

LABUAN INTERNATIONAL OFFSHORE FINANCIAL CENTER (LABUAN IOFC): PERFORMANCE, CHALLENGES AND PROSPECTS

Nursilah Ahmad

Zurina Kefeli @ Zulkefli

Islamic University College of Malaysia

Abstract

Labuan was declared as an International Offshore Financial Centre (IOFC) in 1990, with a goal of developing an international Malaysian capital market. Malaysian government has spared nothing in building up-to-date infrastructures in Labuan to portray the image of world class IOFC. Its objective is to be a financial 'supermarket' offering a wide range of offshore financial products, which specializes in Islamic financial instruments. Labuan has done well at the onset of its operation by attracting some renowned world-class international banks, including triple-A rating of Bayerische Landesbank. However, the financial crisis that hit Asia in 1997 did indeed some damages to the rising IOFC. In the meantime, many Islamic countries are also in doubt on some of its Islamic financial instruments, making its niche fumbled. Recent developments in Islamic financial instruments, nevertheless, have given Labuan its much needed vehicle to survive and excel.

Abstrak

Labuan telah diisytiharkan sebagai Pusat Kewangan Labuan Luar Pesisiran Pantai Antarabangsa (IOFC) pada tahun 1990 dengan matlamat membangunkan sebuah pasaran modal antarabangsa di Malaysia. Kerajaan Malaysia telah membina kemudahan infrastruktur terkini di Labuan bagi menggambarkan IOFC yang bertaraf dunia. Objektif IOFC ialah untuk menjadi sebuah pasaran kewangan hebat yang menawarkan pelbagai produk kewangan luar pesisir pantai yang mengkhususkan kepada instrumen kewangan Islam. Pada peringkat permulaan, Labuan telah berjaya menarik perhatian

bank-bank antarabangsa yang bertaraf dunia termasuk penarafan 3A oleh Bayerische Landesbank. Walau bagaimanapun, krisis kewangan yang melanda Asia pada 1997 telah memberi impak negatif terhadap peningkatan IOFC. Selain daripada itu, banyak negara Islam masih sangsi terhadap sesetengah instrumen kewangan Islam membuatkan pasarannya tidak menggalakkan. Namun begitu, perkembangan terkini dalam instrumen kewangan Islam ini telah memberi semangat baru kepada Labuan untuk terus berkembang maju.

INTRODUCTION

Those who are keen about financial activities probably have heard of Labuan and its vast potential. Targeting an untapped market of Islamic investment and securities, Malaysian government realizes the fact that there has not been any close financial offshore available in the neighborhood. Labuan has what it takes. A huge investment in infrastructures, strategic location and undivided support from the government makes Labuan a new force to reckon with.

Now, after more than 10 years in operation, Labuan is still vulnerable to many unintended economic downturns. The financial crisis in 1997 and the subsequent slowdown in economic activities have indeed leaved inevitable scars on the Labuan performance as a financial center.

Moreover, many Moslem countries are still skeptical about the shariah conformity of Labuan's Islamic financial instruments. Many are accusing Malaysian government of applying a so-called 'cosmetic changes' to the whole range of Islamic financial instruments up for grab at Labuan.

All these unpleasant phenomena are undeniably important to be looked at so as to ensure that Labuan can continue to cater its world-class offshore financial services. This paper focuses on Labuan's performance until 2001 and discusses some challenges and prospects that it possess so as to survive in the world of integrated and highly competitive financial markets.

The next two sections tell historical background of Labuan as the financial center and some of its regulatory frameworks. The paper's core sections which are Labuan's performance, challenges and prospects follow in order.

LABUAN: HISTORICAL BACKGROUND

The Federal Territory of Labuan is a tiny island some 10 km off Sabah, in

the east coast of Malaysia. Labuan was declared as an International Offshore Financial Centre (IOFC) in 1990 with the two-pronged goals of complementing and developing Malaysian capital market. Strategically located on the major shipping and air routes of the ASEAN region, Labuan operates basically on the same time zone with other financial markets in Asia such as Hong Kong, Singapore and Tokyo and business operates round the clock. Since Labuan is a free port, there is no sales tax, surtax, excise or import and export duties levied, except for duties on petroleum and petroleum based products.¹

With the aim of developing the eastern part of Malaysia, Dr Mahathir envisioned Labuan to become "Pearl of the South China Sea." The Brooke family, the famous "White Rajahs" of Borneo had dreamt of turning Labuan (in Malay Labuan means "safe place" or "anchorage") into a free port and trading centre. The saga was transformed into reality.

Following yet another vision of Prime Minister Dr. Mahathir Mohammad, Labuan has transformed itself from a sleepy fishing community with less than 35,000 population with unemployment rate of 11% during late 80's into a vibrant business community with 60,000 inhabitants with hardly any structural unemployment within just a few years.² Since its birth as an IOFC in 1990, Labuan has attracted about 1,000 offshore and support companies, not a small achievement given her tender age⁵

LABUAN: REGULATORY FRAMEWORK⁴

As an international offshore financial center, Labuan is offering credit facilities and receiving deposits, offshore investment banking business, Islamic banking business, building credit business, credit token business, development finance business, leasing business or such activities as approved by the Minister of Finance.

The Offshore Banking Act (OBA) 1990 provides a regulatory framework for Labuan. The act allows for the application of an offshore banking

¹ When Labuan first operated, corporate tax was only 3%. There is no stamp, inheritance, death or estate duty. Other items are not subject to withholding tax. It became a major attraction compared to the neighboring country of Singapore.

² *Malaysian Business*, February 16, 1997.

³ 1997 statistics. As a comparison, Jersey and Isle of Man - fully developed IOFCs, have only 80 offshore banks during 30 years of operation.

⁴ MIDA Homepage

license for the setting up of a branch or subsidiary. OBA Act enables any financial institutions in Labuan to guarantee the secrecy and confidentiality of its customers unless authorized by the customers. An officer or director of an offshore bank is *'prohibited from giving, reproducing or disclosing any information or document relating to the affairs or account of its customers to any persons, unless authorized in writing by the customer or his personal representatives.'*

To self-guard itself against the problems of adverse selection and moral hazards, Labuan required a strong self-regulatory code of conduct which emphasis on the concept of 'knowing your customer.' Accepting cash deposits and opening an account for an unknown customer is prohibited to prevent Labuan to be another safe haven for money-laundering business or illegal activities.

To ensure that a bank has enough capital, capital funds of at least RM10 million (about US\$4 million) is required for an applicant setting up a subsidiary in Labuan. During the early period of its establishment, Labuan will only accept the top 200 banks in the world, even though the regulation has been relaxed by early March 2000. However, only banks with sound track records would be considered.

LABUAN: PAST AND CURRENT PERFORMANCE

"We are still young, but at the same time, we do not have the luxury of time to develop in a progressive manner as there is no mercy in the highly competitive and crowded offshore world. We must therefore learn and act fast." (Governor of Bank Negara)

Labuan strives to be a premier IOFC, a quality player and investor in the Asian region. Its objective is to be a financial 'supermarket' offering a wide range of offshore financial products, which specializes in Islamic financial instruments. Special focus of Labuan is in the areas of trust business, insurance industry, fund management and deepening banking activities via treasury management and investment banking.

Two basic requirements for any IOFC to take off are convenience and confidentiality. Malaysia has guaranteed the confidentiality by declaring that neither the Ministry of Finance nor the Central Bank will inquire into "identity, accounts or affairs" of any customers in Labuan.⁵ Convenience -

⁵ Vatikiotis, *Far Eastern Economic Review*, 1994.

due to lack of infrastructure - was the major factor that recorded sluggish financial activities⁶ during Labuan's early days.

Malaysian government has spared nothing in developing Labuan.⁷ The physical and human infrastructures are upgraded to provide conducive social, economic and legal environment. Those facilities include construction of RM360 million Financial Park Complex, the so-called 'nerve center' of Labuan, modern hospital, international school, airport terminal worth RM120 million, earth telecommunications satellite (RM35 million), fiber-optic submarine cable system (RM800 million) and new roads (RM60 millions). Power supply, drainage and sewerage systems are also upgraded. The effort is epitomized through the creation of one-stop agency LOFSA (Labuan Offshore Financial Services Authority).⁸ LOFSA oversees the regulatory aspect of the IOFC, and is responsible for licensing, supervising and regulating offshore financial services and activities.

At the end of 2001, more than 3,000 offshore and supporting companies have been established in Labuan.⁹ The growing number of companies indicates Labuan increasing popularity. Malaysian Business reported that '... Out of the 10 largest banks in the world, eight are present in Labuan, while of the top 20 banks, 17 are in Labuan and if one were to consider the world's top 50 banks, 34 of them are in Labuan. In terms of nationality, 14 countries ... Japan, Britain, Belgium, France, Germany, Switzerland, the Netherlands, Hong Kong, Taiwan, Singapore, Canada, the United States, Australia and Ireland.'

⁶ During the early days, the bulk of the financial activities were financed domestically. The money was injected from the nation's EPF and Permodalan Nasional Berhad (PNB).

⁷ Seventh Malaysian Plan has allocated RM34 million to build infrastructure in Labuan. Another RM2.5b is allocated to turn her into world class resort and financial center by 2002.

⁸ LOFSA is chaired by the Governor of Central Bank (Bank Negara Malaysia). Datuk Zamani Ghani chaired LOFSA on Dec. 15, 1998. The set-up of LOFSA might be the wisest choice for the government since financial analysts are worried that Bank Negara would keep a tight reign on Labuan. Details and the Annual Report of Labuan is available at www.lofsa.gov.my.

⁹ *LOFSA Annual Report 2001*.

The financial crisis that hit Malaysia in June 1997 did leave a scar to Labuan. The impact was felt in 1998, when for the first time Labuan registered an audited loss of US\$268.9 million (RM1,021.82 million) since its establishment (see Table 1.1). Some financial experts dismissed the situation as just another downward swing in the business cycle. Labuan would be able to bounce back quickly. It did happen when the total pre tax profit increased to US\$57 million in 1999 and then increased more than twice in 2000. However the positive trend did not last longer when the total pre tax profit declined to its second lowest of US\$153 million in 2001.

Table 1.1: Labuan - Selected Indicators

Year	1996	1997	1998	1999	2000	2001
Number of Banks in operation	49	54	62	61	60	54
Total employees	500	535	569	536	519	498
Total pre-tax profit/(loss) (US\$m)	132.5	120.3	(268.9)	57	118.8	(153)
Total Assets (US\$m)	18,254	27,226	22,325	19,715	19,507	18,505
Total staff costs (US\$m)	13.4	14.3	12.3	13.7	13.5	12.7
Return on assets (%)	0.7	0.4	(1.2)	0.3	0.6	(0.8)
Pre-tax profit/(loss) per employee (US\$'000)	265	224.9	(472.6)	106.3	228.9	(307.2)
Staff costs per employee (US\$'000)	26.8	26.7	21.6	25.5	26.0	25.5
Average assets per bank (US\$m)	372.5	504.2	360.1	323.2	325.1	335.3

Source: Malaysian Business, November 1, 1999 and LOFSA 2001 Annual Report.

In order to go global, Labuan has ventured further by introducing Labuan International Financial Exchange (LFX) in March 2000. LFX is a virtual global exchange that traded financial and non-financial instruments including mutual funds, bonds, derivatives, insurance-linked products and possibly intellectual property rights 24 hours per day. Another virtual business that will carry Labuan via the net would be the creation of 'cybermall' when Labuan goes World Wide Web. Since Malaysia initiated the idea of multimedia super corridor (MSC), Labuan will get all the assistance it needs. The rest is up to how Labuan will market itself in the eyes of the virtual investors.

In making Islamic financial instruments Labuan's trademark, the proposed International Islamic Money Market (IIMM) will galvanize the effort. IIMM will operate 24 hours daily, seven days a week, US-dollar

based, to meet the demand for Islamic financing.¹⁰ LOFSA is working with Islamic Development Bank in setting-up a Liquidity Management House (LMH). LMH will play the role of Central Bank to the IIMM with appointed agents in selected financial centers. Labuan hopes to be short listed as one of the financial centers. In addition to that, the first full-fledged Islamic Offshore Bank Ltd (Labuan branch) was created in 1998 to strengthen Labuan's ability in providing Islamic financial instruments.

The following tables (Table 1.2 and Table 1.3) summarize the breakdown of major companies in Labuan from 1994 onwards.

Table 1.2 Growth of Offshore Companies and Support Companies

Year (as at end)	1994	1995	1996	1997	1998
Offshore Companies					
Banks	35	43	52	64	62
Insurance	4	4	8	11	17
Insurance-related	1	1	1	19	18
Fund managers	3	3	3	3	3
Trading and non-trading	313	543	873	1,513	1,713
Leasing	-	-	-	-	-
Support Companies					
Trust companies	11	13	17	20	20
Auditors	11	11	15	15	18
Liquidators	4	4	10	11	13
Total	382	622	979	1,657	1,870

Source: LOFSA 1998 Annual Report, adapted from Malaysian Business, March 16, 2000.

As indicated, the number of almost all offshore and supported companies increased from 1994 to 1997 before going slightly lower a year after. Of all the companies, the trading and non-trading companies have shown a tremendous increase in number, a growth of more than 400 percent.

¹⁰ In 1997, it was reported that the untapped global Muslim fund pool was estimated at US\$120 million.

Table 1.3: Offshore Banks - Key Data

Year (end of)	1996	1997	1998	1999	2000	2001
Number of banks in operation	49	54	62	61	60	54
Total Deposits (US\$m)						
• Malaysian Offshore Banks	2,543	2,834	601	1,399	2,197	1,545
• Foreign Offshore Banks	1,770	2,485	2,117	2,827	2,632	2,112
	4,313	5,319	2,718	4,226	4,829	3,657
Total Loans (US\$m)						
• Malaysian Offshore Banks	2,907	5,159	3,709	3,073	2,214	2,441
• Foreign Offshore Banks	9,055	12,294	11,414	10,288	9,212	8,797
	11,962	17,453	15,123	13,361	11,426	11,237
Number of Employees						
• Malaysian Offshore Banks	130	169	161	154	151	143
• Foreign Offshore Banks	370	366	408	382	368	355
	500	535	569	536	519	498

Source: Reproduced from Malaysian Business, November 1, 1999 and LOFSA 2001 Annual Report.

Table 1.3 shows some significant trends in total deposits, loans and number of employees among the Malaysian and Foreign Offshore Banks. The total deposits in the Malaysian Banks were greater than that in the foreign banks from 1996 to 1997. After 1997, the situation reversed. The Foreign Banks have received total deposits more than the Malaysian Banks, signaling as if there has been an attitude switch by the depositors. The depositors appeared to be more confident in depositing their money in the Foreign Banks rather than in the Malaysian Banks during the financial crisis.

In the meantime, the total loans for both offshore banks shows the same up and down trend. The total loans given increased from 1996 to 1997 but decreased after that. The same trend also reflects the change in the number of employees for both offshore banks.

LABUAN: CHALLENGES

The recent financial crisis turns many loans into non-performing loans (NPLs), reducing credibility and increasing debt servicing by 30% since RM has depreciated. In 1997, eight Malaysian banks in Labuan lend \$5.1 billion at home and in some troubled Asian countries such as Indonesia and

Thailand. Four big local banks - Maybank, Bank Bumiputera, Rashid Hussin and Bank of Commerce - lend \$718 million in 1997 to Hottick Investments; a Hong Kong incorporated company related to Renong's CEO Halim Saad. Hottick bought a controlling stake in National Steel Corporation in Philippines. Hottick fail to service the debt on February 20, 1998. Sime Banks reported huge losses from its Labuan unit through 300-400 million loans given to Thailand and Indonesia. Another \$250 million loan made to MR Investments to help finance the purchasing of Rashid Hussin Financial Securities companies puzzled some bankers in Labuan as to how the loan get approval despite strict requirement and regulation by LOFSA.¹¹

Banking sources criticizes the conservative nature of Malaysia's Central Bank (Bank Negara Malaysia) that keeps a tight currency regime and 'crowd-out' natural market for asset management by using EPF's funds to 'soak up' local funds. Bank Negara has also been accused of running a 'traditionally paternalistic role' in keeping speculators at bay.¹² Louise Paul, chairman of Association of Offshore Banks urges Malaysian government to liberalize the scope of activities in Labuan in order to be able to compete globally.¹³

The September 11 bombing of World Trade Center released a huge amount of Islamic capital from USA to the rest of the world. Malaysia, through Labuan, should grab the opportunities. But first and foremost, Labuan has to resolve the mist surrounding the controversial issue of being 'soft' on the shariah laws.

Severe criticisms towards the legality of *bay' al-inah* and *bay al-dayn* operations by Islamic banks in Malaysia explain why Islamic investors shy away from Labuan. Most Islamic bonds issued by Malaysian companies today have been heavily structured using *bay' al-inah* and *bay' al-dayn* contracts. However, they are not well accepted by the Middle-eastern investors who regard the contracts as something similar to *riba* based financing. Accordingly, Saiful and Mahmood (1999) discovered that there is no significant Shariah justification of *bay' al-inah* and the trading of Islamic

¹¹ Jayasankaran, S.

¹² Michael Vatikiotis.

¹³ Shirene Shan.

bonds at a discount using *bay' al-dayn* has been found unacceptable by the majority of ulama' including al-Shafie.

The continuous effort to win the heart of the Middle East investors and government might soon open the floodgate much needed to propel Labuan into becoming a premier IOFC that is second to none.

LABUAN: FUTURE PROSPECTS

Labuan's strategic location could be either a pull or a push factor for investors. On one hand, there is no other IOFC nearby to cater to the needs of growing neighborhood countries. On the other hand, investors prefer to have several IOFCs located nearby to ensure competitive rates. Labuan therefore has to deliver its promise to be the world class IOFC.¹⁴

Other incentives are the easing of entry requirements for the top 200 banks in the world. Tax rebate of 65% given to trust companies and 50% tax rebates to expatriates will be extended to another five years once it expired in 2000. Other tax exemptions would be on 'second-tier' dividends and stamp duty on shares and filing works.¹⁵

In terms of establishment, the existence of triple-A rating of Bayerische Landesbank, one of the only five triple-A rated banks in the world, in 1994 has earned Labuan the vote of confidence. Another firm, Labuan Re, specializing in reinsurance business also has been rated "A" for its claim-paying ability by MARC International Limited (US based). AM Best Company Inc. awarded Labuan Re "B++", a 'very good' category.¹⁶ Recently, the number of companies doing insurance and insurance related companies has become star performers in Labuan (see Table 1.4). The total number of Labuan insurance companies boost up from 11 companies in 1996 to 98 companies in 2001.

¹⁴ Labuan has minimal attractive tourism spots.

¹⁵ Abdul Razak Chik. Details on tax exemption is available in Bank Negara Malaysia's website (www.bnm.gov.my).

¹⁶ M.K. Megan.

Table 1.4: Growth of the Labuan Insurance Companies

Types of License	1996	1997	1998	1999	2000	2001
Life	-	1	2	2	2	2
General	1	2	2	2	3	3
Composite	-	-	1	1	1	1
Reinsurance	1	5	8	16	20	22
Captive	1	3	3	7	15	19
Insurance Manager	-	3	3	3	4	7
Underwriting Manager	3	3	4	5	8	8
Broker	5	13	17	23	30	36
TOTAL	11	30	40	59	83	98

Note: All data at year end

The introduction of captive insurance by the government to reduce banking risk will help gain back investors trust in Labuan. In a nutshell, captive insurance company is the company that provides insurance to its parent company and/or the parent's affiliates.¹⁷

LABUAN PROSPECTS IN THE GLOBAL ISLAMIC FINANCIAL MARKET

The prospects for growth of Islamic financial instruments are indeed exciting. Currently, the only two Malaysian Islamic Banks are in Labuan providing creative opportunities for investment and retail products as an alternative to those available through conventional means. Besides that, LOFSA is determined to attract foreign Islamic banks especially from the Middle East.

Labuan is introducing ADIL (*Amanah Dar al-Maal al-Islami Labuan*) - an Islamic growth fund - which is supported by internationally recognized *Dar al-Maal al-Islami* (DMI) Trust Group. ADIL operates on the concept of profit sharing and is designed to initially attract Middle East countries

¹⁷ For a discussion of advantages and disadvantages of captive insurance, refer to article by Tony Pereira, 'Captive Challenges,' in *Malaysian Business*, May 1, 1997.

and Muslim countries in Asia subsequently. The strength of ADIL is the monitoring of its activities by international *sharia counsel* DMI. ADIL will only invest in *halal* business. There are about 333 *halal* stocks in Kuala Lumpur Stock Exchange. Sharia counsel will supervise and approve investment decisions. Companies chosen have to maintain earning per share (EPS) growth of 20% per annum for five years and have price-earning ratio halves of EPS.¹⁸

Saiful and Mahmood (1999) proposed Islamic financing based on *Muqarada* and *Musharaka* principles that brought together the elements of equity, justice and social moral values in business transaction as genuine alternatives to interest-bearing financial instruments. These principles could serve as a dynamic alternatives to Islamic private debt securities in Malaysia today as it cannot only attract Middle-Eastern investors but able to free itself from legal device that usually allow back-door interest.

However, it cannot be denied that other factors do play an important role in determining capital flows from Middle-Eastern countries such as the prospect of currency fluctuations when the capital control lifted in September 1999, uncertainties in the financial markets and a less predictable monetary and fiscal policies introduced by the Malaysian government.

Nowadays, by working closely with Islamic Development Bank, Labuan would be able to break the barrier by convincing the others that the principles of shariah laws are fully upheld in its business operation.

Maybank, the biggest bank in Malaysia is closely monitoring the viability of introducing Islamic instruments through Labuan and plans to work with Islamic Development Banks or similar banks in Middle East. This is a prove that others are aware of the approval basis from Islamic Development Bank before plunging ahead with Islamic instruments. Using Labuan as the main trading port, Maybank International Labuan (Ltd) - MILL, plans to focus on four areas - Islamic financing facilities, Islamic trade financing, Islamic deposits accounts and Islamic Unit Trusts.¹⁹

¹⁸ *Malaysian Business*, November 1, 1996, p. 13.

¹⁹ Ollie Yusuf.

Bank Islam joined Labuan much later on July 1, 1997 by setting up its own Bank Islam - Labuan Ltd, known as BILL. BILL offers services such as treasury and money market, Islamic financial restructuring, liquidity management (interbank deposit), trade finance (short term facilities), and shariah advisory (investments instruments). Currently, BILL attracts many customers from Malaysia, Indonesia, Thailand, Saudi Arabia and Brunei due to its twin pledges of nonexistence usury dealings together with ethical banking practices.

What kept Islamic investors at bay is the fear that the underlying modus operandi at Labuan is a camouflage of none other than the old conventional interest-based system. But the cloud over the Shariah legality is fading away recently. What is evident to date is a healthy appetite among Islamic investors for Sukuk or asset-based instruments.²⁰ The seal of approval firstly come from the endorsement of *Sukuk al-Ijarah*, a new lease-based bond introduced by Labuan. The issuance of Serial Islamic Lease Sukuk as the first Islamic bond accepted by Islamic scholars in the Middle East and Southeast Asia in terms of its Shariah application, would definitely attract more foreign Islamic investors

Labuan will also be implementing measures to assist the development of takaful business, including promoting new products such as takaful captive and investment-linked instruments based on takaful principles. It is estimated that the takaful sector will grow by 25 to 40% annually, making it therefore a market with great potential. At present, there are two retakaful operators and one takaful underwriter in Labuan IOFC.

The establishment of the International Islamic Financial Market (IIFM) will significantly facilitate Islamic banks in managing their liquidity. To develop the Islamic capital market further, the Malaysian Government and large Malaysian conglomerates are encouraged to take advantage of international funds by way of Islamic financial instruments issued through Labuan to be traded on the IIFM and listed on the LFX. Besides that, the establishment of the Islamic Financial services Board is expected to position prudential standards and regulations on Islamic banking and finance.

²⁰ *Asiamoney*; London, Aug 2002; Anonymous.

To broaden and deepen the Islamic market in Labuan, the Special Task Force on Islamic Banking and Takaful was established to evaluate existing rules and regulations governing Islamic banking and takaful business. The task force will also make recommendations on any necessary changes for improvement and propose new products to be endorsed by the Shariah Advisory Council (SAC).

RECOMMENDATIONS

Judging from its current performance, Labuan will be able to gain its competitive edge in no time at all. But for now it has to stand and deliver its promises to be an outstanding IOFC. Below are some measurements that could expedite the process:

1. The existence of Islamic financial instruments should give Labuan its niche. Labuan should capitalize on this factor and capture the available surplus Islamic fund. It has to intensify its marketing effort and strategy.
2. The effectiveness of Bundesbank in controlling the financial activities is largely due to its ability to be consistent and trustworthy in its policies and implementation. People are very confident with their business prospects since the sense of reliability and expectation usually converge with reality, as explained by Rational Expectation Theory (RET). There are a few lessons that Bank Negara Malaysia (BNM) could learn here. Public gains trust and confidence in the stability of the political economy through how well the Central Bank can manage the country's financial activities. BNM has been accused of being too 'paternalistic' by which the freedom is not fully accorded to the financial companies. A check and balance system and transparency elements should be Labuan's priorities in ensuring a good financial environment.
3. It is obvious that Labuan and Malaysian government should dig deeper into the Shariah aspects of *bay' al-inah* and *bay' al-dayn* financial operations in order to win support from rich gulf-countries. The dubious nature of these operations full-pledged claim from of shariah principles put Labuan in an awkward position. The recent move in forming alliance with Islamic World Bank might steer Labuan into the right directions.

4. Labuan has to stop extending the incentive-exemption packages. This method should only be used in the first few years of operations. Afterwards, the volume of financial activities should be based on the ground of efficiency and competitiveness to ensure long term commitments of the players. Further incentives would only distort Labuan's real capacity in attracting investors.

CONCLUSION

Since its establishment in 1990, Labuan IOFC has been expanding tremendously by capturing the Asian and World businesses. The financial crisis which occurred then has shaken its performance, thus placing it in undesirable state of affairs. Despite all the obstacles faced, Labuan has indeed what it takes to emerge as a reputable offshore center in providing Islamic financial instruments. The developments described in this paper clearly show the progress that Labuan IOFC has made in promoting the Islamic banking business. With the Financial Master Plan launched in March 2001, a target has been set to enlarge the share of Islamic banking from the present 8% to 20% of the total domestic banking system by the year 2010. In tandem with this target, Labuan has made great strides in attracting new Islamic players through the development of the IIFM, the establishment of the SAC and the issuance of the Serial Islamic Lease Sukuk.

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