshold was higher), resulting in a slightly lower value of anonymous transactions, yet in 2019 it increased again and still remains high.

Table 4

Share of anonymous transactions

	2017	2018	2019
Number of anonymous transactions	98.5%	97.1%	97.9%
Value of anonymous transactions	86.6%	77.6%	78.3%

When looking at the available information on customer composition, it has to be borne in mind that it is compiled on the basis of identified customers who have been subject to customer due diligence by the capital companies: hence, it does not cover the bulk of customers. The customers of capital companies are mostly occasional ones and only four capital companies have established business relationships with their customers. In one of those cases, the business relationships were established with other capital companies to provide currency cash exchange services, inter alia to private sector legal persons registered in the neighbouring countries. Customers are primarily Latvian residents, followed by third country residents and, finally, European Union member state residents (See Table 5). Customers are mostly physical persons, with legal persons accountable for a very small share of transactions (see Table 6). According to the information provided by capital companies, unidentified customers very often are local inhabitants exchanging currency when travelling abroad as well as Latvian subjects working abroad (in Scandinavia and on the British Isles).

Table 5

Customers by home state (% of all identified transactions)

	2017	2018	2019
Latvia	79.0%	87.2%	89.4%
European Union	8.8%	5.1%	3.5%
Third countries	12.2%	7.7%	7.1%

Considering Latvia's geographical location on the European Union's border and the fact that the euro is legal tender in Latvia, the customer composition displayed in Chart 5 is as could be expected. The reduction in the share of customers from other countries in 2018 and also later in 2019 can be explained by the lowering of the transaction value threshold triggering customer due diligence and resulting in an overall increase in the number of transactions involving customer due diligence. These customers have mostly been residents of the Republic of Latvia.

Table 6

Transactions with legal persons (% of the total number of transactions with identified customers)

Country of registration	2017	2018	2019
Registered in Latvia	20.1%	14.7%	10.3%
Registered in the European Union	5.0%	2.9%	1.0%

The number of transactions with identified customers increased in 2018, enabling a more objective insight into the transactions carried out by capital companies. Considering that legal persons usually have no need for small value currency cash exchange transactions, it can be expected that, with the number of transactions involving customer due diligence growing, the share of transactions with legal persons will continue to shrink. This could probably also explain the decrease in the number of such transactions in 2019, as more accurate data from the quarterly reports submitted by capital companies are available for 2019, while for 2018 the data from the survey of capital companies to which not all capital companies responded were used.

II Threats identified in the currency cash exchange sector

The European Commission's Supranational Risk Assessment Report (hereinafter, SNRA) assesses the risks based on the requirements of the fourth EU AML/CTF directive. The SNRA assesses vulnerabilities on a European Union level.

Considering that the currency cash exchange capital companies do not ensure the storage or transportation of cash, the main risks for currency cash exchange capital companies are associated with cash as such. The SNRA concluded that cash remains the most recurring means used for ML/TF purposes, since it allows criminals to conceal their identity. Therefore, the risks posed by cash-intensive businesses are considered to be significant. Accepting payments in large value denominations (EUR 500 and EUR 200 banknotes) was mentioned as a risk-amplifying factor, as smaller denomination banknotes are more commonly used for payments. Consequently, the need for having large denomination banknotes is not entirely clear. The biggest advantage of large denomination banknotes is easier transportation and storage of large amounts of cash, but there is no information on how much of this cash is of a legal/illegal origin. At the same time, large denominations seem to be less often present in terrorist financing cases, where preference is given to lower denomination banknotes as they are easier to access and use.

Currency exchange may have a significant role in financing of terrorism if EUR and USD are sold and purchased (as well as the currencies of countries located within conflict zones or in their proximity) when going to a conflict zone. The SNRA concluded that there have been some terrorist financing cash flows from third countries (including Russia) to the European Union.

Currency cash exchange may also involve money laundering risks, including cases when criminals infiltrate the currency exchange market as businessmen. The use of cash constitutes a risk-increasing factor. Moreover, the most significant risks are associated with transactions where currency exchange is combined with money remittances.

Latvian National money laundering/terrorism financing risk assessment report (hereinafter, NRA) concludes that the most significant money laundering threats are associated with the following criminal offences:

- corruption and bribery (malfeasance);
- tax evasion;
- fraud;
- smuggling.

The most significant threats are caused by criminal offences involving large volumes and/or committed by organised groups. At the same time, it has been concluded that proportionally higher threats are caused by criminal offences committed abroad.

According to the National Terrorism Financing and Proliferation Financing Risk Assessment Report 2017–2018⁵, the national terrorism financing risk was assessed as medium low/medium. The most significant terrorism financing threats are caused from:

- potential joining of the Islamic terrorist groups by Latvian residents;
- potential use of non-governmental organisations and business environment for the purpose of terrorist financing and hidden or masked transfer of funds marked for lawful purposes to terrorist organisations or their participants;
- potential exploitation of individual subjects of the AML/CTF/CTP Law (for example, non-bank lenders or providers of various payment services) for acquisition of funds and their transfer to terrorist organisations or their participants.

There are risks that terrorist financing can happen as self-financing or acquisition of funds from family members or from NGOs (the latter option is purely theoretical and there have been no such cases detected in practice).

Latvia's domestic threats of money laundering are usually confined to self-laundering mostly in relation to illicit circulation of narcotic/psychotropic substances, some lower level property crimes and more complex fraud (e.g. insolvency abuse), and criminal offences in the area of taxes.

Traditionally, money laundering on behalf of third parties is performed or professional money laundering services are provided by legal, tax, financial and accounting service providers and real estate agents. According to the State Police, there have been five criminal cases involving the representatives of the above-mentioned professions over the assessment period, including one conviction against a sworn attorney for large-scale money laundering. In addition to the traditionally observed trend to involve low income or inexperienced persons or persons without a declared place of residence in money laundering, legal entities registered in Latvia or abroad, mostly LLCs, as well as associations, foundations and funds with good reputation and operational background are used in money laundering more and more often.

⁵ National Terrorism Financing and Proliferation Financing Risk Assessment Report 2017–2018 (updated in July 2019). Available at: https://fid.gov.lv/images/Downloads/useful/LV_TF_PF_zinojums_papildinats_2019.pdf

III Comprehensiveness of the legal framework in the fields of prevention of money laundering and terrorism and proliferation financing as well as compliance with restrictions imposed by sanctions

The activities of capital companies having obtained Latvijas Banka licences for purchasing and selling cash foreign currencies in the field of AML/CTF/CPF are governed by:

- AML/CTF/CPF Law and Cabinet of Ministers Regulations adopted on the basis of the said Law;
- Sanctions Law and Cabinet of Ministers Regulations adopted on the basis of the said Law;
- Latvijas Banka's Regulation No. 176 "Requirements for Anti-Money Laundering and Combating the Financing of Terrorism and Proliferation and Sanctions Risk Management in Purchasing and Selling Cash Foreign Currencies" of 16 July 2019 (hereinafter, Regulation No. 176).
- Law on Latvijas Banka and Latvijas Banka's Regulation No. 36 adopted on the basis of the said Law.

Overall, the legal framework is considered sufficient. At the same time, several currency cash exchange capital companies also are engaged in other types of business activities; therefore, they may be subject to the supervision of several authorities.

IV Monitoring of how a currency cash exchange business is started and its quality

A capital company requires a licence from Latvijas Banka in order to provide currency cash exchange services. The procedure for granting Latvijas Banka licences and monitoring the capital companies is governed by Article 11 of the Law on Latvijas Banka and the pursuant Latvijas Banka's Regulation No. 36.

Licences are granted to each currency exchange office (location). The licences granted by Latvijas Banka are open-ended. The licence has to be re-registered in cases when the location of the currency exchange office is changed.

Pursuant to the Cabinet of Ministers Regulation No. 372 "Regulation on Stamp Duty for Granting a Permit (Licence) for Purchasing and Selling Foreign Currencies", the following stamp duties are applicable with regard to licences for purchasing and selling foreign currencies:

- for granting a licence to a single currency exchange office (location) – EUR 14 200.
- for re-registration of a licence of a single currency exchange office (location) – EUR 1 400.

Paragraph 26 of Latvijas Banka's Regulation No. 36 sets the requirements to be complied with by capital companies in order to receive a licence, including the requirements that the participants of the capital company down to natural persons having qualifying holdings in the capital company, representatives of the executive bodies or holders of procurations have no criminal record, or their criminal record has been sealed or expunged; have not been subject to administrative sanctions for serious breaches of laws and regulations governing commercial activities twice during the last year or have not been prohibited from conducting commercial activities; or have not

been subject to sanctions for serious breaches of laws and regulations on the prevention of money laundering and terrorism and proliferation financing twice during the last three years.

Along with the application for licence registration and documents supporting all the above-mentioned information (including a certificate from the Punishment Register of the Information Centre of the Ministry of Interior which is no older than 6 months), the capital company submits to Latvijas Banka also ML/TF/PF and sanctions risk assessments and the internal control system documents. The Licensing Committee of Latvijas Banka verifies the submitted information, requests clarification or further information when necessary and takes a decision to grant the licence or refuse to grant the licence.

If a capital company is no longer compliant with the above requirements, the previously granted licence is revoked. Should a capital company want to replace a representative of the executive body, a holder of a procuration or a participant intending to acquire a qualifying holding in the capital company, prior to any change, the capital company has to agree it with the Licensing Committee of Latvijas Banka in compliance with the requirements of Paragraphs 52 and 53 of Latvijas Banka's Regulation No. 36.

Table 7

Decisions on replacement or appointment of representatives of executive bodies and participants of capital companies by year

	2017	2018	2019
number	1	2	8

The increase in 2019 was determined by the approval of replacement of a representative of the executive body in several related capital companies.

The procedure for suspending and revoking the licences granted by Latvijas Banka is governed by Paragraphs 56–60 of Latvijas Banka's Regulation No.36.

Paragraph 56 of Latvijas Banka's Regulation No. 36 lists the cases when the Licensing Committee of Latvijas Banka takes a decision to prohibit the capital company from purchasing and selling foreign currencies for a period of up to six months by suspending the licence of a particular currency exchange office (location) or all licences, whereas Paragraph 57 of the above Regulation lists the cases when the Licensing Committee may decide on imposing the above restriction.

Paragraph 59 of Latvijas Banka's Regulation No. 36 lists the cases when the Licensing Committee of Latvijas Banka takes a decision to revoke a licence or all licences, whereas Paragraph 60 of the above Regulation lists the cases in which the Licensing Committee of Latvijas Banka has the right to take a decision to revoke the licence of a currency exchange office (location) or all licences, including where a capital company fails to comply with the requirements of Latvijas Banka's Regulation No. 36, the Law on the Procedure for Introduction of Euro and other legal acts in the field of AML/CTF/CPF, consumer rights protection, business and personal data processing.

Table 8

Number of licences granted and revoked by year

	2017	2018	2019
Licences granted	0	1	2
Licences revoked	4	5	3
including at the capital company's request	-	1	2
including upon expiry	2	1	-
including in the field of AML/CFT/CPF	2	3	1

In 2019, one licence was granted to a capital company as its first licence (previous case of a new capital company entering the market was registered in 2015). Another licence was granted to an existing market participant expanding its business. There have been no rejected licence applications over the reporting period.

One licence was revoked in 2019 for violations of the laws and regulations in the field of AML/CTF/CPF. For comparison, in 2018, a capital company's licences were revoked as it did not resume its business within a period of six months as of suspending its validity.

The granting of licences and monitoring of the operation of capital companies licensed by Latvijas Banka is ensured by the Licensing Committee of Latvijas Banka consisting of five members. Inspections of capital companies are carried out by the members of the Licensing Committee of Latvijas Banka as well as other duly authorised representatives of Latvijas Banka (overall, 16 persons). The Chairman of the Board of Latvijas Banka may appoint other additional staff to carry out inspections if required by the scope of the inspection or if the inspection requires specific in-depth knowledge of a particular area.

Latvijas Banka has successful cooperation experience with the Estonian Intelligence Unit in the context of capital company inspections, checking whether Estonian companies, their executive bodies and participants have no record of violations of the requirements of legal acts concerning AML/CTF/CPF.

Latvijas Banka's Regulation No. 36 currently provides for partial checking of the good repute of the beneficial owners, participants and members of executive bodies of the capital companies by examining the existence of their administrative and criminal records. At the same time, the above Latvijas Banka's Regulation does not provide for identification of the source of the beneficial owner's funds and wealth. Therefore, the risks associated with the capital companies' process of starting business and its monitoring are considered medium. Although Latvijas Banka does obtain information about the participants and representatives of the executive bodies of the capital companies, a vulnerability is associated with identifying the origin of the beneficial owner's funds. Although when starting a currency cash exchange business no major capital investment is required to set up a business location, a licence has to be purchased and a sufficient stock of cash in various foreign currencies has to be built to ensure operation. At the same time, the fact that criminals potentially could use currency exchange capital companies as a cover for their activities should be also borne in mind. Regardless of the fact that the overall market is shrinking, Latvijas Banka should start

identification of the beneficial owners of the capital companies and the sources of their funds and wealth.

V Effectiveness of supervisory activities

Supervision of capital companies purchasing and selling foreign currency cash is carried out by Latvijas Banka pursuant to Article 11 of the Law on Latvijas Banka. According to Article 10 of the above Law, Latvijas Banka has the right to inspect compliance with the regulations and regulatory guidance it has adopted. The inspections are carried out by persons authorised by Latvijas Banka and upon its assignment.

The supervisory and control functions of Latvijas Banka in the field of AML/CTF/CPF are governed by the AML/CTF/CPF Law, whereas in the field of compliance with the sanctions it is governed by the Sanctions Law.

Latvijas Banka's obligations include the following:

- to conduct regular inspections according to the methodology developed by it, in order to assess the compliance of the subjects under Latvijas Banka supervision within the meaning of the AML/CTF/CPF Law and the Sanctions Law with the requirements of this Law, and, when finding a violation, to decide on the drawing up of an inspection report and imposition of sanctions;
- to impose sanctions for violations of laws and regulations specified in laws and regulations or propose that other competent authorities impose such sanctions, and to control the measures for elimination of those violations.

Latvijas Banka has the right to visit the premises owned or used by the supervised capital companies and to conduct inspections therein, and to request information related to compliance with the requirements of the AML/CTF/CPF Law and the Sanctions Law. In addition to the above, the procedure for control measures is governed by Latvijas Banka's Regulation No. 36.

Paragraphs 91 and 92 of Latvijas Banka's Regulation No. 36 stipulate that inspections are carried out without prior notice and coordination. Inspections may be carried out at the registered address of the capital company, at the currency exchange office (location) or off-site by checking the documents provided by the capital company. The persons authorised by Latvijas Banka have the right to request any documents or information related to the capital company's currency exchange business, and the capital company has an obligation to provide the documents and information requested to the authorised representatives of Latvijas Banka.

According to Paragraph 93 of Latvijas Banka's Regulation No. 36, Latvijas Banka exchanges information with other supervisory and controlling authorities in the Republic of Latvia or abroad on its own initiative or upon request, in order to achieve the licensing objective and reduce money laundering and terrorism and proliferation financing possibilities. Latvijas Banka has so far cooperated with several Latvian and foreign institutions.

Inspections of capital companies are carried out following the Procedure for Carrying out Inspections at Capital Companies Holding a License for Purchasing and Selling Cash Foreign Currencies or Having Submitted an Application for Receiving a New

License or Reregistering a License (internal regulatory act) approved by the Board of Latvijas Banka.

Inspections are carried out based on an inspection plan approved by the Licensing Committee of Latvijas Banka. The plan of inspections of the operational compliance of the capital companies is drafted so that to ensure that each licensed currency cash exchange capital company is inspected at least once in every four years. It is also based on the results of the capital companies' operational risk assessment matrix approved by the Licensing Committee of Latvijas Banka, which inter alia takes into account the following principles:

- the capital company's market share;
- changes in the transaction volumes of the capital companies;
- violations detected during the previous inspections of the capital company;
- the share of anonymous transactions;
- the presence of other signs pointing to potential non-compliance with laws and regulations.

In addition to the scheduled operational compliance inspections, ad hoc inspections, as requested by Latvijas Banka's Licensing Committee, are also carried out when receiving a complaint from a private person or other information on any violations in the operation of a capital company as well as when required in light of specific new developments concerning a subject-matter or an area (implementation of new legal requirements, nature and number of identified instances of non-compliance with legal requirements, information in the mass media etc.) or if evidence suggesting potential non-compliance with the requirements of the legal acts governing purchasing and selling foreign currency cash has been discovered when carrying out risk assessment-based measures within the control framework.

The operational compliance inspection is carried out to assess the compliance of the operation of the capital company with the requirements of the laws and regulations governing the purchasing and selling cash foreign currencies and laws and regulations governing the prevention of money-laundering and terrorist and proliferation financing as well as the compliance with the restrictions imposed by sanctions. The operational compliance inspection may be carried out both on- and off-site.

The scope of inspections and areas to be inspected have not been previously defined; therefore, the Licensing Committee of Latvijas Banka is approving the plan of the respective inspection prior to starting each operational compliance inspection, outlining the type of inspection, tasks to be carried out during the inspection and their scope on the basis of the risk score of each capital company.

Operational compliance inspections with their scope adjustable depending on the risk score of the capital company were introduced at the beginning of 2019. This meant that the overall number of inspections decreased, but they became more time-consuming and in-depth, including a stronger focus is put on specifically checking compliance with the requirements of the AML/CTF/CPF and compliance with the restrictions imposed by sanctions.

Latvijas Banka receives regular information about transaction volumes in foreign currencies and in euro from capital companies. Information about the number of

transactions, number of customers and other more detailed information about transactions and customers is currently collected on a quarterly basis.

The inspectors draw up an inspection report. Photos may be taken during the inspection and enclosed with the inspection report. Inspections are carried out by a team of at least two Latvijas Banka employees. Inspection results are approved by the Licensing Committee of Latvijas Banka which decides on applying sanctions on a capital company, if necessary.

Table No. 9 displays statistics regarding the number of inspections carried out.

Table 9

Inspections of capital companies

	2017	2018	2019
Number of licensed capital companies (offices)	39 (70)	36 (66)	34 (64)
Standard inspections	25	23	3
In-depth inspections	3	3	-
Off-site inspections	8	17	1
On-site operational compliance inspections	-	-	12
Off-site operational compliance inspections	-	-	-
Thematic inspections	-	-	2

In its 2018 Evaluation Report about the Republic of Latvia, MONEYVAL noted that Latvijas Banka exercises effective supervision of the currency cash exchange companies⁶. Latvijas Banka mostly carries out a relatively wide scope on-site inspections in the field of compliance with AML/CTF/CPF, which means that these are time-consuming inspections even in the case of lower risk capital companies.

VI Application of penalties for violations in the fields of prevention of money laundering and terrorism and proliferation financing as well as compliance with the restrictions imposed by sanctions

Article 11 of the Law "On Latvijas Banka" states that Latvijas Banka is entitled to revoke a license of a capital company violating regulatory requirements.

Sections 77 and 78 of the AML/CTF/CPF Law stipulate that, for violations in the field of AML/CTF/CPF, Latvijas Banka is entitled to impose a fine of up to 10% of the capital company's turnover or up to EUR 5 000 000 on the responsible person. On 12 September 2019, the Board of Latvijas Banka issued Recommendations No. 1584/5 "Recommendations (Guidelines) for the Imposition of Administrative Sanctions for Breaches of Laws and Regulations in the Field of Prevention of Money Laundering and Terrorism and Proliferation Financing and Sanctions Risk Management".

According to the capital companies' survey data, all capital companies believe that the types of fines and their amounts are sufficient to deter the capital companies from violating the AML/CTF/CPF-related regulatory requirements.

⁶ MONEYVAL Anti-money laundering and counter-terrorist financing measures. Latvia. Fifth Round Mutual Evaluation Report. Published in July 2018; main findings in the section on IO3, see pp.107 and 108. Available at: https://eng.fid.gov.lv/images/Downloads/useful/MONEYVAL2018_5th-Round_MER-Latvia.pdf

Table 10 shows the compiled statistics of the administrative sanctions imposed by the Licensing Committee of Latvijas Banka.

Table 10

Administrative sanctions imposed by the Licensing Committee of Latvijas Banka

	2017	2018	2019
Number of completed inspections	25	40	10
Violations of regulatory requirements governing the prevention of money laundering and financing of terrorism and proliferation	10	14	7
Written warning	8	10	0
License revocation	1	0	1
Fine applied to capital company	0	4	6
Total fines in EUR	-	5257	8850
Fine applied to representative of executive body	0	1	0
Other fine applied to responsible person	0	1	0

Table 11 displays the violations of regulatory requirements in the fields of AML/CFT/CFP most often detected by the Licensing Committee of Latvijas Banka.

Table 11

Violations of regulatory requirements in the field of AML/CFT/CFP most often detected by the Licensing Committee of Latvijas Banka

2017	2018	2019
Incomplete knowledge of the regulatory requirements in the field of prevention of money-laundering and terrorist financing	Incomplete knowledge of the regulatory requirements in the field of prevention of money-laundering and terrorist and proliferation financing	Incomplete knowledge of the regulatory requirements in the field of prevention of money-laundering and terrorist and proliferation financing
Violations of the procedure established in an internal control document: <ul style="list-style-type: none"> ▪ deficiencies with regard to customer identification; ▪ delays in reporting to the Financial Intelligence Unit 	Violations of the procedure established in an internal control document: <ul style="list-style-type: none"> ▪ deficiencies in customer due diligence; ▪ delays in reporting to the Financial Intelligence Unit 	Violations of the procedure established in an internal control document: <ul style="list-style-type: none"> ▪ deficiencies in development of internal control documents and procedures ▪ risk assessment is not compliant with regulatory requirements and is inadequate considering the actual level of risks in the capital company ▪ deficiencies in customer due diligence and monitoring of customer transactions
There is no meaningful assessment of the effectiveness of the internal control system	There is no meaningful assessment of the effectiveness of the internal control system	There is no meaningful assessment of the effectiveness of the internal control system

None of the administrative acts on application of administrative sanctions has been challenged, and Latvijas Banka has concluded no administrative agreements.

Latvijas Banka considers the existing regulatory framework to be sufficient and efficient.

VII Operational efficiency of internal control systems of capital companies

Section 6 of the AML/CTF/CPF Law and Section 131 of the Sanctions Law provide that a capital company, according to its type of activity, shall conduct and document the assessment of the money laundering and terrorism and proliferation financing risks in order to identify, assess, understand, and manage the money laundering and terrorism and proliferation financing risks associated with its activities and customers, and, on the basis of such assessment, shall establish an internal control system, including by developing and documenting the relevant policies and procedures, which shall be approved by the board of the capital company, if any is appointed, or the senior management body of the capital company.

All capital companies have performed their AML/CTF/CPF risk assessments which have been submitted to Latvijas Banka and are assessed within the framework of its supervisory activities. In 2019, examination of the AML/CTF/CPF risk assessment documents of six capital companies found deficiencies in all of them. As at the end of 2019, part of the capital companies had failed to review their risk assessments conducted at the end of 2017 or in the beginning of 2018, even though the AML/CTF/CPF Law had been supplemented with new requirements concerning the prevention of proliferation financing and the capital companies had become supervised bodies within the meaning of the Sanctions Law.

According to Section 8 of the AML/CTF/CPF Law a capital company shall, on a regular basis, but at least once per each three years, review and update the money laundering and terrorism and proliferation financing risk assessment in accordance with the inherent risks. The capital company shall, on a regular basis, but at least once per each 18 months, assess the efficiency of the operation of the internal control system, including by reviewing and updating the money laundering and terrorism and proliferation financing risk assessment related to the customer, its country of residence (registration), economic or personal activity of the customer, services and products used and their delivery channels, as well as the transactions made, and, if necessary, shall implement measures for improving the efficiency of the internal control system, including shall review and adjust the policies and procedures for the prevention of money laundering and terrorism and proliferation financing.

A capital company shall carry out the risk assessment and implement measures for improving the internal control system also if it plans to introduce changes in its operational processes, governance structure, services and products provided and their delivery channels, customer base or geographical regions of operation, as well as before introducing new technologies or services.

The currency cash exchange market is relatively static in Latvia, and the latest technologies have not been really introduced yet. Nevertheless, Latvijas Banka's control measures often reveal that capital companies have no understanding of how to assess the effectiveness of their internal control systems. Latvijas Banka has published no detailed guidelines on performing the assessment of the internal control system's effectiveness. However, in practice, Latvijas Banka has observed that capital

companies view the assessment of the internal control system's effectiveness as merely checking if the provisions of the AML/CTF/CPF Law and Latvijas Banka's Regulation No. 176 are formally covered by the internal control system document, without assessing whether these provisions can be implemented in the day-to-day work and whether they serve the objective.

When implementing control measures, Latvijas Banka often finds deficiencies in the internal control documents of capital companies, as they have not been prepared according to the capital companies' level of risk or are superficial. Non-compliance with the requirements of the AML/CTF/CPF Law and Latvijas Banka's Regulation No. 176 is often detected, complemented by non-compliance with the procedure for implementing the above regulatory acts which has been outlined in more detail in the internal control document: for example, staff training has been carried out and documented but in a manner and form other than that which is provided for in the internal control document.

Violations in the field of AML/CTF/CPF were detected in all the inspections completed by Latvijas Banka in 2019 which were carried out based on the model of a modified scope operational compliance inspections introduced in the beginning of 2019. The inspection results point to the capital companies' poor understanding of how the requirements of the regulatory acts governing the field of AML/CTF/CPF should be successfully implemented and complied with: when checking the internal control system documents and risk assessments within the framework of inspections, in all cases incompletenesses and non-compliances with regulatory requirements were detected, and in most cases the level of awareness of the existing regulatory requirements in the field of AML/CTF/CPF of the capital companies' staff was assessed as low and insufficient for successful discharge of job responsibilities without additional training on those specific issues.

Section 10 of the AML/CTF/CPF Law obliges capital companies to appoint one or several employees, including from senior management, who are entitled to take decisions and are directly responsible for ensuring compliance with the requirements of this Law and for ensuring the exchange of information with the relevant supervisory and control authority. Moreover, Section 10 provides that at least one of the above-mentioned persons must be from senior management. Considering that, apart from cashiers, a capital company often has only one or two other employees, one and the same person, who is directly interested in increasing the company's profit, is in charge of the AML/CTF/CPF supervision and management or profit-seeking.

Latvijas Banka's observations suggest that the quality of the internal control system documents and the operational effectiveness of the internal control system correlate with the capital company's size and the proportion of its transactions involving due diligence. This suggests that the more often an internal control system document is referred to in daily work, the better aware the capital company's staff are of its provisions (and, consequently, also of the provisions of the applicable external regulatory acts). Most of the small capital companies conduct customer due diligence so rarely that the staff of the capital companies objectively cannot be expected to be very skilled in conducting customer due diligence should such need arise.

VIII Effectiveness of supervision and reporting of suspicious transactions

According to Section 11 of the AML/CTF/CPF Law, a capital company is obliged to conduct customer due diligence in cases when the transaction amount or the total amount of several seemingly related transactions exceeds EUR 1500.

Also, according to Section 20 of the AML/CTF/CPF Law, a capital company is obliged to monitor customers and their transactions, paying particular attention to:

- an unusually large transaction for the customer; a complex transaction or seemingly related transactions, or a transaction with no apparent economic or explicitly lawful purpose;
- a transaction involving a person from a high-risk third country.

With respect to monitoring of customer transactions, Paragraphs 51–50 of Latvijas Banka's Regulation No. 176 stipulate that capital companies shall ensure ongoing monitoring of their customer transactions and shall document the monitoring procedure accordingly.

Latvijas Banka's control measures regularly reveal that capital companies comply with the regulatory requirements in the field of AML/CTF/CPF merely formally, often violating the procedures laid down in the internal control system documents regarding the regularity and documentation of the monitoring of customers and their transactions. Moreover, such violations have been identified mostly in smaller capital companies with a relatively small number of transactions involving due diligence, thus, there are no transactions to monitor, and in capital companies that are not using information system/computerised? monitoring tools.

The information provided by the Financial Intelligence Unit about the reports on unusual or suspicious transactions submitted by the capital companies licensed by Latvijas Banka points to problems with respect to the identification of suspicious transactions and their reporting (Table 12).

Table 12

Reports on unusual or suspicious transactions submitted to the Financial Intelligence Unit by the capital companies licensed by Latvijas Banka

	2017	2018	2019
Number of reports on unusual transactions and number of threshold declarations	1203	1972	1998
Number of reports on suspicious transactions	179	12	32

Although the number of submitted reports on unusual transactions increased in 2018, it has to be remembered that in 2017 the threshold for a transaction to be considered unusual was EUR 8000, whereas in 2018 it was reduced to EUR 5000; hence, the reasons behind the change in the number of submitted reports cannot be objectively evaluated.

At the same time, the number of reports on suspicious transactions submitted to the Financial Intelligence Unit is comparatively small, suggesting that capital companies do not identify suspicious transactions as well as potentially suspicious transactions reaching the threshold of an unusual transaction could be reported as an unusual

transaction without examining its potential suspiciousness. Moreover, over the last three years, actually only a few capital companies have reported suspicious transactions to the Financial Intelligence Unit. Most capital companies have never submitted this type of report to the Financial Intelligence Unit. In 2018 and 2019, only three capital companies submitted reports on suspicious transactions to the Financial Intelligence Unit.

Apart from violations with regard to the reporting time frame, Latvijas Banka has identified no other significant violations concerning reporting to the Financial Intelligence Unit within the framework of its control measures.

IX Availability of beneficial ownership information

According to the provisions of the AML/CTF/CPF Law, capital companies are obliged to identify the beneficial owner of the customer when performing customer due diligence.

The information at Latvijas Banka disposal shows that only four capital companies have transactions with legal persons. At the same time, all capital companies have covered the possibility of having transactions with legal persons in their internal control documents.

Based on the customer's risk assessment, a capital company takes the necessary measures to verify whether the initially identified beneficial owner is the actual beneficial owner of the customer.

Capital companies providing services to legal persons mainly use the data available from the Enterprise Register for identification of the beneficial owner. Only one capital company has cooperation with legal persons from other European Union member states, inter alia taking measures to identify the beneficial owner.

According to the internal control system documents submitted by the capital companies to Latvijas Banka, the capital companies have established their customer due diligence procedures, including for identification of the beneficial owners. According to the internal control system documents submitted by the capital companies, when conducting customer due diligence, a capital company identifies the beneficial owner by requesting a written statement from the customer on whether the customer is carrying out the transaction on its own behalf or on behalf of another person who is the beneficial owner. The beneficial owner of a legal person is identified by conducting due diligence of the legal person and identifying the beneficial owner by using publicly available national and private information systems.

At the same time, it can be concluded that the capital companies lack resources to verify that the beneficial ownership information provided by their customers reflects the objective reality, particularly with regard to natural persons, both residents and non-residents, since the national information systems containing the identification data of natural persons as well as the information on their administrative penalties and criminal records are not publicly accessible. Moreover, contrary to e.g. credit institutions, the capital companies licensed by Latvijas Banka are not entitled to request information from the Population Register, the data bases of the State Revenue Service, the Punishment Register, etc. Moreover, the capital companies licensed by Latvijas Banka also lack resources to verify the beneficial ownership information provided by their customers with respect to legal persons registered abroad.

X Integrity of capital companies' staff and their understanding of the AML/CTF/CPF as well as compliance with the restrictions imposed by sanctions

At the end of 2019, 34 capital companies operated in the market of purchasing and selling cash foreign currencies. According to Latvijas Banka data, only five capital companies were employing more than 10 employees at the end of 2019 (Table No. 13).

Table 13

Number of employees in currency cash exchange capital companies

Number of employees	2017	2018	2019
1–4 employees	16	16	12
5–10 employees	11	11	17
11 or more employees	5	5	5

One of the most often detected non-compliances in the operation of the capital companies with the requirements in the field of the AML/CTF/CPF and compliance with the restrictions imposed by sanctions is insufficient staff knowledge about the requirements in the field of the AML/CTF/CPF and compliance with the restrictions imposed by sanctions. The information contained in the NRA suggests that at least five capital companies operating in the currency exchange sector have been involved in criminal proceedings. At the same time, there is no information of any criminal proceedings being initiated or criminal conviction having been issued against any employees of the capital companies operating at the end of 2019.

Purchasing and selling cash foreign currencies is a type of business activity dominated by an intensive use of cash. As already mentioned before, anonymous customers account for almost 80% of the total transaction volume. Such a profile of transactions enables dishonest capital companies to deliberately hide the origin of funds or engage in unregistered activities. The operational results of the capital companies are an indirect indication that this might be happening, as about half of the capital companies have net turnover below EUR 50 000 (Table No. 14). Moreover, looking at the movement of the current assets (ratio of net turnover to the balance of current assets as at the end of the current year), it becomes obvious that in 2/3 of the capital companies those assets are not turned over even once and only three capital companies have a turnover of 2.5 times and higher (Table 15).

Table 14

Annual net turnover of capital companies

Net turnover	2016	2017	2018
Up to EUR 10 000	3	4	4
EUR 10 000 to EUR 50 000	15	13	12
EUR 50 000 to EUR 250 000	11	12	13
EUR 250 000 and more	4	5	5

Table 15

Current asset turnover ratio of capital companies

Ratio	2016	2017	2018
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Up to 0.2	6	4	4
From 0.2 to 0.5	11	11	8
From 0.5 to 1.0	8	9	11
From 1.0 to 2.5	5	7	8
2.5 or higher	3	3	3

Based on the capital companies' survey data, practically all capital companies have established employee selection criteria, inter alia assessing the existence of criminal records of employees. Capital companies believe that their employees are loyal and do not engage in criminal activities. Approximately half of the capital companies have established formal disciplinary action which can be taken by the management for failure to comply with the AML/CTF/CPF procedures or for other violations, the management's discretion. Overall, over the past three years only five capital companies have taken disciplinary action against their employees. In two of those cases, disciplinary action was taken in capital companies where it was not formally prescribed.

Latvijas Banka's control measures and the information provided by some capital companies reveal that employee selection criteria and the remuneration of employees are low in several capital companies. At the same time, with capital companies experiencing labour shortages, they employ the available labour with relatively low qualifications. This, however, does not apply to the largest capital companies where employees have relatively good qualifications.

Most employees in a capital company are cashiers. The supervisory function over the compliance with the requirements in the field of the AML/CTF/CPF in capital companies is most often discharged by a member of the Board (who often is the only member of the Board and the owner) or another employee of the capital company combining offices. Considering the low proportion of transactions involving customer due diligence, capital companies have an arrangement, whereby the results of customer due diligence are confirmed by the person responsible for the implementation of the AML/CTF/CPF requirements in the capital company, enabling capital companies to employ less qualified staff. Under such an arrangement, it is impossible to have an independent AML/CTF/CPF monitoring function and anonymous reporting on violations in the operation of a capital company is also virtually impossible. At the same time, based on the capital companies' survey data, such a system has been formally introduced by several capital companies, not only the largest ones. Latvijas Banka has introduced an opportunity to submit whistle blower reports, including with regard to the operation of capital companies. Reporting is not anonymous, but Latvijas Banka ensures the anonymity and protection of the reporter.

With the participation of relevant representatives from the Financial Intelligence Unit, State Security Service and State Revenue Service, Latvijas Banka regularly organises educational seminars on issues concerning the AML/CTF/CPF and compliance with the restrictions imposed by sanctions for the capital companies' employees appointed as the responsible persons in the AML/CTF/CPF-related matters. Such seminars were held in 2017, 2018 and 2019. The seminars are generally attended by the responsible employees of all licensed capital companies. At the seminars, the Licensing Committee of Latvijas Banka provides information on the most recent developments in the field of AML/CTF/CPF and compliance with the restrictions imposed by sanctions as well as informs about the violations identified within the framework of the implemented

control measures, explains the reasons for such violations occurring and provides recommendations on how to rectify them and prevent their recurrence.

According to Paragraphs 81 and 82 of Latvijas Banka's Regulation No 176, capital companies shall ensure training for their recently hired employees on matters related to the internal control system as well as regular training for permanent employees on AML/CTF/CFP-related matters and at least once a year. According to the capital companies' survey data, capital companies conduct training on matters relating to AML/CTF/CFP and compliance with the restrictions imposed by sanctions once or twice a year, with only four capital companies conducting such training more than twice a year on a regular basis. Representatives of capital companies rarely attend external training. At the same time, they give preference to Latvijas Banka's seminars where most capital companies are usually represented. Moreover, several capital companies participated in the training organised by the Association of Non-bank Financial Services Providers at the end of 2019.

Despite all the above-mentioned, the data compiled by the Licensing Committee of Latvijas Banka and observations suggest that most employees of the licensed capital companies still demonstrate overall insufficient knowledge in the field of the AML/CTF/CPF and compliance with the restrictions imposed by sanctions. At the same time, there are also cases when adequate attention has been paid to this matter, including by allocating adequate resources. The involvement of the Association of Non-bank Financial Services Providers in staff training is an indication that the market is willing to improve the overall compliance of the sector.

Simplified customer due diligence is mostly conducted in capital companies with few customers whose transactions reach the threshold triggering mandatory customer due diligence, and even when the transactions do reach the threshold, they are carried out by occasional customers and are non-recurrent. As a result of the above, in such a scenario, capital companies lack incentive to invest their resources to improve their employees' knowledge of the requirements in the field of AML/CTF/CPF and compliance with the restrictions imposed by sanctions, since this involves additional costs and such knowledge would have no practical use. Thus, capital companies lack incentive to meet more than the minimum regulatory requirements and, as a result, employees have insufficient knowledge and competencies, thereby giving rise to a significant vulnerability.

XI Money laundering risk

Main threats in the currency cash exchange sector are associated with the network of transporting contraband goods, where Latvia is one of the links in the chain from East to West and there is a need to exchange currency, as well as smuggling of illegal proceeds in cash through Latvia, most likely in the East-West direction. The main vulnerability of the sector is associated with the anonymous transactions representing 97% of all transactions, which means that most of the cash flow is absolutely untraceable and could be easily used to hide illegal proceeds. The service is characterised by occasional transactions where the customer can easily back out of the transaction, split the transaction amount in several amounts and turn to other service providers, which makes meaningful customer due diligence and prevention of the potential laundering of illegal proceeds significantly more difficult. Moreover, when conducting customer due diligence, the capital company has no access to the information about the customer's general financial condition (e.g. account statements

or other information confirming income) that could be independently checked, at the same time ensuring immediate completion of the transaction.

The sector is adequately regulated, inter alia the minimum requirements for and limits for customer due diligence are laid down, thus mitigating the threats. The launching of a capital company's operation is subject to regulation. In addition, Latvijas Banka also performs compliance inspections of the existing market participants. Latvijas Banka inspects all market participants and Latvijas Banka is able to identify any violations in the field of the AML/CTF/CPF and apply adequate penalty sanctions. All the above-mentioned confirms that the system is operational.

When assessing the risks related to the operation of the currency cash exchange capital companies, it should also be taken into account that the profit-generating objective of such companies mostly is stronger than their objective to comply with the regulatory AML/CTF/CPF requirements. This is suggested by the violations of the respective laws and regulations revealed by Latvijas Banka's control measures, the quality of the internal control system documents and the operational effectiveness of the internal control systems, well as the staff of the capital companies. At the same time, the capital companies whose market shares are larger than those of the rest have established adequate systems and ensure adequate quality of the internal control systems.

The average value of an anonymous transaction is just slightly above EUR 300, which is commensurate to an amount of cash that a traveller or businessman wishing to pay cash and staying for several days could have on hand when travelling. The overall market share of the currency cash exchange sector in Latvia's overall financial sector is small. Considering the above-mentioned, the money laundering risk in the currency cash exchange sector is to be considered medium high.

XII Terrorism financing risk

Latvia's terrorism financing risk has been assessed as medium low/medium⁷. Despite the detection of individual cases when a physical person had travelled to participate in a military conflict or radicalised (including a case reported by the State Security Service when it prevented a planned domestic act of terror at the end of 2018⁸), the ability of the competent authorities to monitor such cases is viewed as sufficient.

Apart from the above-mentioned case at the end of 2018, there is no information about any cases of terrorism or terrorist attempts in Latvia (including no persons or groups that could be labelled as terrorists have been identified). The State Security Service views the above case as a single incident which has no significant effect on the overall assessment.

Terrorism is often financed by small transfers of cash of a potentially legal origin. Apart from the persons whose names are on the public terrorist watch lists, no information on related persons or persons monitored by the competent authorities is available; hence, it is virtually impossible to detect cases of terrorist financing among occasional transactions without having additional risk information, if the customer does not announce the intention himself/herself. It has to be also taken into account that cross-border terrorist financing would require transportation (either by a transfer or a personal

⁷ National Terrorism Financing and Proliferation Financing Risk Assessment Report 2017–2018 (updated in July 2019). Available at:

https://fid.gov.lv/images/Downloads/useful/LV_TF_PF_zinojums_papildinats_2019.pdf

⁸ Annual Report 2019 of the State Security Service <https://vdd.gov.lv/en/useful/annual-reports/>

delivery) of money to the end user who would not find currency exchange itself of any help. Consequently, it can be concluded that currency exchange could be potentially used at the stage of accumulating the financing, before it is moved on.

Vulnerabilities in the field of terrorist financing are similar to those in the field of money laundering, an additional factor to be taken into account being the possibility of using legal origin funds for financing (rather, self-financing) of terrorism. In light of the above, the risk of terrorism financing in the currency cash exchange sector is considered to be medium.

XII Proliferation financing risk

With Latvia being located on the European Union border, there is a risk that it could be used as a link in proliferation or proliferation financing chain. Proliferation is mostly prevented by controlling the circulation of strategic significance and dual-use goods. Special attention has to be paid to screening and business specifics of customers who are legal persons, conducting due diligence. At the same time, the risk assessment has to take into account the fact that the share of transactions by legal persons in the currency exchange sector is minor. Moreover, it partly represents transactions between market participants.

According to the proliferation risk assessment by the State Security Service, mostly the formal financing system is used for financing proliferation, suggesting that cash is not a very common means of proliferation financing. Currency exchange is an on-site cash transaction, whereby money is handed over to another person. Moreover, the existing customer identification threshold is adequate to prevent the exchange of significant cash amounts, provided that the capital company is not directly involved in a criminal offence. Considering the above-mentioned, proliferation financing risk is viewed as low.

XIII Sanctions risk

Sanction compliance is basically ensured by screening customers to make sure that the customer is not subject to sanctions. Although sanctions are mostly imposed on wealthy persons with an objective of stopping their operations in a given area, this can by no means affect their ability to engage in small currency cash exchange transactions where the customer can remain anonymous. Such a transaction, no matter how small the amount, would be considered a breach of sanctions. Where a customer acts on behalf of a person subject to sanctions, the capital companies would have the same problems with customer due diligence that were mentioned in the section on money laundering risk assessment, making identification of a customer's actions on behalf of a person subject to sanctions significantly difficult.

The Sanctions Law does not provide for a risk-based approach, which means that the capital companies have to ensure compliance with sanctions. As at the end of 2019, pursuant to the above Law, there were no persons subject to sanctions in Latvia, which means that the risk of sanction non-compliance is mainly associated with foreign representatives, noting, however, that most persons subject to sanctions have also been subject to an entering ban.

The US OFAC sanctions list is applicable voluntarily rather than directly, i.e. most capital companies also apply the sanctions outlined in the OFAC list as a principle of the best practice and complying with the requirements of other financial and

cooperation institutions. This means that even if any Latvian residents were subject to sanctions, such persons could use the currency exchange capital companies to breach sanctions due to the anonymous nature of transactions.

In light of the above-mentioned, the sanctions risk is considered medium high.