II Labuan IBFC special report

INTERNATIONAL INVESTMENT

Labuan IBFC
International Business and Financial Centre, Malaysia

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Welcome

Mark Battersby introduces II's special report on Labuan IBFC

Mark Battersby
Editor,
International **Investment**

As economies emerges from pandemic lockdowns, this year has seen Labuan International Business and Financial Centre (Labuan IBFC) forge ahead on multiple fronts to position itself not just as a key play in the Asian economy but across the world.

Labuan IBFC is not only Asia and MENA's fastest-growing risk and reinsurance wholesale intermediation market, boasting more than 220 license holders, it is also the only jurisdiction in Asia that provides for the protected cell company (PCC) structure, with more than 10 PCCs licensed to date.

Our special report drills down into the unique role this free zone plays as it carves a special place on the international stage.

Our overview article shows how since its establishment over 30 years ago in 1990, Labuan IBFC has become an ever more integral component of Malaysia's economy with its latest contribution of about RM4.6bn in the nation's fiscal revenue collection arising from the new tax regime in 2019 and 2020.

We also feature insights by Labuan IBFC on how it has embraced the rapidly evolving development in line with international standards.

A further focus in our special report is on how Labuan IBFC is becoming an innovative base for Islamic financial products, home to the world's first USD-denominated exchangeable sukuk which has reinforced Malaysia's position as the global leader in sukuk issurance.

Captive insurance and its huge potential is another area where Labuan IBFC points towards Asia leading the way.

Labuan IBFC looks to be setting the pace as one of the fastest growing domiciles in the world with a strong commitment to innovation, which bodes well for a bright future.

Labuan IBFC overview

Located off the coast of East Malaysia on an island named Labuan, in the heart of Asia-Pacific, the Labuan International Business and Financial Centre (Labuan IBFC) contributed more than 60% to the gross domestic product (GDP) of the jurisdiction in 2021.

Since its establishment over 30 years ago in 1990, Labuan IBFC has become an ever more integral component of Malaysia's economy, with its latest contribution of about RM4.6bn (£820m) in the nation's fiscal revenue collection arising from the new tax regime in 2019 and 2020.

Labuan IBFC is also one the largest employment providers, with more than 6,000 people employed in the financial services sector or 15% of the Labuan's total employed workforce.

In addition, the international financial centre has contributed to more local spending and other economic spin-offs in the island as it has added to the workforce and increased in demand for office spaces, commercial building and eating places.

Playing an intermediation role to facilitate trade, investments and financial capital flows into Malaysia, Labuan IBFC also enables Malaysians investing overseas to use Labuan as a conduit for outward investments.

> Labuan IBFC is Asia and MENA's fastest-growing risk and reinsurance wholesale intermediation market

Labuan FSA, which is under the Ministry of Finance (MoF), is responsible for the development and administration of Labuan IBFC.

The regulator has built up a wide range of international links with a wide range of organisations such as the International Association of Insurance Supervisors (IAIS), Group of International Insurance Centre Supervisors (GIICS), Group of International Finance Centre Supervisors (GIFCS), Asia/Pacific Group on Money Laundering (APG), Financial Action Task Force (FATF), and International Organisation of Securities Commissions (IOSCO).

This has enabled Labuan IBFC to establish different channels of cooperating with overseas regulators in supervising the activities of Labuan entities.

Labuan IBFC is Asia and MENA's fastest-growing risk and reinsurance wholesale intermediation market, boasting more than 220 license holders.

It is also the only jurisdiction in Asia that provides for the protected cell company (PCC) structure, with more than 10 PCCs licensed to date.

Farah Jaafar, CEO of Labuan IBFC, highlighted recently how Labuan IBFC's captive insurance business had continued its upward trajectory in 2021.

"As at 30 September 2021, nine new captives were formed, representing more incorporations than we enjoyed during the whole of 2020. We are now home to 64 captives and in terms of premiums, 70.2% originate from international markets – clearly indicating a coming of age and maturity of the market, making Labuan IBFC a global domicile of choice."

Industry practitioners, via the Labuan International Insurance Association (LIIA), have recently set up a globally represented captive subcommittee aimed at further strengthening the captive proposition via close cooperation and discourse with Labuan IBFC's regulator, Labuan Financial Services Authority (Labuan FSA) to augment and improve the captive industry as a whole.

Nik Mohamed Din Nik Musa, Director General, Labuan FSA

"Despite the various challenges, especially regulatory challenges, facing Labuan IBFC, one fact that becomes increasingly clear for Labuan FSA is that it has to be agile", Labuan Financial Services Authority Director General Nik Mohamed Din Nik Musa said in an interview with Malaysia's national news agency Bernama in conjunction with Labuan FSA's 25th anniversary (1996-2021) this year.

Nik Mohamed Din, who became Director General from 1 May this year, alongside Datuk Siti Zainab Omar as its chairman, said: "Agile to developing solutions that address the evolving needs of international regulatory reforms, businesses and financial markets to match the evolving trend and catch up with the latest global developments."

Nik Mohamed Din said Labuan FSA needs to align to global development to ensure that Labuan IBFC continues to remain relevant in the competitive business landscape. "This will also help Labuan IBFC adopt new norms in the changed business landscape such as increase utilisation of digital channel, more engagement with the industry to forge more facilitative or market-boosting initiatives to spur growth, enhance existing business and regulatory policies and processes for niche sectors such as digital financial services, captive insurance, and Islamic finance," he said.

Since the establishment of the Labuan FSA 25 years ago, the guidance and leadership of Labuan FSA had been instrumental in charting the growth and development of Labuan IBFC which correspondingly contributed towards the physical and socio-economic development of Labuan as a whole.

Nik Mohamed Din said Labuan FSA had also continuously been deepening Labuan IBFC's business propositions to create greater value for investors. "Labuan IBFC views Asia as a strategic growth area and more than 70% of the entities incorporated originated from this region. By offering a regional home to businesses across Asia, Labuan IBFC seeks to play an important role as a facilitator of trade and investment," he said.

Nik Mohamed Din said Labuan IBFC's pragmatic midshore proposition combines the ease of doing business with high international standards of regulation and supervision, making the jurisdiction the ideal base for global business trailblazers seeking innovative growth in Asia.

> "The pandemic has posed an unprecedented challenge to Labuan FSA and Labuan IBFC

Labuan IBFC now hosts several top-ranked financial institutions and intermediaries, and it also has a pool of professional service providers serving clients from around the globe. "Labuan IBFC has welcomed more than 5,000 operating companies, which include more than 850 licensed entities in banking, insurance, reinsurance, risk management, leasing, capital markets digital financial intermediation and wealth management with parallel offerings in Islamic finance," he said.

As for the Covid-19 pandemic, it had upended nearly every aspect of life: "The pandemic has profoundly impacted and posed an unprecedented challenge to Labuan FSA and Labuan IBFC. The global economic slowdown and travel restrictions had impacted some of the business activities in Labuan IBFC," he said.

Labuan FSA has provided temporary regulatory reliefs to alleviate some of the regulatory burdens and offered flexibility to the market to keep businesses viable.

2021 and beyond

Looking to the future, Labuan IBFC is envisioned to become a digital-based gateway with Islamic finance capabilities for all global investors and players as the future of Islamic finance looks ever promising.

This year, Labuan FSA launched two key policy documents – The Guiding Principles on Business Continuity Management to enhance the Labuan financial institutions' operational resilience; as well as a digital governance and cyber resilience framework which aims to protect DFS providers from cyber threats.

As at September 2021, the number of DFS providers that have been approved to operate in the Labuan IBFC digital space has grown to 85 licensees, having licensed 25 intermediaries as of September 2021. The key licensees include two digital banks, one insurtech and one digital securities exchange, 16 payment systems providers, 18 credit token issuers and 33 money brokers (digital currency exchanges). Out of the total number of DFS providers in Labuan IBFC, the majority were licensed to provide digital currency trading platform, issuance of digital token and e-payment system or e-wallet.

Labuan IBFC's debut as a digital friendly jurisdiction began in 2017 with just one licence and has since expanded with a wide range of digital businesses and players, from digital banking and insurtech to intermediaries such as robo-advisory, digital asset exchanges, crypto trading platforms, tokenisation licences and e-payment systems.

Having celebrated its 30th year of establishment in 2020, Labuan IBFC is now home to more than 5,000 active entities, which include 70 banks, 232 insurance and insurance-related entities, 65 trust companies and other business sectors, with an ecosystem creating a robust environment promoting the growth of digital business.

"Being home to one of the fastest-growing digital families in Asia, our ethos of constant engagement with industry coupled with innovation and facilitation, puts us in good stead to embrace the next digital evolution, governed by sound regulatory parameters, Labuan IBFC's Jaafar said, "This curates a regulated digital ecosystem, providing synergy between wholesale financial intermediation and digitalisation allowing our licensees to operate in a facilitative borderless environment."

Mark Battersby
Editor, International Investment

Pragmatic and evolving digital regulation

A torrent of technology-driven innovation in financial markets and services has reshaped how markets are structured; how companies access and deploy capital; how investors respond and react to information and how customers receive and use financial services in their new innovative form. Faster response to rapid technological advancement and shifting market dynamics require fresh thinking as to how regulation can best foster the responsible development of this digital industry.

Similarly, as an international financial marketplace, Labuan IBFC is no exception to a more agile and iterative rulemaking process. The Authority has been promoting digital innovation for business solutions that are tailored to current market needs, whilst ensuring businesses are conducted in a conducive and safe operating environment.

Regulatory enhancement for digital businesses

Current digital transformation megatrends are fast changing the way financial institutions operate. These require rapid regulatory responses that are appropriate to the nature and complexity of the financial institutions' digital and virtual operations. The Authority recognises that no single regulatory model fits all, and divergent regulatory frameworks in a complex, fast-moving landscape can add complexity, create uncertainty and dampen innovation. Against this backdrop, the Authority developed the appropriate prudential policy measures to safeguard the Labuan financial institutions (LFIs) from the cyber vulnerabilities and prepare the market to embrace digital transformation in the new norm operating landscape. The measures were aimed at:

(i) enhancing business contingency planning to minimise material consequences arising from any major operational disruptions; and
(ii) strengthening cyber resilience for digital operations to ensure operational agility and efficiency.

Enhancing market practices for business contingency and cyber resilience

As As part of initiatives to ensure that LFIs maintain operational resilience and effectively manage the emerging cyber risks and other related vulnerabilities arising from digital transformation, the Authority had embarked on regulatory policy enhancements as depicted in the diagram below.

Measures to enhance business continuity and cyber resilience

	BCM Guiding Principles	Digital Governance Framework
Governance Oversight	Board and senior management oversight on: • Business continuity management • Digital and cyber resilience policies	Corporate oversight on: • Business continuity arrangement • Cyber risk internal controls
Risk Management	Assessment and monitoring of potential disruption risks Business impact analysis	Cyber risk management Digital security controls
Recovery Strategy	Alternative recovery arrangements	Backup plan for critical data
	Disaster recovery planning	
	Stakeholders' communication plan for business contingency activation and cyber incidents	
Awareness and Training	Periodic training and awareness on: • Business continuity preparedness • Cybersecurity management and emerging threats	

The following are the key policy enhancements that are being undertaken by the Authority:

(i) Guiding Principles on Business Continuity Management which provided principle-based requirements for LFIs to:

- maintain a sound and effective business continuity management (BCM) with board and senior management oversight;
- assess and mitigate risks from major disruptions, concentration of critical business functions and outsourcing arrangements as part of its BCM;
- adopt recovery strategies that reflect the magnitude of the potential disruption risks to the LFI's critical business operation;
- develop the IT disaster recovery plan for critical business functions and related technology infrastructure to provide assurance to relevant internal and external stakeholders of LFI's preparedness in the event of a major disruption;
- conduct a continuous organisation-wide awareness and testing for business continuity and resumption plans;
- develop an effective communication plan to address the reputational risks; and
- undertake periodic review and maintenance of approaches and strategies for business continuity to assess the LFI's operating environment and business circumstances.

(ii) Digital Governance Framework that is intended to inculcate effective management of cyber risks by requiring the LFIs to:

- ensure that its digital governance and cyber risk management is overseen and approved by the board and senior management;
- maintain enterprise-wide strategies to preserve data confidentiality, systemsecurity and resilience in a systematic and consistent manner;
- implement robust security controls that are matched with the risk and complexity of its digital services on continuous basis;
- effect obligations of the external service provider for the outsourced IT systems and digital services in the service legal agreement; and
- conduct awareness programme and participate in trainings for emerging cyber risks and digital-related issues to mitigate cyber threats and vulnerabilities.

Labuan IBFC's Digital Toolbox

Labuan IBFC has been progressive in embracing the rapid evolving fintech development in line with international standards of compliance, transparency and prudential requirements, and will continue to benefit Labuan IBFC moving forward.

Islamic Finance to be the Fulcrum of Labuan's Inclusive Future

Introduction

By Farah Jaafar,
Chief Executive Officer, Labuan IBFC

At 1.7 billion people, the global Muslim population represents more than 23% of the world population. With Islam being one of the fastest growing major religions in the world, the share of the global Muslimpopulation is expected to increase 25% by 2030.

With a complete suite of Islamic financial structures and solutions, effective regulatory standards, a facilitative business environment as well as a Shariah Supervisory Council (SSC), Labuan IBFC is well-positioned to cater to the needs of the global Islamic industry.

Underpinning these innovative structures is Labuan IBFC's comprehensive infrastructure with dedicated legislations, Shariah governance and fiscal incentives for Shariah-compliant financial transactions providing a facilitative and flexible framework for industry players.

Operating as an Islamic financial entity in Labuan IBFC, means that Shariah compliance is endorsed by the Labuan Financial Services Authority's SSC comprising leading global Shariah scholars and practitioners. Unlike other similar bodies in other jurisdictions, Labuan IBFC's SSC takes on a supervisory role, not merely advisory, and hence SSC rulings are able to be used as reference in the court of law.

With this infrastructure, Labuan IBFC has become an innovative bed for Islamic financial products. It is home to the world's first USD denominated exchangeable sukuk and reinforced Malaysia's position as the global leader in sukuk issuance.

Unexpected events

Last year started off with a series of unexpected events that would have profound impact to the international market and businesses. Global situations including economic uncertainty, trade war, depressed oil prices and the Covid-19 pandemic posed great challenges to the financial world.

With the growing scale of the Covid-19 pandemic and its social and economic impact, particularly on Labuan island, Labuan IBFC's financial services and intermediation community comprising Labuan Financial Services Authority, Association of Labuan Banks, Labuan International Insurance Association, Association of Labuan Trust, Labuan Investment Bank Group and Labuan Fintech Association, banded together to assist local authorities in relief efforts via the pooling of resources. The formation of the Labuan IBFC Covid-19 Fund focused on providing relief to frontliners, local hospitals, quarantine centres and those less fortunate in Labuan.

Labuan Financial Services Authority (Labuan FSA) also announced Temporary Regulatory Reliefs (TRRs) for Labuan entities to help cushion the impact and disruption to business operations caused by the coronavirus pandemic. The TRRs provided administrative and financial relief to Labuan entities during the Covid-19 crisis as well as facilitated uninterrupted business and market operations in Labuan IBFC.

Labuan FSA also took a facilitative approach in catering to the unique challenges caused by Covid-19 by allowing digital alternatives where possible, whilst ensuring regulatory standards were set both within the jurisdiction and that international requirements were not mitigated.

> "Islamic fintech is by nature financially inclusive and aims to promote economic well-being

Huge potential

Since the introduction of digital financial services (DFS) in 2018, there has been an influx of digital set-ups ranging from digital banking, insurtech to digital-based intermediaries in Labuan IBFC and this is expected to grow even more in the coming year. To date, there are fifty license holders in the digital space ranging from financial services such as digital banks, Insurtech and robo-advisory to digital intermediaries such as digital asset trading platforms, e-wallets, Security Token Offering (STO) issuances, etc. Labuan IBFC is also home to two digital securities exchanges.

Labuan IBFC recognises the huge potential of the Islamic fintech landscape, with Islamic green financing being an important service that helps financial institutions adjust their balance sheets and optimise their economic capital to meet Basel III Accord requirements. Armed with Shariah principles, values and goals, Islamic fintech is by nature financially inclusive and aims to promote economic well-being and creates socio-economic equitable distribution which is in line with the spirit of the United Nation's Sustainable Development Goals.

The ethos of a digital Labuan is that there are no 'sandboxes' to better facilitate digital players and inclusion with the usage of existing licenses that apply digital solutions in their business processes. The jurisdiction also remains tax neutral and currency agnostic, which can ease the setting up of a digital startup.

Strategic plans

2020 marked 30 years of innovation, intermediation and inclusion for Labuan IBFC and Labuan's birth as an international wholesale trade, finance, risk and asset intermediation centre.

The business and financial landscape post Covid-19 is fraught with uncertainties and challenges. However, we firmly believe that the situation can be managed with the support of all stakeholders. Strategic thrusts have been put in place to chart Labuan IBFC's way forward including measures to enhance the role of the jurisdiction to intermediate regional businesses.

Indeed, as a midshore jurisdiction with a clear appreciation of the value of proportionality in regulation and a bespoke approach to market engagement, we strongly believe it is this philosophy that is a prerequisite during these times of change, and will serve us well moving forward.

Democratisation of self-insurance: Could Asia lead the way?

When it comes to risk management, the adage ‘failing to plan is planning to fail’ rings truer than most, but is the luxury of planning limited to entities with deep pockets?

Globally, captives are the most prominent instrument for alternative risk transfer (ART) market and yet, with the world’s GDP amounting to almost $90trn, should there not be a faster uptake of captives globally and especially so in Asia? After all, Asia is home to more than 50% of the world’s GDP, according to the World Bank, and 40% of all Fortune 500 companies.

In theory, Asia should have a larger number of captives, however numbers do not support this current assumption. Could it be that the harder reinsurance market coupled with greater awareness as well as the understanding of captives will lead to the tipping point for the growth of captives in Asia?

At present, only 6% of parent captives are from Asia. Overall, Asian domiciles have fewer than 200 captives, with Labuan IBFC being the fastest-growing domicile for captives in Asia and MENA, having licensed a quarter of all captives in these regions. Labuan IBFC has progressively shown an upward trend, with eight new captive formations in 2020 and six formations in the previous year.

> “As a jurisdiction in Asia, by Asia, for all, we believe the potential for growth in Asia is much larger and wider

In 2020 more than a third of all premiums written in the jurisdiction were from captives, with the industry expecting this percentage to grow in 2021. This expectation is founded on the fact that growth in incorporations remains unabated in 2021, with eight new captives formed in the first half of 2021 alone. We believe that the growth seen in the jurisdiction is merely the beginning of a coming of age for Asian self-insurance vehicles.

Much has been said about the unrealised potential growth in Asia, pointing at a general lack of awareness amongst the risk management and board level professionals, to the misconception that captives are somehow a tax-dodging vehicle, to the assumption that the only way a captive would be economically beneficial would be if the premiums placed into the captive vehicle runs into tens or hundreds of millions dollars.

Other potential reasons being bandied include the possibility of large conglomerates that make up most of the businesses in the region already own commercial insurance companies, with mergers and acquisitions between large companies involving captive subsidiaries as well, and as such negate the need for a new captive/self-insurance set-up.

As a jurisdiction in Asia, by Asia, for all, we believe the potential for growth in Asia is much larger and wider. The current ever-hardening conditions in certain markets, the unavailability of cover for increasingly esoteric risk profiles, the acceptability of self-insurance vehicles generally and greater awareness as well as appreciation of strategic risk management solutions are all key factors towards this expected growth. Another key element of this virtuous confluence is cell captives.

Enter cell captives

Asians are notorious for being cost sensitive, and while the cost benefit of a traditional pure captive structure is undeniable, the time it takes to enjoy these savings for some Asian risk owners can sometimes seem too long. This is where the availability of cell captives comes to the fore, and we believe this will spur the greater appreciation of pure captives as a strategic risk management tool to be considered for a medium term timeline.

Much has been said about the lack of a strategic risk management element in the usage of cells as "band aid" for risk cover, referencing the use of cells as a stop-gap measure for risk that is harder or too expensive to place in the conventional reinsurance market.

And while this might be true, it does not negate the advantages of cells that provide for a fast and cost-efficient solution to such risk profiles. In a well-regulated eco system such as Labuan IBFC that boasts a wide range of self-insurance structures and a strong ecosystem of intermediaries, cells are seen as an efficient (cost-wise and operationally) conduit for medium sized entities to begin their self-insurance journey.

The availability of conversion of a cell into a full-fledged captive is present in mature jurisdictions like Labuan IBFC, and is made even more seamless with a regulator like the Labuan Financial Services Authority taking a proportionate business-friendly approach to the intermediation of wholesale financial risk.

Cell captives may or may not act as a replacement to pure captives, but in the current times it does provide an opportunity for all entities, large and small to reap the benefits of self-insurance as they continue to manage the ever-evolving risk landscape their businesses are facing. And as the understanding and appreciation of self-insurance increases in Asia due to the ready availability of cells, we expect the growth of pure captives to also increase as these businesses will plan ahead for a more holistic strategic risk management.

> "A full understanding of the ecosystem available in each centre able to support the running and maintenance of a captive vehicle is key

Universal factors to consider when setting up a captive

The increased interest in captives has also meant an increase in scrutiny. A classic example: captives are now subject to the administrative burden to demonstrate it is a genuine risk management tool based on the Organisation for Economic Co-operation and Development's (OECD) Base Erosion Profit Shifting (BEPS) guidelines. In a way, this has reduced the misconceived notion mentioned earlier that captives is somehow a "tax play" by companies looking to reduce their fiscal burden.

Other considerations that need to be factored when it comes to captives are also the capital commitment and the risks-averse results. The current low interest rate environment and the lack of more efficient capital utilisation means businesses should seriously think through the additional benefits of considering a captive formation. Another crucial consideration is a potential exit strategy of the captive, which is often a vital aspect that is overlooked when planning to set up a captive.

Other challenges include differing regulations from one jurisdiction to the other, which although on surface may seem disparate, at the core are similar from one jurisdiction to another. What is key is a full understanding of the ecosystem available in each centre able to support the running and maintenance of a captive vehicle.

Captive as an integrated risk management strategy

Clearly there are benefits to considering a captive solution towards mitigating corporate risks and if managed efficiently, there can even be additional benefits derived from the management of retained profits within the captive structure.

In addition, the growing importance of risk management further stimulated by regulators and shareholders in relation to corporate governance, and the pressure of earnings and capital management from shareholders, all render the need for flexibility that captives offer.

Overall, even during these demanding times, the benefits of captives as a risk management tool still outweigh its perceived challenges.