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Baltic Anti-Money Laundering Survey 2011

How banks are facing up the challenge in
the Baltic states

Forensic Advisory
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Glossary

AML	Anti-Money Laundering
KYC	Know Your Customer
PEP	Politically Exposed Person
FIU	Financial Intelligence Unit

Contents

The contacts at KPMG in connection with this report are:

Jimmy Helm

Forensics in CEE
*Lead Partner, Prague,
KPMG Ceska republika s.r.o.*
Tel: + 420 222 123 147
Fax: + 420 222 123 100
jhelm@kpmg.cz

Stephen Young

Financial Advisory in Baltics and Belarus
Senior Partner, Riga, KPMG Baltics SIA
Tel: + 371 67 038 028
Fax: + 371 67 038 002
stephenyoung@kpmg.com

Evija Mieзите

Forensics Advisory
Associate Director, Riga, KPMG Baltics SIA
Tel: + 371 67 038 066
Fax: + 371 67 038 002
emiezite@kpmg.com

Povilas Akstinas

Forensics Advisory
Associate Director, Vilnius, KPMG Baltics UAB
Tel: + 370 52 113 660
Fax: + 370 52 102 659
pakstinas@kpmg.com

Taivo Epner

Partner, Tallinn, KPMG Baltics AS
Tel: + 372 62 687 00
Fax: + 372 62 687 77
taivoepner@kpmg.com

	Page
Executive summary	3
Banking sector characteristics	5
Survey results	7
■ Summary of respondents	7
■ The role of senior management	8
■ Cost of AML compliance	9
■ AML policies and procedures/KYC approach	11
■ Transaction monitoring	12
■ Suspicious activity reports	13
■ Sanctions and payments	14
■ Banks' view on AML requirements	15

Issue	Summary observations
Survey respondents	<p>First of this kind of survey in the Baltics</p> <ul style="list-style-type: none"> ■ 22 respondent banks from Latvia, Lithuania, and Estonia (of a total of 67 banks and branches of foreign banks) ■ Respondents included <ul style="list-style-type: none"> – Both market leaders and niche players – Subsidiaries and branches of foreign banks, as well as locally owned banks ■ Respondents were represented by the head of the compliance or anti-money laundering departments, with management responsibility for AML
The role of senior management	<p>AML compliance is a high profile issue for banks in Baltics</p> <ul style="list-style-type: none"> ■ 82% of the respondents (and all respondents from Latvia) admit that AML is a high profile issue in which the management board takes an active interest. The other 18% of respondents, from banks in Lithuania and Estonia, indicated that AML is a moderate profile issue in which the management board takes some interest.
Cost of AML compliance	<p>AML costs have significantly increased over last three years, and are expected to increase, though to a lower extent</p> <ul style="list-style-type: none"> ■ 84% of the respondents estimated that their AML compliance costs have increased. Most of these respondents indicated that the costs increased 21 to 50%, while some banks experienced an increase in the costs of more than 100% and some by less than 10%. ■ 8% of the respondents observed a decrease in AML compliance costs, and the same number of respondents retained these costs at the same level. ■ More than half of the respondents expect that AML costs will increase, although to a lower extent than in the past.
Know Your Customer (KYC) procedures	<p>Banks apply a risk based approach</p> <ul style="list-style-type: none"> ■ For account opening. One of the most often used criteria for applying the risk based approach is the country of residence, which is reflective of the significance of non-resident customers for the Baltics banking sector. ■ For updating KYC documentation. Though many banks perform this review on all customers, most would obtain missing KYC documentation when an existing customer transacts new business with the bank. ■ To monitoring of customers. Nearly all respondents have specific procedures for identification and monitoring of PEP customers.
Transaction monitoring	<p>Use of internally rather than externally developed transaction monitoring systems</p> <ul style="list-style-type: none"> ■ Such an approach may be explained by the relatively smaller size of banks in the Baltics. At the same time, banks in this region are known to have large volumes of transactions, and many non-resident customers with complex structures which may be better monitored using more sophisticated systems. ■ 27% of the respondents admitted the systems operate at below a satisfactory level.

Executive summary

Headlines

Issue	Summary observations
Sanctions compliance	Moderate challenge in sanctions compliance <ul style="list-style-type: none"><li data-bbox="435 430 1349 493">■ Possibly due to the focus of the banks on local Baltics customers and non-resident customers from CIS countries.
Banks' view on local legislation	Acceptable but need to be better focused <ul style="list-style-type: none"><li data-bbox="435 555 1349 646">■ The majority of the respondents assessed the overall level of regulatory burden as acceptable, but at the same time reveal a need for better focused requirements in order to ensure a more effective AML system.

Banking sector characteristics

Baltics

Banking sector in the Baltic states

- There are in total 37 commercial banks and 30 branches of foreign banks present in the Baltic states, the majority of which are located in Latvia.
- Historically the number of banks in the Baltic states has remained roughly constant, while the number of branches of foreign banks has increased substantially over the last decade since accession to the EU.

Assets of banks in the Baltic states

- The banking sector in the Baltic states shows substantial growth over the last decade, nearly doubling assets over the last five years in all three Baltic countries.
- As at 31 December 2010 40% of all banking sector assets of Baltics are in Latvia, followed by 34% in Lithuania and 26% in Estonia.
- In addition, we see that the global financial crisis has negatively impacted the growth of banking sector in all three countries during 2009 and 2010, affecting Latvia the most, while having relatively lower impact on Lithuanian banking sector. However, Latvia's banking sector is also showing the fastest recovery.

Asset structure of banks in the Baltic states

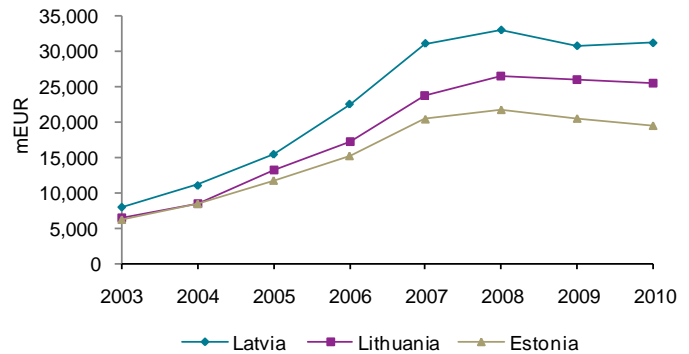
- As seen traditionally, the majority of banking sector assets are loans outstanding, ranging from 60% and 65% in Estonia and Latvia respectively to 82% in Lithuania.

	Latvia	Lithuania	Estonia
Banks	21	9	7
Branches of foreign banks	10	9	11
Total	31	18	18

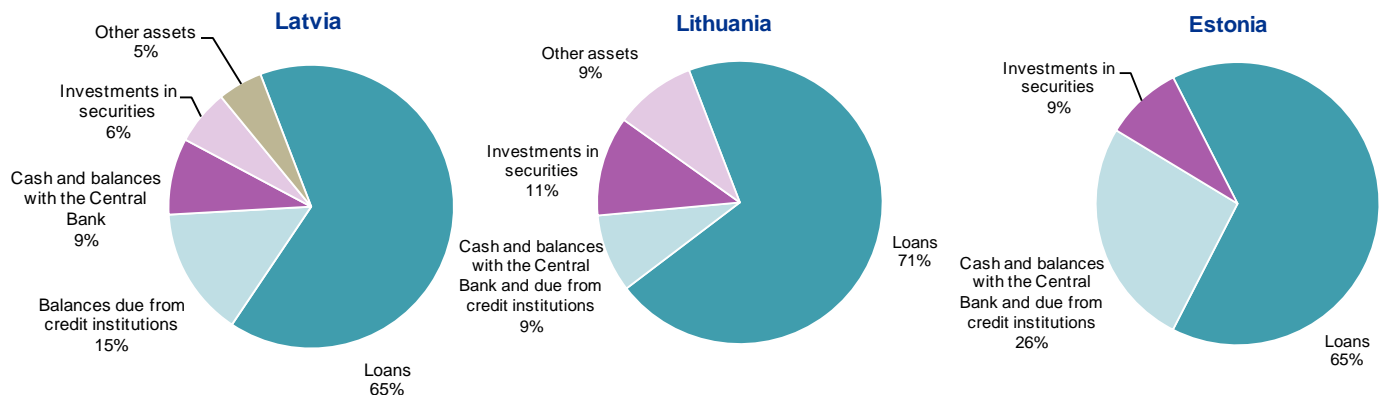
Note: (a) As at 31 December 2010.

Source: Association of Latvian Commercial Banks, Bank of Lithuania, Financial Supervision Authority in Estonia.

Total assets of banks in the Baltic states, 2003 - 2010



Source: Association of Latvian Commercial Banks, Bank of Lithuania, Financial Supervision Authority in Estonia.



Source: Association of Latvian Commercial Banks

Source: Association of Lithuanian Banks

Source: Bank of Estonia

Banking sector characteristics

Baltics

Deposit structure of banks in the Baltic states

- During the decade ending in 2008, the deposit base of banks in the Baltic states experienced rapid growth, both with regards to resident and non-resident deposits. The amounts have stabilized during the last three years.
- With respect to non-resident deposits, Latvia displays a notably different deposit structure than the other two Baltic states, namely, the proportion of non-resident deposits to total deposits in Latvia is 45%, whereas in Lithuania and Estonia it is 7% and 16%, respectively.

Resident and non-resident deposits in the Baltics states, 2003-2010



Source: Association of Latvian Commercial Banks, Bank of Lithuania, Financial Supervision Authority in Estonia.

Survey results

Summary of respondents

First of this kind of survey in the Baltics

- 22 respondents from banks in Latvia, Lithuania, and Estonia
- Respondents included
 - Both market leaders and niche players
 - Subsidiaries and branches of foreign banks, as well as locally owned banks

Experience and responsibilities of respondents

- Respondents were represented by the head of the compliance or anti-money laundering departments, with management responsibility for AML
- 95% of the surveyed employees have experience in the anti-money laundering area for at least four years. Around one third of the respondents have experience in the AML area of more than ten years.

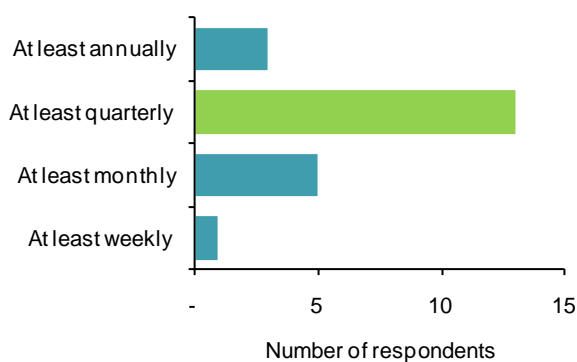
Survey results

The role of senior management

AML compliance is a high profile issue for banks in Baltics

- 82% of the respondents (and all respondents from Latvia) admit that AML is a high profile issue in which the management board takes an active interest. The other 18% of respondents from banks in Lithuania and Estonia indicated that AML is a moderate profile issue in which the management board takes some interest.
- None of the banks reported that senior management took little interest in the subject.
- Moreover, over 80% of respondents said that their management board formally discussed AML issues at least quarterly, a third of these saying they did so at least monthly or even weekly.
- The size of the Baltics, especially Latvia's banking, business with clients from countries with higher money laundering risk and the regulatory emphasis on AML compliance (said to be enforced more vigorously in Latvia), are the natural cause of AML being an item high in the agenda of the senior management of banks.

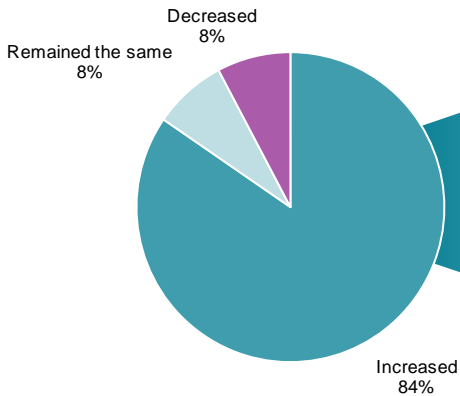
Frequency of AML reporting to the Board, Baltics



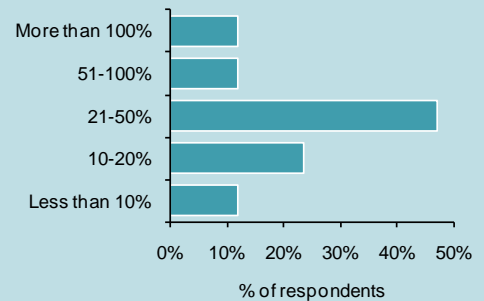
Survey results

Cost of AML compliance

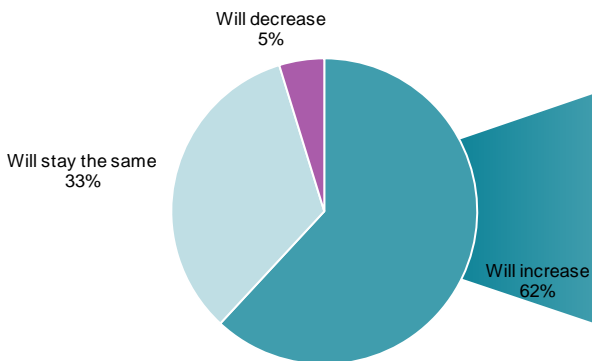
Cost of AML compliance, 2010 vs 2007



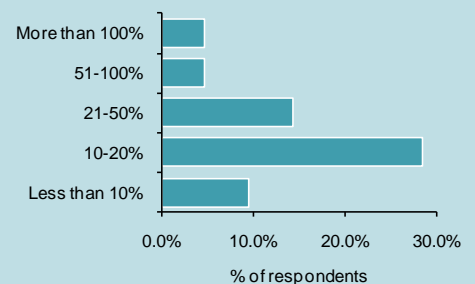
Increase in the cost of AML compliance, 2010 vs 2007



Expected cost of AML compliance in the Baltics over the next 3 years



Expected increase in the cost of AML compliance



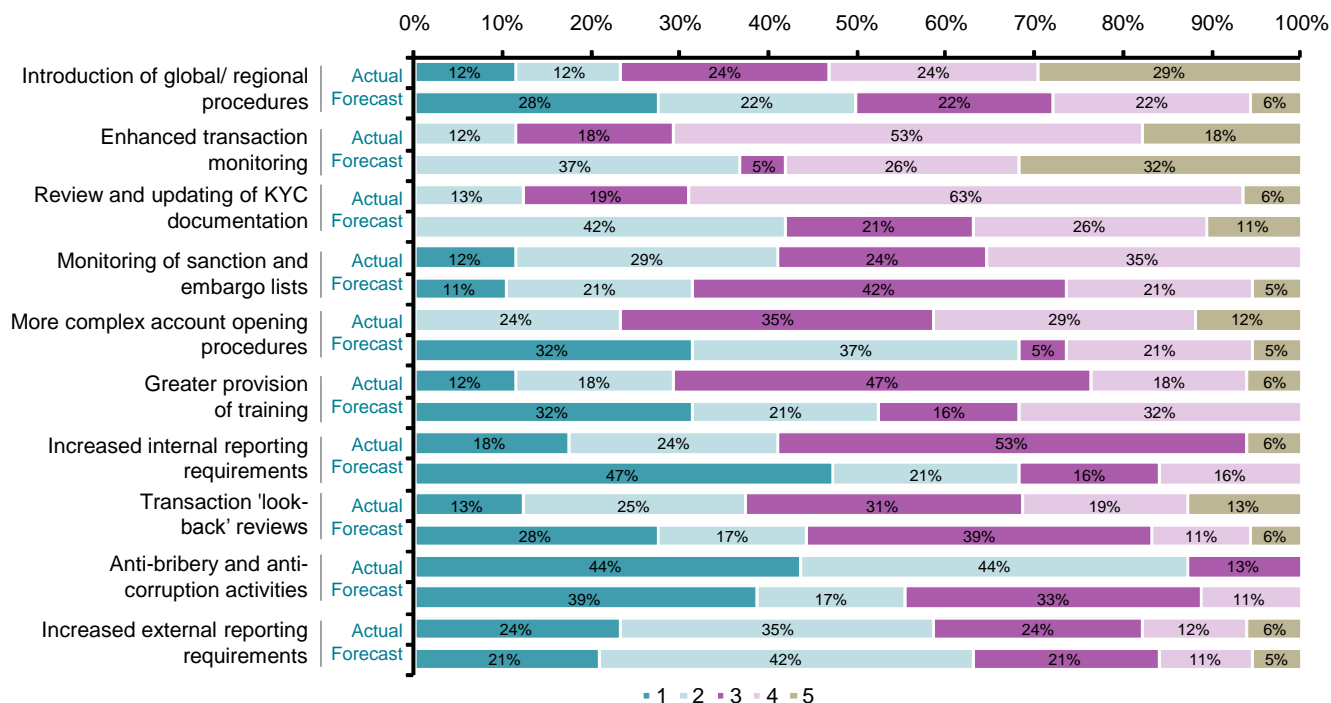
AML costs have significantly increased over last three years, and are expected to continue to increase, though to a lower extent

- The expectations about AML compliance cost dynamics are more optimistic, if compared to the increase in costs in the past.
- The difficulty of estimating AML costs is that cost may be spread across several functions (operations, compliance, risk), involve direct and indirect costs, and overlap with processes that are embedded in normal business practice (e.g. risk management or customer relationship management). These factors complicate the estimate of the cost level and assessment of past and future changes, which also impacts the quality of the information contained in these slides. Not all banks were capable of estimating the total costs of AML compliance.
- Where banks are not aware of the full costs of AML compliance, they may not necessarily be well positioned to consider how they can better apply their resources to focus on the major areas of AML risk. Although there may be difficulties in identifying and quantifying all of the drivers of AML costs, there can be certain benefits to doing so. It can, for example, indicate areas in AML processes that can be optimized.

Survey results

Cost of AML compliance

Actual and forecast cost of AML compliance



Note: The above ten potential reasons for increased costs were evaluated on scale 1 to 5 (no impact to very strong impact). *Actual* represents the assessment of the reasons for the increase in the cost of AML compliance 2010 vs 2007, whereas *Forecast* represents the assessment of the reasons for increasing cost in the 3 future years

Areas of the largest increase in AML expenditure

- The AML activities requiring the largest investment over the previous three years include enhanced transaction monitoring and revision of KYC documentation for existing customers.
- The driver of higher expenditure appear to be greater expenditure on transaction monitoring capabilities and implementation or upgrades to the software used for AML compliance. Another driver is the regulatory monitoring of bank's AML compliance which caused an expenditure on updating of KYC documentation.

Outsourcing or offshoring of AML functions

- Globally, a topical issue is the use of outsourcing or offshoring. Banks in the Baltics appear to have been reluctant to consider moving AML functions offshore or to a third party. This reluctance appears to stem from legitimate concerns among the management of the banks about their accountability for a function they may cease to have day-to-day control or oversight over.
- 77% of banks in the Baltics reported never having considered the outsourcing or offshoring of AML functions.
- The reluctance to offshore may be because Baltic countries are themselves relatively low cost centers, and therefore the relative attractiveness of outsourcing or offshoring is diminished.

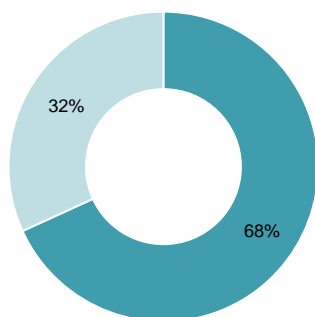
Reasons for the expected increase in AML compliance costs

- The areas that require the largest investments in the future appear to be the same that required investments in the past: enhanced transaction monitoring and revision of the KYC documentation for existing customers, though to a slightly lower extent.
- Interestingly, the Baltic banks have named anti-bribery and anti-corruption among areas that will require larger investments going forward than in the past.

Survey results

AML policies and procedures/KYC approach

AML policies and procedures in the Baltics



- Global/regional policies yet detailed procedures are local
- Local policies and procedures only

AML compliance addressed mainly locally

- Most of the banks with parents in other EU countries (to a large extent Scandinavia) have adopted the bank's group policy, which reflects the need to ensure management of AML risks using a consistent and comprehensive approach. These banks though have implemented procedures that correspond to the local legislative and business needs. The local banks, and usually also the subsidiaries of CIS banks, have developed AML policies and procedures independently.
- The geographic responsibility for AML is typically assigned to an employee in the country in which the bank operates. Alternatively, some banks have organized the AML function at the Baltic level, and some AML officers in banks in the Baltics have responsibility over branches both in EU and non-EU countries.

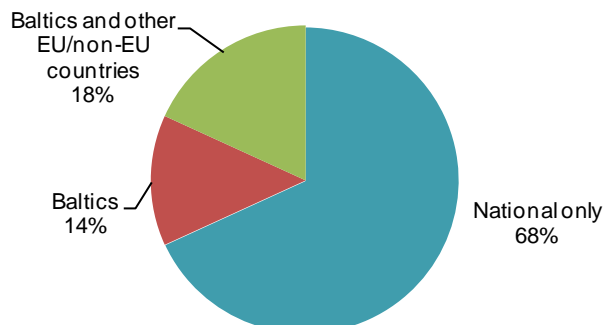
A risk-based approach to account-opening

- The majority of banks employ a risk-based approach at account opening, while only one out of 22 respondents indicated that it does not apply a risk based approach.
- The banks use a wide range of risk factors that determine the extent of the account opening procedures. One of the main criteria is the country of residence, which reflects the specifics of the source of financing for the banks in the Baltics, being non-resident customers.

Specific procedures on PEP's

- Nearly all respondent banks in Lithuania, Estonia and Latvia have specific procedures in place for identifying and monitoring Politically Exposed Persons (PEPs) on an ongoing basis.
- When asked what approach banks took to create or obtain PEP lists, banks in the Baltics responded that they mostly rely entirely on commercial lists purchased. In Lithuania, however, three respondent banks indicated that they apply a combined approach using commercial lists with in-house additions.

Geographical area of responsibility for AML



Continuous update of the KYC documentation for existing customers

- For remediating KYC information, the majority of the banks either apply
 - a risk-based approach to obtaining missing KYC information for higher risk customers only; or
 - procedures across the entire customer base to obtain missing KYC information for all customers.
- Banks would also typically obtain missing KYC information whenever an existing customer opens a new account or transacts new business with the bank.

Customer risk is scored

- Monitoring of customers varies on the basis of defined risk ratings for customers.
- Broadly half of the respondents have defined three risk groups for its customers, namely, low, medium, and high. While the other half have either two, or four customer risk groups. In the case of four risk groups, the banks have assigned a maximum risk rating in excess of the high risk classification for a certain customer group, e.g. Politically exposed persons.
- A few banks have implemented a detailed risk scoring system, based on which customer specific monitoring program is applied, and hence the customers are not assigned a defined low, medium, or high risk grade.
- Monitoring of customers is typically performed based on both an automated procedures and manual analysis.

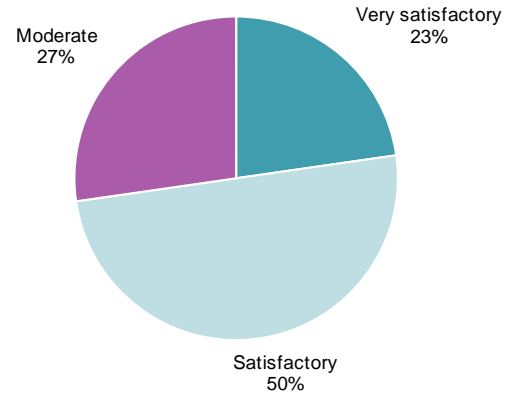
Survey results

Transaction monitoring

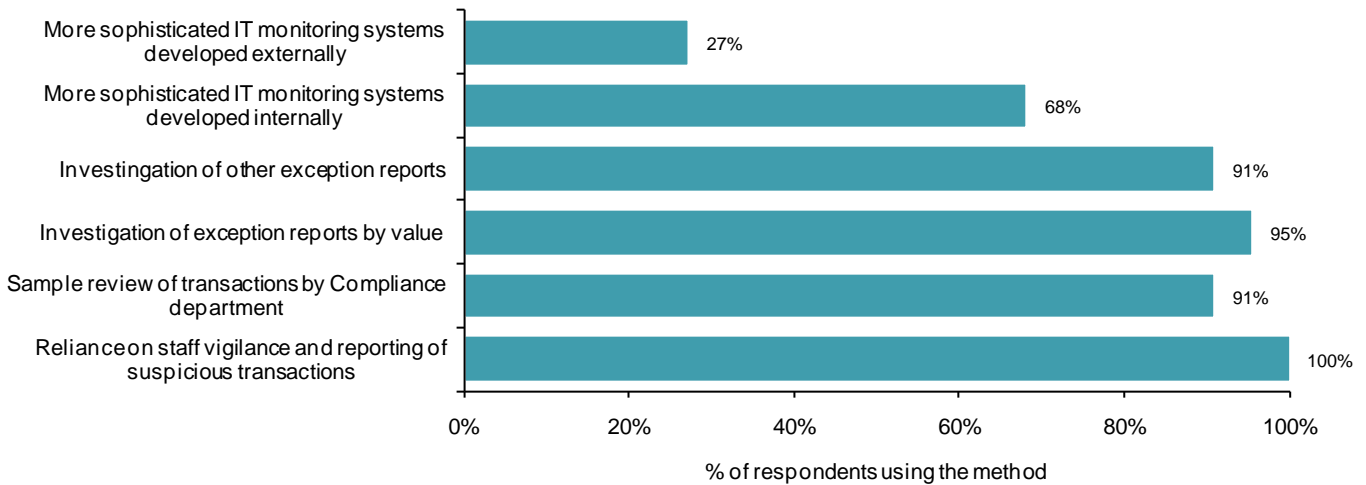
Transaction monitoring systems

- The banks in the Baltics have reported the use of various tools for transaction monitoring as detailed below. However, only a third of respondents purchased from external providers IT monitoring systems that produce more sophisticated reports than exception reporting. Two thirds rely on internally developed systems that allegedly produce more than defined exception reports. The limited use of externally developed IT systems for AML compliance may be attributed to the relatively small size of the banks in the Baltics. At the same time, the Baltic banks appear to have rather large volumes of transactions and non-resident customers with complex structures which might be better monitored using more sophisticated systems.
- 27% of respondents assessed their transaction monitoring systems as below satisfactory.

Satisfaction with current transaction monitoring systems



Methods used for transaction monitoring



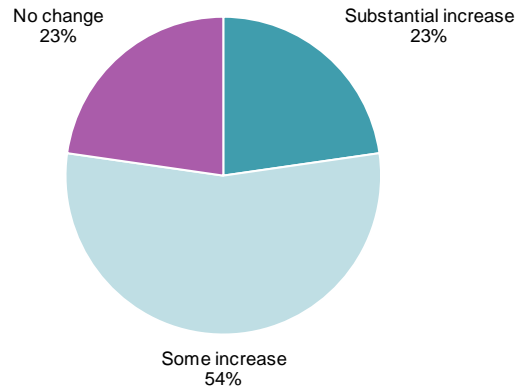
Survey results

Suspicious activity reports

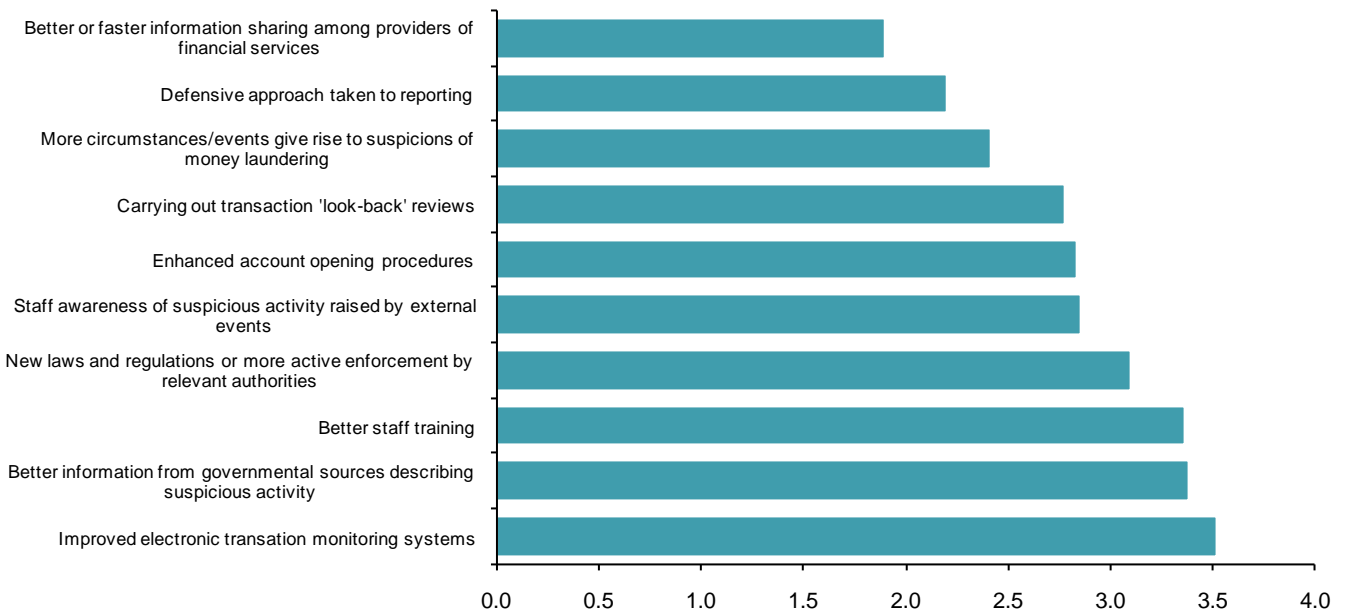
Increase in the number of suspicious activity reports

- 75% of respondents reported an increase in the number of suspicious activity reports. Whereas only a quarter noted a substantial increase.
- The chart presents average ratings assigned by the respondents (who reported an increase in the number of suspicious activity reports) to evaluate the potential reasons behind the increase in the number of suspicious activity reports on the scale 1 to 5 (no impact to very strong impact).
- The increase in the number of suspicious activity reports is attributed primarily to the following reasons:
 - improved monitoring systems
 - clarified definitions of suspicious activity by the government institutions, and
 - increased staff awareness

Increase in the number of suspicious activity reports



Potential reasons behind the increase in suspicious activity reports



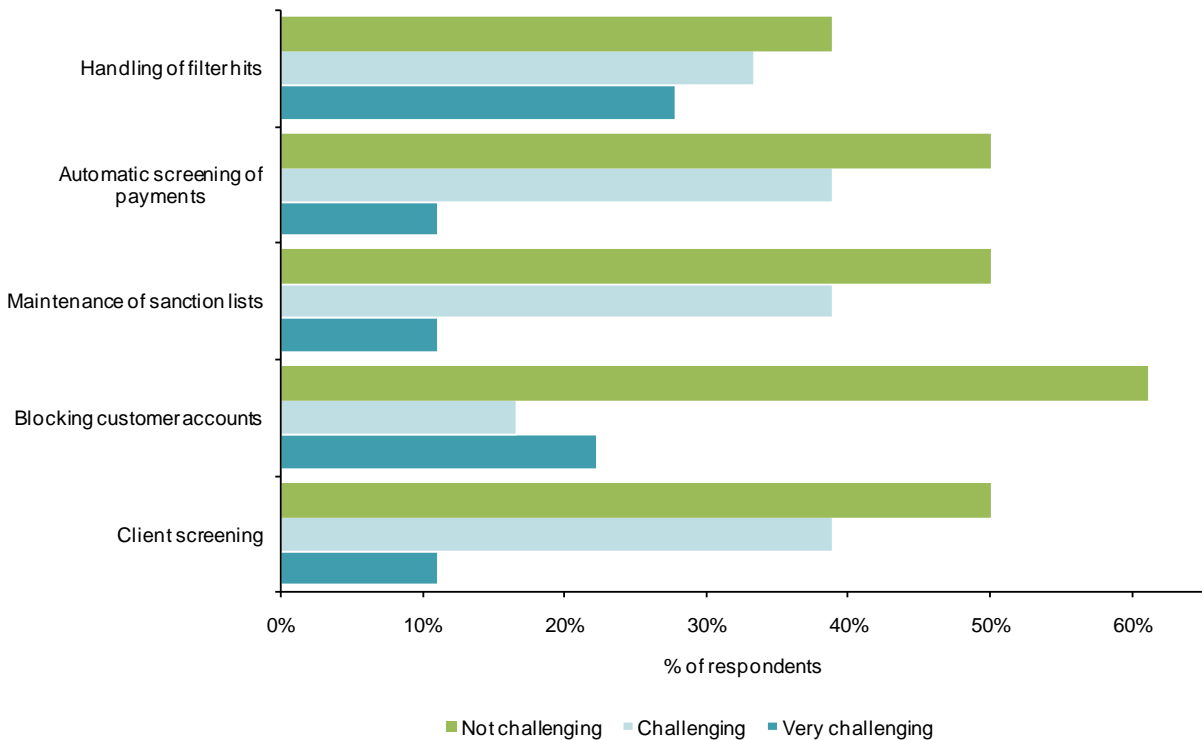
Survey results

Sanctions and payments

Sanctions compliance

- The chart presents the assessment of challenges in the sanctions compliance evaluated as either very challenging, challenging or not challenging.
- Overall, sanctions compliance is viewed as a moderately challenging area of AML compliance in the Baltics compared to other areas such as transaction monitoring. This may be attributed to the fact that the business of the Baltic banks is focused on local clients and non-resident customers from the countries of the CIS region.
- Handling of filter hits was recognized as the most challenging area of all AML compliance - very challenging by 28% and challenging by 33% respondents. Whereas blocking customer accounts was assessed as very challenging only by 22% and challenging by 17% of respondents.

Assessment of areas of sanctions compliance



Survey results

Banks' view on AML requirements

Acceptable, but need to be better focused

The majority of the respondents have assessed the overall level of regulatory burden as acceptable, but at the same time reveal a need for better focused requirements in order to ensure a more effective AML system. The view is homogenous despite the legislation being different amongst the three Baltic countries.

The banks have named a number of areas of AML regulations that could be improved:

- Risk assessment of customers is defined by the regulations in too much detail, while a more efficient approach is believed to be one that left space for the banks to define their own criteria for risk assessment (Latvia).
- A principle based rather than a rule based system in more general AML compliance regulations is also sought by respondents from Estonia.
- On the contrary, the requirements for the identification of beneficial owners could be clearer, for instance the inclusion of appropriate references to the required sources would ensure higher efficiency of the AML system (Latvia, Lithuania).
- More directions on the definition of suspicious transactions is also sought by a few banks (Latvia, Lithuania).
- Better collaboration/sharing of information amongst governmental institutions is also expected as these institutions have more thorough information from different institutions, as this would ensure increase in the system efficiency (Lithuania).



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