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Making Labuan an Islamic IOFC

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AT the official opening of the RM360-million Financial Park in Labuan last year, Datuk Seri Dr Mahathir Mohamad said that for Labuan to become a successful International Financial Centre, it must strive for an environment that encourages greater linkages and value-added activities in treasury operations, foreign exchange dealings and capital market instruments, as well as Islamic financial products.

The Prime Minister also called on local and foreign financial institutions to introduce Islamic financial services in Labuan, describing the activities as an important niche for the island.

In presenting the 1997 Budget, Finance Minister and Deputy Prime Minister Datuk Seri Anwar Ibrahim announced that financial activities based on Syariah principles, including interest-free banking, takaful, fund management, loan market and private debt securities would be encouraged and towards this end, the Offshore Banking Act would be amended to allow merchant banks and Islamic banks to operate in Labuan.

The confluence of these initiatives and pronouncements seems to indicate an exciting phase in the development of Labuan as a premier IOFC.

Offshore financial centres proliferated after the 1973 oil price shock when added impetus was given to the growth of the Eurodollar market because of the need to recycle the surpluses of the Organisation of Petroleum Exporting Countries.

In the 1980s, the emphasis had become one of globalisation; involving truly international banking and capital markets, which began to merge, and 24-hour trading revolving around international financial centres.

In this phase geographic positioning, particularly in terms of time zones, has become crucial. It has become possible, for example, that 24-hour trading could revolve around a European centre, a North American centre and an Asia-Pacific centre.

An offshore centre has been defined as a place which has made a deliberate attempt to attract international banking business by reducing or eliminating restriction upon operations as well as lowering taxes and/or other levies.

International banking business here refers to non-residents, foreign currency denominated, assets and liabilities. Offshore centres may be classified as "paper" or "functional".

Paper centres, such as the Bahamas, act as locations of records with little or no banking activities being carried out. Functional centres, such as Labuan, are those in which deposit taking or final lending is actually carried out.

The major functional centres have been caught up in the process of securitisation which has led to a confluence of banking and capital markets in the 1980s.

Thus, although traditionally called offshore banking centres, they are now more accurately called offshore financial centres.

The functional centres serve as an important links between the Eurocurrency and Eurodollars markets and other markets such as the Asian dollar and yen markets, and help to channel funds from major financial centres to final borrowers.

Paper centres are mainly used by international banks to minimise taxes and other levels and are sometimes called tax havens. Regardless of their type, most offshore centres do not require full compliance with local

capital requirements, which insist on minimum capital bases which must be held in the form of onshore assets.

They also generally charge low licence fees, allow easy access, especially for large international banks, and provide for favourable fiscal treatment, such as exemption from withholding and turnover taxes and reduced corporate and other business taxes. Reserve requirements are rarely imposed.

Many of these centres have advantageous geographical positions by virtue of their proximity to important loan outlets and deposit sources.

Hong Kong, for example, is well situated in relation to the Southeast Asian countries and China, Bahrain is an offshore base for petro-dollar transactions with the Gulf States.

Their fortunes are, to some extent, tied to those of the regions they serve. Bahrain, for example, has not enjoyed such a rapid business growth in the 1980s as oil prices have fallen and some of the Gulf States have gone from surplus to deficit.

Labuan could have chosen the path of other offshore centres which are very relaxed in their supervision and have liberal operating environments, which may well attract many players in a short period of time.

But the authorities in Labuan have indicated that more emphasis would be placed on attracting long-term players as they want Labuan to be recognised as being a stable and clean IOFC.

To meet the objective of keeping Labuan "clean", the authorities imposed tough eligibility and entry requirements on applications for an offshore banking licence.

Allowing only the largest and most reputable international banks into the Labuan offshore banking industry would ensure availability of capital and requisite expertise, as well as a high standard of professionalism and ethics in the conduct of offshore banking business.

The authorities will only consider an application from a bank which is among the largest banks in the world, or is among the largest banks in an Asian or Asean country and which has to satisfy other stringent requirements.

Today, Labuan has 52 licensed offshore banks in operation, of which 45 are foreign owned and are among the top 100 banks in the world in size, financial standing and reputation.

While the Government have continuously stressed the importance of supervision, it has also searched for ways to make it easier for business to operate on the island.

The establishment of the Labuan Offshore Financial Services Authority last year as a one-stop regulatory authority was one such measure. Lofsa's main role is to develop Labuan's financial infrastructure.

To further ensure Labuan's development into an IOFC of international repute, the Malaysian Government has identified the shortcomings in Labuan. A series of development projects have been identified.

These projects, which will cater for both the short and long-term needs of investors in Labuan, are already being implemented in some cases, and others are in the final stages of planning prior to commencement of work.

As the development of Labuan needs concerted and co-ordinated efforts by public agencies as well as private individuals to ensure its effectiveness, the Labuan Development Authority was formed in 1992 under the chairmanship of the Economic Adviser to the Government, Tun Daim Zauddin, to ensure the synchronisation of the island's overall infrastructural planning.

Being strategically located in the centre of the Asia-Pacific Rim and with close geographical proximity to many Asian capitals, Labuan is in a good position to attract surplus funds in the Asia-Pacific region.

While Europe and America have developed a number of IOFCs to serve their needs, Asia has not.

The Asian market is a new phenomena and the offshore industry here is in its infancy, apart from Hong Kong and Singapore.

So it makes good economic sense for Labuan to serve this region. There is no doubt that the Asia-Pacific region offers immense opportunities for both lending and fee-based business.

An indication of the potential lending opportunities in the Asia-Pacific may be seen in the size of the offshore banking business conducted in Hong Kong and Singapore.

When Labuan was established in 1990, international financial statistics published by the International Monetary Fund indicated that in the case of Singapore's Asian Currency Unit, its asset base from modest beginnings in 1968 has risen, from US\$888 million (RM2,202 million) in 1971 to US\$280 billion in 1989, an increase of more than 300 times over an 18-year period.

Over the same period, the assets of the Hong Kong offshore market increased from US\$1.8 billion to US\$356 billion, an increase of about 200 times. In 1989 alone, the rate of growth of the ACU asset base over the previous years was 22 per cent, compared with 15 per cent increase in the asset base of the Hong Kong offshore market during the same period.

At the same time on the home front, the lending opportunities from Malaysia alone were quite substnatial. Total offshore borrowings by Malaysians in 1990 amounted to RM5.6 billion, compared with offshore borrowing of RM3.7 billion during 1989.

These borrowings were taken by non-resident controlled companies, resident controlled companies, non-financial public enterprises and individuals to finance various investments, including the purchase of immovable property.

Today, this trend is expected to continue and the Central Bank is encouraging all residents wishing to obtain offshore borrowings to derive their requirements from Labuan.

The offshore financial world is highly competitive with many centres trying to carve out their own particular niche in the world market. In the Asia-Pacific region, Singapore and Hong Kong are relatively well established and, therefore, it is necessary for Labuan to do its utmost to compete.

But Labuan has a number of prime advantages, namely it is a zero tax haven compared with the low rates offered by Singapore and Hong Kong and the prevailing view is that the tax incentives offered in Labuan are far more attractive than those at the other two financial centres.

Labuan is also in the same time zone or within an hour or two of the majority of the countries in the region. This is of particular importance in many financial transactions where time is of the essence and where often verbal communications is required in addition to communications by telex or fax.

It is also anticipated that Labuan will be the heir to Hong Kong when the latter enters a new era, that as part of China by July 1, and the political uncertainty prevailing thereto would help to induce investors to choose Labuan.

Competitive rates offered for both loans and deposits has also helped to drive business from Singapore to Labuan, Surprisingly, having recently discovered the existence of Labuan as a "safe haven", investors from Taiwan have increasingly parked their funds on the island.

This interest was said to be initially driven by fears of conflict after China's military exercises in the Taiwan Strait during Taipeh's presidential elections in March last year.

Malaysia has been generally regarded as a world leader in Islamic banking - it has come a long way since Bank Islam began its operations in 1983. A combination of guidance from the central bank and the Government has paved the way for the incorporation of interest-free banking schemes by 48 financial institutions in the country.

Today, 47 financial institutions offer Islamic banking alongside conventional banking schemes, while Bank Islam is solely engaged in Islamic banking. Malaysia also offers an Islamic interbank market, two takaful (Islamic insurance companies), several Islamic will trusts, Islamic corporate bonds and an Islamic banking institute.

So it is a logical step to extend Islamic banking to Labuan. The Dubai-based Islamic Economics Journal estimates that the funds of Islamic financial institutions around the world stand at US\$152 billion and some of these funds are parked in interest-free accounts around the world.

Labuan's financial community believes that the relative shortage of global investments based on Islamic principles coupled with Malaysia's known successes at financing projects on Islamic basis and launching of capital market products like Islamic bonds would attract Islamic investors to the IOFC.

The strong progress Malaysia has made in developing a feasible, commercially viable system of Islamic banking could put it on the brink of tapping into a massive pool of global Islamic funds.

In an interview with Business Times in August last year, the Director-General of Lofsa, Dr Awang Adek Hussain, said that in its effort to develop Labuan as an Islamic offshore financial centre, Lofsa was now working with Islamic scholars to identify potential offshore activities and products and an international conference on Islamic instruments in Labuan was also being planned.

Initiatives such as these will escalate the financial engineering abilities of Islamic financial institutions whilst gaining an in-depth understanding of the working mechanics of Islamic instruments. It would seem that Labuan is slowly metamorphosing itself into a leading Islamic IOFC.

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