HIGH-LEVEL SUMMARY TECHNICAL ASSISTANCE REPORT

PROJECT SUMMARY

Nordic-Baltic Regional Technical Assistance Project Financial Flows Analysis, AML/CFT Supervision, and Financial Stability

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Legal Department

Project Summary: Nordic-Baltic Technical Assistance Project – Financial Flows Analysis, AML/CFT Supervision, and Financial Stability

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The *High-Level Summary Technical Assistance Report* series provides high-level summaries of the assistance provided to IMF capacity development recipients, describing the high-level objectives, findings, and recommendations.

ABSTRACT: In their efforts to strengthen the effectiveness of Anti-Money Laundering/Countering the Financing of Terrorism Frameworks across the Nordic-Baltic Region (Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden), the Governors of the Nordic-Baltic Central Banks reached out to the IMF to request technical assistance. The request stems from various international money laundering banking scandals (ABLV, Danske Bank, Nordea, Swedbank), involving cross-border payments by non-residents that exposed financial integrity risks in the financial sector of the region, attracting international scrutiny on the level of non-resident Money Laundering/Terrorist Financing ML/TF risks and highlighting the vulnerabilities related to AML/CFT risk-based supervision of banks in the region. The flagship project relied on a novel methodology to leverage data analysis to understand ML/TF threats and vulnerabilities and their potential impact on financial stability, and developed country and regional recommendations. Notably, the project involved an analysis of (i)potentially high-risk financial flows to and from the region; (ii) the AML/CFT domestic and regional supervisory landscape related to banks and virtual assets; and (iii) the potential implications of financial integrity shocks on financial stability.

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Background

1. Various international banking scandals concerning Anti-Money Laundering and combating the Financing of Terrorism (AML/CFT) breaches have taken place in the Nordic Baltic region, with far-reaching financial and reputational consequences. Similar to other global scandals, most of these took place at a time when AML/CFT standards and their application were still at a nascent stage, with some instances in 2005 although they would be discovered well into 2015 and beyond, including some taking place up to 2017. These breaches have shown the importance of understanding ML risks inherent in cross-border financial flows, the need for effective domestic AML/CFT regulatory frameworks, and strong regional and international cooperation. In the Nordic Baltic region, the Danske case stands out due to its extensive cross-border illicit activities across countries in the region, affecting other financial institutions. Danske bank was acquired in 2007 the Finland-based Sampo Bank, which also had an Estonian branch. At this branch, during 2007–2013, 44% of all deposits came from non-residents customers. These customers conducted around 7.5 million transactions with an aggregated flow of money added up to approximately 200 billion euros. The bank was forced to close the Estonian branch in 2019 and pled guilty to fraud in the U.S, forfeiting $2 billion along with an additional fine for EUR 470 million in Denmark. Several Nordic-Baltic countries became significant recipients of funds from non-resident politically exposed persons, sometimes ill-gotten either due to political connections or due to illicit business practices and lack of accountability. The tracing of funds and the source of wealth of these customers is challenging due to the lack of accurate or verifiable sources of information.

2. As part of its surveillance mandate, the IMF has engaged with all countries in the Nordic Baltic region, through Article IV Consultations and Financial Sector Assessment Programs, with several common recommendations across such countries. Key recommendations included ensuring accurate beneficial ownership information, enhancing AML/CFT risk-based supervision and finetuning the inspections of banks, ensuring adequate resources and improving the capabilities of supervisors, in particular, to banks and fintech operators. In-depth analytical work supported key recommendations, on enhancing understanding of ML/TF risks arising from non-resident and cross-border financial activities, including monitoring of cross-border payments, consolidating the fintech sector for countries where it is mature, stepping up cross border supervision, including cooperation with regional international authorities, and strengthening regulatory frameworks for crypto asset service providers (CASPs).

3. Financial integrity issues could potentially present risks to financial stability in the short and medium term. Banks facing financial integrity (FI) issues could face short-term tensions related to wholesale funding (reputational impact and higher credit risk) and liquidity (due to outflows and a possible decline in counterbalancing capacity). In the medium term, banks with AML/CFT failures might experience higher funding costs and might reduce their exposures to countries where FI issues occurred. Such cutback on activity could result in a sharp reduction of financial services offered to residents, especially if the domestic banking sector is reliant on those cross-border banking groups. Such de-risking, along with a reduction in or more direct termination of correspondent bank relationship (for example, in response to a FI related scandal), could weigh on the financing activity of the banking sector and ultimately reduce economic activity (Erbenova et al, 2016). The high-profile AML/CFT failings events[1] over the last few years also affected the banking sector's financial reputation and soundness since they involved banks with significant cross-border activity.[2] Given the high degree of integration in the region, assessing the impact of money laundering shocks is key to understand better how financial integrity events can affect financial stability in the banking sector at a country and potentially regional levels.

[1] Referred hereafter as financial integrity (FI) events Referred hereafter as financial integrity (FI) events.

[2] The six largest cross-border Nordic banks account for 40 to 75 percent of lending in the region (Farelius et al., 2020). Relatedly, foreign branches and subsidiaries account for the majority of banking sector assets in Estonia, Latvia and Lithuania (EBF, 2023).

Summary of Findings

4. The Nordic-Baltic region's cross-border financial flows have increased steadily since 2013. The countries' aggregate financial flows are highly material, including after adjustment to the gross domestic product (GDP) and the value of deposits. The materiality of these flows for most of the countries in the region indicate that a focus on cross-border financial flows is merited. The region's financial flows also have a significant geographic reach, which is driven by the open, large, and advanced Nordic economies, exposing them to additional complexity and different nature of cross-border ML/TF risks. Closer monitoring of cross-border financial flows would provide countries with a deeper understanding of their external ML threat environment and evolving cross-border related risks they are facing.

5. The depth of geographic ML/TF risk analysis and understanding differs among the Nordic-Baltic countries. For the identification of higher-risk countries, country authorities utilize the FATF grey list, European Commission (EC) higher-risk third country list and non-cooperative tax jurisdictions lists, maintaining minimal flows with the countries on these lists. Nordic-Baltic countries' efforts to mitigate ML/TF cross-border risks would benefit from developing own understanding of higher-risk countries, incorporating country-specific risk factors and focusing on jurisdictions with substantial flows. Results of the economic fundamentals and outlier detection analyses developed by IMF staff[3] contributed to a targeted and up-to-date understanding of higher ML risks countries and related payment trends and patterns.

6. There has been clear investment in ML/TF risk models across the region, but some gaps remain, notably, advanced data collection and analysis. All countries have advanced the development of risk assessment models to guide AML/CFT risk based supervisory engagement, drawing from international and regional best practices. In most countries, supervisors are well-versed with their risk models and update them on an ongoing basis. However, further work, notably, in refinements to methodologies, more granular data collection, particularly on cross-border payments and increased investments in data analysis, are required to ensure that robust ML/TF risk assessments underpin the supervisory approach for banks. Further, increased focus is also needed to tailor risk- models to crypto asset service providers to support the AML/CFT risk-sensitive supervision of this sector.

7. Similarly, active AML/CFT supervision has advanced in the region. Development of targeted supervisory strategies for high-risk entities, coordinated regional supervisory efforts, and ongoing assessments of resource adequacy are among the top priorities. Increased resourcing for the AML/CFT supervision function reflects its heightened priority in the region; however, resourcing should be assessed on an ongoing basis, including through the development of minimum engagement models, to ensure that it remains commensurate with risks. Countries could also further leverage supervisory colleges -such as through cross-border supervisory strategies and joint inspections- for more coordinated regulatory action. The general move in the region towards thematic inspections can help maintain a risk-sensitive supervisory presence, and should continue, targeting areas of highest ML/TF risks. Further, as countries advance their supervisory approaches for the newer crypto asset sector, effective market entry controls, investments in resourcing and specialized tools, as well as regional information exchange would be key.

8. Quantifying the financial stability impact of money laundering shocks is an understudied area. Studies on the impact of AML/CFT failings on banks' liquidity and funding are scarce and this area requires further examination to better integrate financial integrity issues in risk analysis and stress testing to help assessing the vulnerability of banks to financial integrity events and its impact on cross-border banking relationship. Looking forward, building on the work provided by IMF staff, this would benefit from

[3] IMF staff developed an unsupervised machine learning algorithm to monitor global financial flows to detect unusual and potentially suspicious patterns of financial flows using transactional payments data and indicators of higher (weak AML/CFT regime, higher economic crimes, financial secrecy, and harmful tax practices) and lower (underlying trade and investments) ML risks.

further exploration (at the country level), including by collecting information on additional financial integrity cases to help improve the robustness of impact estimations.

9. **Based on the analysis conducted so far, banks facing financial integrity issues faced a sharp equity price decline, an increase in credit risk, and a deterioration of their liquidity with some contagion effects.** AML/CFT failures are associated with a large drop in equity price for the affected bank, and to a lesser extent other banks from the same country and banks from the region with similar cross-border exposures. Similarly, credit risk increases around financial integrity events for the affected banks and for other banks in the same country or banks from the region with similar cross border exposures. Liquidity, as measured by deposit flows, tends to deteriorate around FI events for the affected bank while other domestic banks' liquidity could benefit from positive substitution effects in the short-term. At the regional level, preliminary results tend to indicate possible contagion effects on the liquidity side.

Summary of Recommendations

10. **AML/CFT regimes in the region would benefit from better understanding of the ML threats associated with cross-border financial flows and non-resident activities.** The authorities could consider developing a national mechanism for comprehensive monitoring of cross-border financial flows, particularly for the countries with the most material cross-border payments. Efforts could also be made to enhance further national understanding of ML/TF cross-border and non-resident risk, by incorporating additional sources of data (e.g., macro-economic variables such as trade and investments) and other information (e.g., business models of financial institutions and their foreign linkages) into the national/sectoral risk assessments. In addition, cross-border ML/TF risk mitigation would benefit from developing the understanding of ML/TF higher-risk countries based on country-specific risk factors with a focus on the countries with the most material financial flows, in coordination with all relevant agencies with AML/CFT-relevant mandate, including tax administration.

11. **In order to address cross-border AML vulnerabilities, efforts to enhance the supervisory understanding of ML risks, strengthen the risk-based supervision of banks and CASPs, and deepen cooperation should continue.** The authorities should consider taking steps to strengthen the supervisory ML/TF risk assessment of banks through a greater focus on inherent risk (in particular, product risk), and should enhance the collection and analysis of more granular information (including transaction-level data) supported by increased automation and the exploration of data analytics tools. Countries should also assess the adequacy of resources on an ongoing basis against changes in size and risk profiles of the supervisory population (including CASPs). The authorities could consider further leveraging positive cooperation and information-sharing practices through the establishment of joint AML/CFT supervisory strategies for the highest risk cross-border bank and continue efforts to ensure strong coordination between prudential and AML/CFT supervisors. Along with taking steps to proactively identify unauthorized CASPs, countries could leverage regional platforms to share sector-specific information and develop sector specific (CASP) strategies.

12. **The impact of AML failings on financial stability should be further explored.** This analysis should be supported by AML/CFT supervisors, prudential supervisors, and financial stability experts within the respective agencies. In addition, based on the calibration exercise set out in the report, the authorities should explore further work to calibrate stress test scenarios featuring FI issues and apply them where relevant to banks more vulnerable to FI issues, relying among other factors on financial flow analysis (to better understand the threat) and the conclusions of the supervisory ML/TF risk assessment (to capture banks that are most vulnerable).