

Muhammad bin Ibrahim: Labuan IBFC – past, present and future

Speech by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Labuan Industry Annual Dinner 2016 “Labuan IBFC: Past, Present and Future”, Kuala Lumpur, 27 October 2016.

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Introduction

Thank you for the opportunity to speak here at the 2016 Labuan Industry Annual Dinner. It is a pleasure to share some of my thoughts tonight with the industry players here. Since its inception 26 years ago, we have all played a part in developing Labuan IBFC into what it is today. You have had a hand in its *past*, and you have indeed shaped its *present*. But the global operating environment has significantly changed, and Labuan like any other international financial centre needs to adapt to this new reality. Winds of change are upon us, and will only blow harder as we move forward. This will, I anticipate, alter Labuan’s role as events around the globe continue to shape its future.

Drawing on tonight’s theme “Bold and Beautiful”, let us not shy away from asking the *bold* questions facing Labuan IBFC and its future. I believe that successful and actionable plans to secure the industry’s future can only stem from us collectively and bravely confronting the truths, however harsh or inconvenient.

With this in mind, my remarks tonight will focus on three areas:

- reflections on the evolution of international financial centres over the last few years;
- the imperatives for change; and
- possible strategies for Labuan’s next level of development.

Travelled waters: The historical emergence of international financial centres

The historical emergence of international financial centres is closely linked to the use of strategies to improve the efficiency of doing business and tax planning. International financial centres were developed over many decades. Cultivated piece by piece around the globe, strategies were put in place to enable businesses to be conducted more easily, more efficiently and more profitably. Let me briefly attempt to recount the historical milestones to contextualise the environment that we are now facing.

As far back as the 1880s, the American state of New Jersey liberalised its business registration laws to attract corporates to register there. The success of this approach, at a time of highly restrictive incorporation laws was then emulated by the state of Delaware. In 1929, the British courts ruled that an Egypt-based company registered in London was not subject to British taxes since it did not conduct any activities in the UK. This significant ruling set a precedent for the tax treatment of non-resident corporates, not only for the UK, but for the entire British Empire. In 1934, Switzerland introduced laws that strictly upheld bank secrecy, criminalising offences and limiting information shared with third parties. These various events introduced elements that attract businesses such as ease of company incorporation, advantageous tax treatment, sheltered offshore operations, and safeguarded confidentiality and secrecy.

These elements had the effect of reducing the costs and improving the ease of doing business. Until recently, these elements formed the cornerstone of modern international financial centres.

International financial centres proliferated in the 1960s and 1970s with the emergence of the offshore interbank market – or Eurodollar market – in London. Banks were allowed to carry

out largely unregulated deals as long as these were in foreign currency and between non-resident clients. The development of the Eurodollar market in London proved to be the principal force behind an integrated offshore economy. Jurisdictions with close links to London – British Crown dependencies and former colonies such as Hong Kong and Singapore – quickly latched onto this development and opportunity.

From this quick glimpse to the past, we can see that the emergence and growth of international financial centres is a testament to *human resourcefulness and ingenuity*. Opportunities have been quickly seized upon, and barriers have been promptly overcome. In particular, businesses are continuously able to find innovative solutions in search of a brighter future. This is an important lesson. To secure Labuan's future, we will need to call upon this resourcefulness and ingenuity.

Changing tides: Developments shaping international financial centres

Beginning in the 1990s, the attractiveness of international financial centres began to evolve following the wave of liberalisation and deregulation. Industrial countries also began offering incentives similar to those available in international financial centres. It is perhaps at this point of the evolutionary journey that the paths of international financial centres began to diverge. Some continued to work towards stronger standards of regulation and supervision, while others resorted to the use of less stringent regulations and opaque structures. The latter, unfortunately, gave rise to the perception of international financial centres as shadow centres that harbour unscrupulous financial activity.

The mid-nineties to the millennium were the defining years for international financial centres. In the aftermath of the financial crisis and the ensuing economic slowdown, pressures began to mount for international financial centres to tighten laws and adhere to international standards on disclosure and transparency. Efforts against international tax avoidance and money laundering intensified and have since proliferated across the globe, with initiatives such as the Common Reporting Standards and the Base Erosion and Profit Shifting (BEPS) measures. The Financial Action Task Force (FATF), of which Malaysia is a member, has also been instrumental in driving stronger safeguards that protect the integrity of the financial systems.

This is a positive development for us in Labuan as the business activities here have always been developed and held to high regulatory and supervisory standards that promote sound and transparent operations.

These regulatory developments now evolving around the globe will likely lead to different business models for international financial centres. With the expansion of global agreement and coordination in areas such as tax harmonisation and regulatory upscaling, privileges such as tax incentives and secrecy will eventually cease to be competitive differentiators. International financial centres will need to metamorphose into "new environment relevancy" in order to survive these changes.

Value propositions will need to be rethought, anchored on new expectations amidst a new operating environment. Indeed, we are already seeing other jurisdictions repositioning themselves – drawing on real talent and specialisation, leveraging on infrastructure both "hard" and "soft", and diversifying into other business segments ranging from arbitration services to medical tourism.

Sink or swim: Repositioning Labuan IBFC

In a world where cross-border funds are shifting in significant volumes, where rules are being rethought, where advancing technology is rapidly redefining the nature of financial transactions, we must ask ourselves the important question of how we should respond to remain relevant as an international financial centre. *Sink or swim* – such is the imperative of Labuan IBFC's continued success, or even existence.

Although modelled and adapted after other international financial centres, Labuan IBFC was always envisioned to benefit from overall growth and economic development in the region. Today, it has become a centre for players in niche financial services such as aircraft and oil and gas leasing services, reinsurance and captive insurance.

Nevertheless, the mandate to focus on out-out business still has much room for improvement. Labuan was initially given the flexibility to accept domestic business to give it a head start. It was never the intent to make domestic based business a focal point. And yet, at present, almost half of the insurance business here originates from Malaysian risks. Similarly, for the banking sector, over half of bank deposits here are derived from Malaysian residents. In fact, loans to Malaysian residents have more than doubled the last five years from USD5.9 billion in 2010 to USD12.9 billion in 2015. Such loans now account for 40% of Labuan's total loans outstanding. This increased reliance on domestic business runs contrary to the central theme of Labuan IBFC's global ambition. The reinvention of Labuan going forward should not lose sight of its original vision.

Returning once again to tonight's theme, "Bold and Beautiful", let us confront some of the *bold* questions about Labuan:

- First, and fundamentally, with the Island in close proximity to long established global financial hubs, what could we offer that other global hubs could not? In short, *what sets Labuan apart?* We need to find a differentiator.
- Second, with other international financial centres now strengthening their own unique value propositions beyond tax privileges and confidentiality, what strategies should we adopt?
- And the third question relates to *us* as industry players. Are we prepared to face the winds of change? Do we have the resources and expertise in place to contribute meaningfully so that as a collective we can reposition Labuan for the new environment?

Allow me to share some thoughts on what is in store as Labuan moves forward into new and competitive territory.

Strategies to reposition Labuan IBFC

First, we need to rethink on how Labuan IBFC can develop a distinct value proposition that distinguishes itself from other competitors, as well as from the onshore market. To its credit, the centre has already embarked on this journey by repositioning itself from an "offshore centre" to a "midshore centre" over the past few years. As a "midshore centre", it offers both the ease of doing business found typically in offshore centres, combined with high international standards of regulation and supervision found onshore.

We now need to further refine the "midshore centre" concept by moving away from broad-based financial services already widely offered and available onshore, to focus on niche areas with high growth potential.

These include leasing, captives, commodity trading and wealth management. These areas have continued to show an upward trend in driving the centre's growth in recent years. Wealth management, in particular, offers a unique value proposition given that it is the only international financial centre in Asia to offer private foundations and special purpose trusts, including Islamic foundations or *waqf*. In the insurance space, the increasing interest among corporates to establish captives as a risk management strategy presents immense opportunities to offer risk solutions that complement the onshore activities. This strategy of developing specialised areas would minimise overlaps and maximise complementarities between financial services offered by the onshore market and in Labuan IBFC. I am confident that with proper planning and execution, the "midshore centre" concept could very well be a game changer.

On the part of the industry, much more needs to be done. Rates of retention for Malaysian risks in Labuan have been steadily declining from 66.2% in 2011 to 57% in 2015. Retention for offshore risks also reduced from 76.9% to 72.7% during the same period. The optimisation policy, which accords the centre a preferred status after optimising onshore insurance capacity, places a strong expectation for insurers here to maximise retention of premiums in Labuan. Many of the offices of international players here today only act as conduits. This situation is certainly not satisfactory.

On the talent front, despite greater operating flexibility and lower regulatory costs, significant investments to develop local capacity and human capital have not materialised. For many institutions, the outfit here merely consists of a name and skeletal staff, with full-fledged presence in other parts of the region. Hence, while business is booked in the centre, dealings and technical support are provided by regional offices where the experts reside. This is not what the founders of Labuan IBFC envisioned and certainly detrimental to the best interest of Malaysia. Industry players should seriously rethink about leveraging on the strength and opportunity here to review Labuan's business strategies. And I suspect leveraging on ICT would enable us to discover new opportunities, lower transaction costs and improve efficiency and productivity. This is especially relevant given the emergence of fintech that will alter the way financial services is delivered. Labuan IBFC can seize this opportunity to carve its own niche in this new area.

Secondly, the regulatory regime of Labuan IBFC must continue to subscribe to high international standards of regulation and supervision. Policies and regulations must be facilitative of business and proportionate to risks. A well-defined regulatory framework, highly competent supervisors, as well as closer engagements with home and host authorities are key enablers to maintain a balanced regime that promotes the stability and integrity of the centre. This prevents our industry from attracting undesirable activities and elements.

I should also highlight that a tax review exercise is currently in the works to harmonise the tax regime of Labuan IBFC with the national tax system.

This will better align the centre with international efforts to arrest tax evasion and profit shifting, whilst preventing leakages of tax income accruing to the nation for transactions involving residents. With this review, we can expect tax rules and regulations that are more levelled with the onshore market for transactions involving residents. We should envisage that business transactions involving non-residents will continue to be incentivised to ensure continued competitiveness of the financial sector here. Measures to streamline regulations between the domestic market and Labuan IBFC will provide greater confidence and certainty to international businesses and investors, benefitting both the onshore and offshore markets.

There is also a need to elevate the level of connectivity between Labuan, the rest of Malaysia and the region to better facilitate economic and financial linkages. As an international financial centre, connectivity is one of the most important measures of competitiveness. Connectivity increases the probability of success. If we harbour ambitious plans and aspirations for Labuan IBFC, we need to continue expanding its role in facilitating cross-border investment and financial flows and we need to improve infrastructure. This requires additional investment in infrastructure – “hard” and “soft” – to increase the connectivity of the island to levels comparable to the world's leading international financial centres.

While infrastructure development on the island has come a long way since the 1990s, more can be done to enhance the connectivity between the island and mainland Sabah. This will greatly unlock Labuan's vast potential and provide synergistic benefits to Sabah as well. It will create spill over benefits to sectors such as tourism and retail businesses. Perhaps several of these initiatives could include greater connectivity by sea or even a construction of a bridge with the mainland. Regional connectivity will be enhanced via the Kota Kinabalu International Airport. Further seaport development can also assist in diversifying Labuan's economic model by positioning the Island as the preferred national offshore oil and gas port, and even a marine hub that houses marine-related functions (such as specialist marine

insurance claims, underwriting and maritime training) given its strategic location along international trade routes. Investment in faster internet connection is another imperative as it will facilitate business interactions and improve general liveability.

Overall, better connectivity will not only benefit *inbound* access to the centre, but also *outbound* access. Businesses based in the Island will thus enjoy access to the rest of Malaysia and neighbouring countries. More specifically, given the establishment of the ASEAN Economic Community last year, there is significant potential for Labuan IBFC to tap into greater regional financial flows for economic development in the region.

Initiatives undertaken by Labuan FSA

As the regulator of the centre, Labuan FSA has a critical role and continues to strive towards ensuring that Labuan IBFC remains a vibrant and progressive business destination. Today, I am pleased to announce three key policy initiatives that will be embarked upon in 2017:

- Firstly, the legal framework is being reviewed to better reflect regulatory and supervisory policy intentions, as well as to ensure the legal requirements remain relevant and current. This reflects the ongoing commitment of the centre to be a leading jurisdiction in advocating strong prudential, transparency, anti-money laundering and counter terrorism financing standards. The new legal settings will allow international players to enjoy jurisdictional neutrality, while operating in a sound and stable environment;
- Secondly, Labuan FSA will deploy more efficient systems for regulatory reporting, leveraging on technology. This will improve the timely access, accuracy and value of information that is captured by Labuan FSA to support its work. The new system also aims to provide for the ease of reporting and data exchange with other stakeholders; and
- Thirdly, Labuan IBFC will implement the Inter-Governmental Agreement of Model 1B. This will facilitate compliance by financial institutions here to the Foreign Account Tax Compliance Act (FATCA) and exchange information with the US. This and other similar agreements will further strengthen the framework for international cooperation and confidence in Labuan IBFC globally.

Moving Forward

The future of Labuan IBFC is inextricably linked with the broader Malaysian financial system. Much needs to be done. We face the same waves and undercurrents. Any actions and strategies undertaken with regards to the future of the centre, affect not only Labuan, but Malaysia as a whole.

Collaboration of various stakeholders is essential. It is with this in view that the Labuan FSA is collaborating with Bank Negara Malaysia, Labuan Corporation and the Ministry of Finance to undertake a comprehensive positional review of the centre and the Labuan Island as a whole. The outcome of this review, once finalised, will ensure that Labuan IBFC emerges not only as a stronger international financial centre, but one with an enlarged role in the Malaysian financial system and economy.

This is a bold journey with great promise. All of us here tonight need to give our best and play our roles in transforming Labuan IBFC. With a shared vision and steadfast commitment to common objectives and principles, together, let us steer our journey in unison to a better destination.