

Labuan, Malaysia: Assessment of the Supervision and Regulation of the Financial Sector—Review of Financial Sector Regulation and Supervision

This review of financial sector regulation and supervision in Labuan, Malaysia in the context of the offshore financial center assessment program contains technical advice and recommendations given by the staff team of the International Monetary Fund in response to the authorities of Malaysia's request for technical assistance. It is based on the information available at the time it was completed in July 2004. The views expressed in these documents are those of the staff team and do not necessarily reflect the views of the government of Malaysia or the Executive Board of the IMF.

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**ASSESSMENT OF THE SUPERVISION AND REGULATION OF THE
FINANCIAL SECTOR**



Review of Financial Sector Regulation and Supervision

Labuan, Malaysia

JULY 2004

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GLOSSARY

AA	Anti-Corruption Act
ACA	Anti-Corruption Agency
ALTC	Association of Labuan Trust Companies
AGC	Attorney General's Chambers
AMC	asset management company
AML	anti-money laundering
BCP	Basel Core Principle for Effective Banking Supervision
BAFIA	Banking and Financial Institutions Act
BNM	Bank Negara Malaysia
CA	Customs Act
CFT	combating the financing of terrorism
DDFPA	Dangerous Drugs (Forfeiture of Property) Act
EA	Extradition Act
FATF	Financial Action Task Force
FT	financing of terrorism
FIU	financial intelligence unit
IOFC	International Offshore Financial Center
IOSCO	International Organization of Securities Commissions
LFX	Labuan International Financial Exchange
LOFSA	Labuan Offshore Financial Services Authority
LOFSAA	Labuan Offshore Financial Services Authority Act
LOSIA	Labuan Offshore Securities Act
LOTA	Labuan Offshore Trusts Act
LTCA	Labuan Trust Companies Act
MACMA	Mutual Assistance in Criminal Matters Act
MFD*	Monetary and Financial Systems Department
MHA	Ministry of Home Affairs
ML	money laundering
MNRB	Malaysian National Reinsurance Berhard
MoF	Ministry of Finance
MFA	Ministry of Foreign Affairs
MOU	memorandum of understanding
NCC	National Coordination Committee to Counter Money Laundering
NCCT	Non-Cooperative Countries and Territories
OBA	Offshore Banking Act
OCA	Offshore Companies Act
OGBS	Offshore Group of Bank Supervisors
OIA	Offshore Insurance Act
SO	Sovereign Order
STR	suspicious transaction report
UCITS	undertakings for collective investments for transferable securities (investment funds, mutual funds)

* The IMF's Monetary and Exchange Affairs Department (MAE) was renamed the Monetary and Financial Systems Department (MFD) as of May 1, 2003. The new name has been used throughout the report.

PREFACE

At the request of the authorities, an IMF team conducted a Module 2 Offshore Financial Center (OFC) assessment¹ of the Labuan International Offshore Financial Center, September 30–October 11, 2002. The mission undertook an assessment of the extent to which the regulatory and supervisory arrangements for the Labuan offshore financial sector complied with internationally accepted standards and still evolving good practices. Stand-alone assessments were carried out for the banking, securities and insurance sectors, as well as for the regime for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT).² The regulatory regime for trust and company service providers was also reviewed. A follow-up mission by an independent AML expert (IAE) not under the supervision of the IMF was conducted in July 14–22, 2003 to assess implementation of the criminal justice elements of the AML/CFT regime.

The assessment team consisted of: Mr. John Abbott (Mission Chief, MFD), Mr. Kiyotaka Sasaki (MFD), Mr. Cheong-Ann Png (LEG), Ms. Tanis MacLaren (Securities Advisor, formerly of the Ontario Securities Commission), Mr. Peter Dench (Banking Advisor, Reserve Bank of New Zealand), Mr. Lonny McPherson (Insurance Advisor, Canada OSFI), and Ms. Renée Cárdenas (Administrative Assistant, MFD). The IAE was Ms. Ms. Takasu, an Attorney assigned to the Criminal Affairs Bureau of the Ministry of Justice of Japan and public prosecutor of the Tokyo District Public Prosecutors Office.

To conduct the assessments, the mission held discussions in Labuan with the Director-General and senior officers of Labuan Offshore Financial Services Authority (LOFSA) and met with representatives of the financial services industry. In Kuala Lumpur the mission met with the Governor of the Bank Negara Malaysia (BNM) (also the Chairman of LOFSA) as well as conducted discussions with officials of BNM, the Ministry of Home Affairs (MHA), the Ministry of Foreign Affairs (MFA), the Ministry of Finance (MoF), the Attorney General's Chambers (AGC), as well as industry representatives.

The team is very grateful for the excellent cooperation and warm hospitality received from the authorities of both LOFSA and the Bank Negara Malaysia.

¹ The Module 2 assessment is described in “Offshore Financial Centers—the Role of the IMF” (June 23, 2000)

² The AML/CFT regime was assessed with respect to the Draft Methodology for Assessing Compliance with Anti-Money Laundering and Combating the Financing of Terrorism Standard (FATF Secretariat Draft of August 26, 2002). Material prepared by the IAE is shown in italics.

EXECUTIVE SUMMARY

A. Supervisory Framework

Labuan, an offshore financial center located in Malaysia, has all the essential elements for a suitable framework for financial supervision. Primary legislation provides LOFSA with adequate authority to supervise prudentially regulated financial institutions and to oversee trust and company service providers. LOFSA staff is well trained and experienced, although the numbers devoted to examination and compliance should be increased. Funding is adequate. Although they have not been tested, enforcement powers appear adequate. The performance of the financial sector has been mixed. Non-performing loans are relatively high in the banking sector and demand for credit has been soft. Average profitability is low and a number of banks and insurance companies maintain only a token presence.

Reflecting the stage of development of the financial industry in Labuan, the supervisory regime for each industry is different. Banking supervision is relatively well developed and on and off-site supervision is being intensified. The regime for insurance is still being developed, reflecting the gradually evolving scope of business of the sector, and falls well short of IAIS standards. Securities and capital markets activities in Labuan are still embryonic and the supervisory regime for this sector will need to be fleshed out as business develops. The regime for trust and company service providers sets an orderly legal framework for registering offshore companies, trusts and limited partnerships and assigns an important role to trust companies in ensuring compliance with regulatory requirements. More proactive compliance supervision of trust companies would be desirable to insure the integrity of the offshore companies sector, particularly with respect to anti-money laundering requirements.

While the broad legal and organizational framework for financial supervision in Labuan is well conceived, the mission identified gaps in the legislation, regulation and practice that hamper LOFSA's ability to fully satisfy international standards and best practices. Detailed points are addressed in each of the core principles assessments. Key themes identified in the detailed report are summarized below in a section on common issues. These include: supervisory independence, transparency, corporate governance, and supervisory practices, including organization and resources.

B. Anti-Money Laundering Framework

The legal and institutional framework for addressing money laundering in Labuan, and indeed for Malaysia, was substantially strengthened with the enactment of the Anti-Money Laundering Act 2001 (AMLA), which came into effect on January 15, 2002.³ AMLA is

³ The conclusions in this report have been partially updated to reflect developments since the end of the first mission, October 11, 2002. At the time of the first mission, major sections of Part IV of the AML Act had not yet been invoked. By the time of the second

(continued)

federal legislation which provides for inter alia: criminalization of the offence of money laundering; establishment of the financial intelligence unit; reporting obligations for financial institutions (including offshore financial institutions); and powers for investigation and enforcement. AMLA is to be read with the Extradition Act 1992 and the Mutual Assistance in Criminal Matters Act 2002 for international cooperation in criminal proceedings. Part IV of AMLA, which deals with required preventive measures for regulated entities, was brought into effect in early 2003, after allowing firms time to prepare to operate under the new requirements. There is currently no specific offence for financing of terrorism although there is an inter-agency working group, led by the Ministry of Foreign Affairs, that is working on Malaysia's accession and implementation of the International Convention for the Suppression of the Financing of Terrorism (1999), which includes the passing of a legislation on financing of terrorism.

Even prior to enactment of AMLA, LOFSA had required offshore banks to be vigilant against money laundering and had issued enforceable guidelines to this effect. In anticipation of the full invocation of AMLA, supervisory attention to AML issues was increased including for the first time issuing guidelines for the offshore insurance sector. Activity in the offshore securities sector is low and, as yet, there are no proposed guidelines for this sector. Except for criteria on suspicious transactions reporting, no other anti-money laundering guidelines have yet been prepared by LOFSA for other non-prudentially regulated offshore institutions (offshore companies, offshore trusts, offshore limited partnerships, etc.) However, the Association of Labuan Trust Companies (ALTC) has provided guidelines in this regard. Given the reliance by LOFSA on trust companies to perform adequate customer due diligence, LOFSA should ensure that the guidelines for this sector are fully in line with the requirements of AMLA and that those guidelines are enforced. More generally, LOFSA should review and update all guidelines to incorporate the requirements of the AMLA as well as international standards regarding AML/CFT, including the FATF Special Recommendations on CFT.

C. Cross-Border Information Exchange and Cooperation

The regime in Labuan for access to and exchange of supervisory information, both with Malaysian financial regulators and with foreign supervisors and regulators, is complex and compartmentalized. Regulations designed to safeguard the confidentiality of customer and institution information inhibit Labuan's ability to fully satisfy international standards with

mission, however, all of Part IV had come into force, with the exception of Section 14 (a). Also, the Mutual Assistance in Criminal Matters Act 2002 (MACMA) came into force on May 1, 2002. The conclusions in this report reflect the fuller implementation of AMLA as of July 2003 and the coming into force of MACMA. In addition, the assessment by the IAE, presented in italics, is based on information available by the end of the second mission, July 22, 2003.

respect to cross-border supervisor cooperation and, even within Malaysia, they complicate the effective consolidated supervision of Malaysian insurance firms. AMLA, however, overrides these confidentiality restrictions to the extent which they interfere with reporting requirements of financial institutions.

Various pieces of legislation impose conditions on what customer information may be accessed by supervisors and with whom it may be shared. LOFSA bank supervisors have routine access to credit information but not customer deposit information. Access may be gained where there is fraud or suspicion of fraud. LOFSA's access to information on offshore companies held by trust companies in Labuan is limited. LOFSA may share information with home monetary authorities, understood to be the parent banking supervisor, but not with non-monetary home supervisors. Sharing of information between LOFSA and BNM is restricted if a Labuan company is an affiliate but not a direct subsidiary of a Malaysian insurance company and similar restrictions appear to apply between LOFSA and the Malaysian Securities Commission. This restriction is partially mitigated by the ability to appoint other regulatory authorities' officers as LOFSA's agent in examination and investigation of such entities. In the case of anti-money laundering matters, AMLA overrides these restrictions on LOFSA's access to information.

Within the avenues of a complicated regime, LOFSA appears to be forthcoming and responsive to requests to share information with both domestic and foreign supervisors. Efforts to amend the relevant legislation are currently under way. In order to meet international standards for the exchange of information, LOFSA should make a comprehensive review of current legal impediments and seek legislative amendments to allow full access to information held by regulated financial institutions and the exchange of such information with other supervisors, both domestic and foreign, subject to safeguards on the confidentiality of such information.

Table 1. Key Recommendations

Observations	Recommendations
<p>LOFSA has dual responsibility for financial development of Labuan and for financial supervision.</p> <p>Autonomy of LOFSA within Malaysian government not fully transparent.</p> <p>Still-evolving supervisory practices, particularly with respect to insurance and securities, not fully transparent.</p> <p>Corporate governance standards for offshore financial institutions are not well developed.</p> <p>More sophisticated risk based supervisory practices, involving more on-site supervision are being implemented.</p> <p>LOFSA’s access to customer specific-information restricted to cases of where crime or fraud believed to have been committed, restricting ability to conduct prudential supervision and to co-operate with overseas regulators.</p>	<p>Separate the promotional and supervisory responsibilities of LOFSA.</p> <p>Develop memoranda of understanding (MOUs) between LOFSA and MoF and between LOFSA and BNM spelling out executive and operational arrangements.</p> <p>Pending development of its own guidelines, consider adopting more of the guidelines issued by BNM, suitably adapted to Labuan.</p> <p>Require greater corporate and financial disclosure. Define roles and responsibilities of corporate directors and management under Offshore Companies Act. Consider adapting BNM “Guidelines for Financial Institutions.”</p> <p>Continue to upgrade supervisory practices. Further develop staff resources and skills. Reinforce attention to systems and controls. Exploit synergies with BNM</p> <p>Constraints on LOFSA’s access to customer-specific information should be removed.</p>
Banking Supervision	
<p>Capital ratios adequate but requirements do not conform to Basel standards.</p> <p>Lack of sufficient compliance staff impedes on-site examination/verification of guidelines and supervisory information.</p>	<p>Capital adequacy risk weight rules should be revised to Basel standards.</p> <p>Expand and upgrade compliance staff.</p>
Insurance Supervision	
<p>Prudential rules are inadequately developed.</p> <p>Monitoring tools and early intervention tools are inadequately developed.</p>	<p>Standards should be developed with respect to the essential criteria for assets, liabilities, technical provisions, and market conduct.</p> <p>Develop early warning tests and key indicators for continuous monitoring and consider a range of early intervention tools that could be used short of breaches of law.</p>

Securities Supervision	
Inspection and enforcement authority of LOFSA is inhibited by secrecy and confidentiality provisions of law.	Modify legislation to allow LOFSA access to information related to the identity, affairs or accounts of customers and to share such information with domestic and overseas regulators, subject to appropriate safeguards.
Onsite and off-site supervision of securities activities are not adequately developed.	Increase staff resources devoted to on-site supervision and, in line with market development, elaborate more complete prudential standards.
AML/CFT	
Financing of terrorism is addressed only indirectly in Malaysian legislation.	Legislation (which was subsequently proposed) to criminalize the financing of terrorism should be adopted, including adequate provisions for freezing and confiscating the proceeds of crime or property used to finance terrorism.
Oversight by LOFSA of implementation of preventive measures by banks is more well developed than it is for insurance, securities, and trust and company service providers.	Develop appropriate AML/CFT guidelines for the nonbank sectors and devote additional resources to compliance monitoring.
LOFSA's enforcement authority and ability to cooperate cross border is inhibited by limitations on its access to specific customer account.	Modify legislation to allow LOFSA access to information related to the identity, affairs or accounts of customers and to share such information with domestic and overseas regulators, subject to appropriate safeguards.

I. INTRODUCTION

1. The Federal Territory of Labuan is a group of islands in the South China Sea off the coast of the east Malaysian state of Sabah. Labuan island covers an area of 92 sq. km. with an estimated population of 75,000. It is a free port where no sales tax, surtax, import or export duties are levied. Labuan Town has an excellent harbor and an airport and is the shipping center for much of North Borneo. In addition to financial services, the main sectors of the economy are oil and gas, shipping, manufacturing, trading, tourism and education. Bahasa Melayu is the national language. However, English, various Chinese dialects and Tamil are widely spoken.

2. While being a discrete geographical location, Labuan is not a sovereign state and possesses no separate legislature. It is a Federal Territory, directly administered by the government of Malaysia. In 1990 Labuan was declared an International Offshore Financial Center (IOFC). In 1996 the Labuan Offshore Financial Services Authority (LOFSA) was created. All legislation relevant to the IOFC is enacted by the Malaysian Parliament in Kuala Lumpur, and all substantial policy initiatives are determined by the national government and its institutions. This means that the institutions located in the IOFC operate within a regulatory framework comprising commercial and financial legislation applicable only to Labuan but subject to federal legislation, such as criminal statutes that applies throughout Malaysia.

II. FINANCIAL SYSTEM AND OFFSHORE OVERVIEW

A. IOFC Background

3. The Labuan IOFC, launched in October 1990, is designed to complement the activities of the domestic financial market in Kuala Lumpur, to strengthen the contribution of financial services to the Gross National Product of Malaysia and to provide a developmental base for the island. Special economic incentives have been provided to encourage development of the offshore center. For financial firms (and their customers) these incentives include:

- No bank reserve requirements and foreign exchange controls;
- Low annual licensing fees;
- No withholding tax levied by the government on income or dividends earned in Malaysia and remitted out;
- Option of a 3 percent annual corporate tax or fixed tax of RM 20,000 (approximately \$5,300);
- No tax on income from “non-trading” activities such as ownership of securities and real estate;

- Absence of stamp duties, value-added taxes, death, inheritance or estate duties;
 - No restriction on foreign ownership limit on Malaysian companies; and
 - Offshore entities in Labuan, which are declared as non-residents for exchange control purposes may freely buy, borrow, sell or lend foreign currency with any non-resident.
4. Operators and investors in Labuan also benefit from double tax agreements.
5. Initially, institutions licensed under the IOFC legislation were permitted to maintain their primary office in Kuala Lumpur, but with the establishment in 1996 of the Labuan Offshore Financial Services Authority (LOFSA), and the development of a substantial physical infrastructure in Labuan, they are now required to maintain a staffed office in the territory. Institutions may also maintain a marketing office in Kuala Lumpur. Currently, the financial institutions in Labuan employ about 1,000 people.

B. Financial Services Institutions and Markets

Institutions

6. A cross-section of financial firms and financial service providers is represented in Labuan. As of September 2002, these financial institutions included:
- Commercial and investment banks (49);
 - Insurance companies and insurance related companies (105);
 - Trust companies (18);
 - Funds Managers (12);
 - Leasing companies (29);
 - Auditors (20);
 - Liquidators (19);
 - Labuan International Financial Exchange (LFX).
7. In addition, as of September 2002 some 2,026 offshore trading and non-trading companies were registered and operating in Labuan.

Banks

8. Of the 49 banks licensed to operate in Labuan, 11 were incorporated as offshore companies in Labuan and 38 banks operated as branches, either of foreign banks or of banks incorporated in Malaysia. All but one of the 11 offshore banks incorporated in Labuan are wholly-owned subsidiaries of commercial banks licensed and supervised on a consolidated basis in Malaysia by BNM. LOFSA policy requires that all offshore banks incorporated in Labuan have a bank as a parent and individuals are not allowed to own banks. Until recently, only the 200 largest foreign banks were permitted to have a banking license. As a result, the foreign banks operating in Labuan tend to be the most prominent names in Asia, North

America, and Europe. Total assets of offshore banks at 30 June 2002 were \$18.7 billion of which loans and advances were \$10.5 billion. Over 80 percent of loans are to Malaysian residents.⁴ Offshore banks had 498 employees as of the end of 2001. Over the last three years, the number of banks and their total loans and deposits has declined slightly in part as a result of parent company consolidation.

Insurance

9. Figures for the end of 2001 showed that 98 firms were then licensed to conduct insurance or insurance related business, an increase from 83 at the end of 2000. Of that total, 47 were insurers and the balance were insurance related brokers (36) and managers (15). Companies are permitted to operate as Labuan incorporated entities or as branches of foreign licensed insurers.

10. Of the licensed insurers, 2 were life, 3 general, 1 composite, 22 reinsurance and 19 captives. There were eight new licenses granted in 2001 (compared to 26 in 2000) and 3 ceased operations. Of the new licenses in 2001, there were 2 new reinsurance licenses and 4 new captive licenses granted in 2001. 78 licensees were fully owned by non-residents, 17 by Malaysians and the remaining six were jointly owned by Malaysians and non-residents. The number of foreign-owned insurance firms has increased in recent years and at the end of 2001 they accounted for 40.6 percent of the paid-in capital of offshore insurance companies compared to only 17.6 percent at the end of 1999. Although all categories of insurance are represented, reinsurance and insurance broking account for most of the insurance activity in Labuan, with reinsurance accounting for the majority of total gross premiums. Insurance operations have expanded significantly over the last three years, albeit from a relatively low base. At the end of 2001 total assets of the offshore insurance sector amounted to \$513 million and the sector employed 217 individuals.

Securities and capital markets

11. Securities operations in Labuan are quite limited. The nascent Labuan International Financial Exchange (LFX) lists nine issues, however, only one trade has been effected on the trading system. These listings include five open-end mutual funds, and three Sukuk (Islamic) instruments, and one secondary listing of a floating rate note. Bank Negara Malaysia (BNM) has recently given approval for certain categories of Malaysian companies to invest up to a limit of \$5 million in certain foreign exchange denominated products if they are listed on the LFX. Apart from issues listed on the LFX, a number of private and public funds, mostly

⁴ Although the offshore financial center was introduced with a view to developing business with non-residents, a preponderance of the business conducted in Labuan is done with Malaysian residents. See discussion on page 11 below.

closed-end, have been authorized. In 2001 a total of 17 mutual funds were approved with a fund size of \$815 million.

Trust Companies

12. Trust companies are the principal company service providers in Labuan. In addition to managing business activities of offshore companies, trust companies are intermediaries in the incorporation of offshore companies and serve as registered offices in Labuan for offshore companies. They keep the books and records of offshore companies that are required to be maintained in Labuan. The Offshore Companies Act 1990 also requires that all documents be filed for offshore companies by their trust company. In addition, trust companies may engage in establishing and administering offshore trusts. As of September 2002, 70 public trusts were administered in Labuan with an estimated aggregate asset size of \$38 million. The top five countries which account for the client base of these trusts are Korea, Canada, Australia, Hong Kong and Philippines. Regional linkages and double taxation treaty provisions appear to account for the geographical distribution of business.

Leasing and Offshore Companies

13. Leasing is a licensed activity and the bulk of the business carried on in Labuan appears to be large value equipment leasing related to both Malaysian and international transactions. The business appears to be driven by tax incentives, frequently using corporate vehicles. Few statistics are available to categorize the various unlicensed business activities of the 2,026 offshore companies. Discussion with Labuan service providers suggests that many of the companies are asset holding vehicles for financial structures, vehicles for holding international property rights, and corporate structures for small international service providers, such as consulting firms.

Offshore business developments

14. Islamic banking is well developed in Malaysia and institutions in Labuan are developing a niche business in providing foreign currency Islamic financial products (banking, insurance, and securities) for both the Malaysian market and for the wider international market.

15. While the offshore players operating in Labuan have widely diversified origins, Malaysian related business accounts for the preponderance of business conducted in the IOFC. This reflects the interplay of Malaysian capital and exchange controls, the tax and policy incentives provided in Labuan, and general competitive factors. Offshore financial entities in Labuan are not permitted to carry on ringgit business and, in practice, they are primarily engaged in providing authorized foreign currency financial services for business involving Malaysian residents. Banks in Labuan engage primarily in commercial lending. Tax incentives (absence of withholding and stamp tax as well as low income tax) make Labuan an attractive domicile for foreign banks extending dollar credits to Malaysian entities or for trade credits to foreign suppliers selling into Malaysia. Similarly, tax incentives make

it attractive for Malaysian banks to book their foreign currency lending to Malaysian firms through Labuan. Multinational firms operating in Malaysia are also important clients of the foreign banks established in Labuan.

16. In the administration of the Malaysian foreign exchange control regime, preference is accorded to exchange transactions conducted through Labuan. The regulations require foreign currency borrowers to demonstrate that an effort has been made to arrange the financing through a Labuan bank. According to BNM officials, this requirement is routinely satisfied.

17. The insurance business in Labuan is similarly dominated by transactions with Malaysian residents. In the reinsurance sector, Malaysian policy aims to optimize national retention capacity through a right of first refusal process. Under a gentleman's agreement voluntary reinsurance cessions are made to the national reinsurer, Malaysian National Reinsurance Berhad (MNRB). Requirements beyond MNRB's capacity are reallocated to the local or overseas market. In administering forex approval for non-ringgit reinsurance the authorities expect Malaysian firms to show that an effort has been made to obtain reinsurance through a Labuan firm.

18. While at least half of the insurance broking business appears to be for Malaysian risk, Labuan brokers also are active in broking international risks in the region. One company reported success in developing an active regional reinsurance business through its Labuan subsidiary.

19. In the small life insurance sector, Malaysian owned firms have developed investment linked foreign exchange products marketed to Malaysian high net worth clients. Permission has been granted by Bank Negara Malaysia to high net-worth Malaysian residents to purchase such products up to RM 100,000 in single or annual premium policies. These products enjoyed early success. However, apparently in response to the resulting capital outflow, the Malaysian authorities have capped further sales of this product to Malaysian residents.

C. Regulatory and Supervisory Framework of the Offshore Financial Center

Legal framework

20. The Labuan Offshore Financial Center was launched in 1990 when Malaysia enacted specific legislation authorizing offshore companies, offshore banking, offshore insurance, and Labuan trust companies. In 1996 LOFSA was created to be a 'one-stop' agency to streamline the supervisory and regulatory arrangements in Labuan IOFC.⁵ It operates as a

⁵ Appendix I provides a tabulation of the legislation applicable to the Labuan offshore financial center.

statutory body under the purview of the Ministry of Finance. LOFSA was established under the Labuan Offshore Financial Services Authority Act 1996 (LOFSAA). The authorizing legislation gives LOFSA a developmental and a regulatory role. Under the Act, some of the objectives of LOFSA are:

- to promote and develop Labuan as a center for offshore financial services; and
- to develop national objectives and priorities for the orderly development and administration of offshore financial services in Labuan, and to make recommendations to the Minister in respect thereof.

21. The legal system is essentially one of common law tradition. The functions and powers of the Authority under the Act establish LOFSA as the financial supervisor for the IOFC. The Act gives LOFSA authority to administer, enforce, carry out and give effect to the provisions of the various laws related to the offshore financial services in Labuan. The Act establishes LOFSA's authority, in the conduct of its supervisory function, to require financial institutions to submit to LOFSA information deemed necessary or expedient for the supervisory functions.⁶ The Act authorizes LOFSA to conduct examinations of financial institutions and corporations, to impose levies, and to impose and collect fees.

LOFSA

22. Under the LOFSAA the governing board of the Authority consists of the following members appointed by the Minister of Finance for terms not exceeding three years but permitting reappointment:

- A Chairman;
- The Director General;
- Not less than three and not more than seven other persons, two of whom shall be from the public sector.

23. The Director General is the chief executive officer of the Authority and is entrusted with the day-to-day administration of the Authority.

24. Currently the Chairman of LOFSA is the Governor of the Bank Negara Malaysia, Dr. Zeti Akhtar Aziz. Other representatives from the Malaysian regulatory sector currently appointed to the board are the Chairman of the Securities Commission, the CEO of the

⁶ Limitations on the information LOFSA may require of financial institutions as well as the provisions for exchanging and safeguarding supervisory information are discussed below.

Companies Commission of Malaysia, the CEO of Labuan Corporation (the national development agency for Labuan), a representative from the Ministry of Finance and the Director-General. The other current appointees are the Executive Chairman of the Kuala Lumpur Stock Exchange, the CEO of Malaysian Airlines, and an executive director of RHB Management Co. Sdn.Bhd (a non-financial subsidiary of the financial group, RHB).

25. LOFSA has a staff of approximately 55 and is organized into five departments: policy development, operations, legal and administration, and corporate affairs, and the Director-General's office. Day-to-day supervisory activities are carried out primarily by the operations and legal and compliance departments. All department heads and senior officers, as well as many staff, have prior regulatory experience with Bank Negara Malaysia.

26. LOFSA is a single regulator for the Labuan International Offshore Financial Center. As such, it is responsible for regulation of offshore banks, insurance companies, trust companies, and securities dealers as well as having responsibility for the registration of offshore companies. Licensing activities are handled by the Operations Department with 13 staff and one director. This department also acts as the company registrar. Monitoring and supervision of licensed companies are carried out primarily by the Legal and Compliance Division with 7 staff reporting to the director. We were advised that LOFSA plans to add 4 additional staff to the Legal and Compliance Division in the coming year in order to deepen specialized skills in banking and insurance.

27. Over the past year LOFSA has initiated on-site visits and examinations of banks and insurance companies. The program includes both prudential visits with senior management as well as systematic detailed examinations. To date, on-site examinations have been carried out on five subsidiary banks and three insurance subsidiaries, with the assistance of Bank Negara Malaysia staff. While there are no formal arrangements structuring the working relationship between Bank Negara Malaysia and LOFSA, both LOFSA officials and BNM officials, including Governor of BNM, confirmed that BNM stands ready to assist LOFSA as necessary to insure that supervision in Labuan becomes fully effective.

28. LOFSA is funded largely by revenue from the incorporation of companies and annual licensing fees of offshore players. Additional funding was provided in the form of interest free loans by BNM since LOFSA was established in 1996. Funding does not appear to be an issue for LOFSA. According to the 2001 Annual Report, operations in 2001 generated a surplus of RM 500,000. A full budget for 2002 was not made available but planning figures for expenditure show a rise of RM 15.7 million, which would represent an increase of approximately 40 percent over 2001. LOFSA officials indicated that higher 2002 outlays will be fully covered by prior increases in fees and interest income and that budgetary constraints are not a limitation on its ability to carry out its responsibilities.

III. STRENGTHS AND VULNERABILITIES IN FINANCIAL REGULATORY AND SUPERVISORY ARRANGEMENTS

A. Supervisory Independence

29. Statutorily LOFSA has dual objectives for fostering development of the Labuan IOFC and for supervising the financial sector. While the potential exists that promotional priorities will conflict with regulatory disciplines, no evidence was encountered that would indicate that development priorities are inhibiting regulatory efforts. On the contrary, there has been a significant increase in the intensity of LOFSA's supervision in the last two years, a trend that is scheduled to continue with the planned increase in the number of specialized staff devoted to compliance. LOFSA, supported by government policy, has several initiatives underway to increase the number of firms operating in Labuan and to expand the range of products and services available, most notably in the area of Islamic banking and Islamic financial products. Going forward, to ensure the autonomy of the supervisory function, it would be desirable to have greater separation between promotional and supervisory responsibilities of LOFSA. Ideally, this would be done by modifying the legislative objectives of LOFSA. Short of this, LOFSA may wish to consider an organizational structure that provides a clear delineation of the two activities.

30. It would also be useful to clarify the autonomy of LOFSA within the Malaysian government to carry out its regulatory responsibilities. While the LOFSAA gives broad operational autonomy to LOFSA, LOFSA is accountable to the MoF and the relationship is outlined in very general terms in section 4(1). Members of the board and the Director General are appointed by the Minister (section 5 (1) and the Minister may revoke an appointment at any time (section 7 (1)). Likewise, under section 9(1) the Minister may from time to time issue binding directions to LOFSA, and under section 9 (2) the Minister may from time to time require LOFSA to provide information on any of its functions. For transparency, it would be useful to clarify the conditions for continuation and removal of board members, and to spell out more clearly the circumstances under which the Minister might be expected to exercise his authority to give directions to, or require information from, LOFSA. These arrangements could take the form of an MOU. Additionally, conditions for continuation and removal of a board member could be included in the instrument of appointment and that instrument made public. The relationship between BNM and LOFSA is close and reinforced by the fact that the Governor of BNM is also the Chairman of LOFSA, the fact that many LOFSA staff are drawn from BNM, and the fact that many Malaysian institutions licensed in Labuan have parents supervised by BNM. To avoid doubt about the autonomy of LOFSA the authorities may wish to consider developing an MOU to spell out more clearly the arrangements for operational relationships between LOFSA and BNM.⁷

⁷ For a discussion of issues related to supervisory independence and autonomy, see *Regulatory and Supervisory Independence and Financial Stability*, MAE Operational Paper (MAE OP/20/6), Monetary and Exchange Affairs Department, IMF, October 2002.

Transparency

31. The transparency of many aspects of LOFSA's supervisory practices needs to be enhanced, particularly in the insurance sector. This reflects the fact that supervisory practices are still evolving as well as the fact that many authorized activities have not yet developed in the market place. Accounting standards are not clearly specified, particularly for insurance companies and for Islamic financial accounts. No guidance has been provided with respect to internal controls, or credit or liability risk management for insurance companies. Standards for valuing liabilities of insurance companies have not yet been established. LOFSA's supervisory expectations would be made more transparent through expanded publication of guidance and examination manuals. Where guidelines have been established they are not always readily accessible; it would be desirable to make greater use of LOFSA website to post all rules, regulations and guidelines issued by LOFSA. On a more informal basis, LOFSA makes excellent use of the sectoral trade associations established in the IOFC to explain its policies and to get feedback from industry, thereby contributing to the transparency of supervision.

32. Pending independent development of its own guidelines, LOFSA may find it useful to provisionally adopt more of the guidelines used by BNB, suitably adapted to Labuan conditions. Consideration should be given to publication of annual financial statements of licensed companies.

B. Corporate Governance

33. Corporate governance standards in Labuan need to be further enhanced. The Offshore Companies Act needs to be reviewed on matters of corporate governance for offshore companies and separate guidelines should be issued by LOFSA. Although shareholders have access to information regarding offshore companies, shareholder's rights need to be specified and corporate transparency enhanced with requirements for providing corporate and financial information to stockholders on a timely basis. The roles and responsibilities of company directors and management, other than that of resident director/secretary, should be defined under the Offshore Companies Act. To a limited extent LOFSA has used its supervisory powers to fill some corporate governance issues not addressed under the OCA. LOFSA's "fit and proper" standards deal with the competence and integrity of directors and principle officers of licensed firms and the supervisors also assess corporate governance practices when conducting on-site examinations. Guidelines issued by LOFSA for banks, insurance firms, securities firms, the LFX and for Trust Companies should also systematically address corporate governance. Some trade associations have drafted codes of ethics and have discussed implementation of these codes with LOFSA.

34. Although LOFSA is stringent on entry requirements for companies allowed to operate in Labuan thereby providing a degree of comfort on the inherent corporate governance standards within these organizations, it would be desirable for LOFSA to enhance corporate governance standards in Labuan. As financial markets develop this is likely to become a matter of more pressing importance. Lack of strong corporate governance standards is likely

to limit international acceptance of Labuan securities. As an interim measure, LOFSA may wish to consider adopting (subject to adjustment for the circumstances in Labuan) some of the standards adopted by Bank Negara Malaysia in its “Guidelines for Financial Institutions,” as well as the standards established in the Central Bank Act for the Board of BNM.

C. Supervisory Practices, Organization, and Resources

35. In the last two years LOFSA supervision has evolved significantly away from reliance on audit reports and off-site monitoring toward a more proactive approach involving more detailed, on-site examinations. The mission strongly endorses this development. The new procedures allow a more risk based approach to supervision but they also are more labor and knowledge intensive than previous work. Staff resources and skills are being expanded. Recruitment is underway to fill authorized increases in the staffing in the Legal and Compliance Division. Staffing levels will need to be kept under review as more experience is gained in examination.

36. Over the last year LOFSA has initiated joint examinations with BNM. The mission endorses this practice and believes it should be systematized. Examinations to date appear to have been limited to bank and insurance subsidiaries of Malaysian institutions. Given BNM’s role as the consolidated supervisor for these institutions, there is a natural base for continuing joint examinations, although LOFSA will wish to assure that the Labuan entities satisfy regulatory requirements on a stand-alone as well as a Bank Negara Malaysia consolidated basis. It would also be useful to clarify the role BNM will or can play in the examination of branches and subsidiaries of foreign offshore banks and insurance companies. Care will, of course, need to be taken not to become over reliant on BNM staff given the unique business conducted in Labuan.

37. LOFSA may also wish to reinforce its use of internal and external auditors. As LOFSA develops more detailed supervisory guidance (following the recommendations on corporate governance and transparency), LOFSA may wish to encourage auditors to direct more attention to firm’s systems and controls. Such an orientation will be particularly useful for verifying the integrity of the operations of foreign branches as well as supporting implementation of new requirements under AMLA.

IV. SUMMARY OF OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES

A. Basel Core Principles for Effective Supervision

General

38. The following is a summary of an assessment of compliance with the Basel Core Principles for Effective Banking Supervision (BCP), which was performed in the context of the IMF’s Offshore Financial Center (OFC) program. The assessment covers the practices of the Labuan Offshore Financial Services Authority (LOFSA) with respect to offshore banks licensed in the International Offshore Financial Centre (IOFC) of the Federal Territory of

Labuan. The assessment used the BCP Methodology document and was prepared by Mr. Peter Dench, Adviser, Banking System Department, Reserve Bank of New Zealand.

39. The assessment was based in part on LOFSA's self assessment of compliance with the Core Principles. The mission reviewed the relevant laws and regulations, interviewed staff of LOFSA and the Malaysian central bank, Bank Negara Malaysia (BNM), and held discussions with representatives from the offshore banks, the Association of Offshore Banks and external audit firms. The assessment does not cover the supervision of the domestic banking sector in Malaysia or the operations of BNM, except as they apply to consolidated supervision of the Labuan-incorporated subsidiaries of Malaysian banks. The mission would like to acknowledge the excellent cooperation and assistance received from the staff and management of LOFSA, Bank Negara Malaysia and the financial sector representatives.

40. The Offshore Banking Act 1990 (the OBA) and the Labuan Offshore Financial Services Authority Act 1996 (the LOFSAA) provide the main legal foundation for banking supervision in Labuan. In addition, the assessment used guidelines, instructions, advisories and other documentation issued or used by LOFSA in the licensing and supervision of offshore banks. The mission was given full access to all relevant information.

Offshore banking sector

41. There are 49 offshore banks licensed by LOFSA as at mid-September 2002 including 11 banks incorporated as offshore companies in Labuan and 38 banks operating as branches, either of foreign banks or of banks incorporated in Malaysia. The nine other offshore banks incorporated in Labuan are wholly-owned subsidiaries of commercial banks or merchant banks that are licensed and supervised on a consolidated basis in Malaysia by BNM. Offshore banks are not permitted to make loans or accept customer deposits in Malaysian Ringgit. Most transactions conducted by offshore banks are denominated in US dollars and are wholesale-banking in nature. Total assets of offshore banks at 30 June 2002 were \$18.7 billion of which loans and advances were \$10.5 billion. Over 80 percent of loans are to Malaysian residents. Customer deposits at that same date were only \$4.5 billion, with the majority of funding, \$12.2 billion, coming from banks. The Labuan-incorporated banks collectively appear to be adequately capitalized. Disregarding special risk weight concessions, banks have a BIS-equivalent capital ratio of around 10 percent.

General preconditions for effective banking supervision

42. Labuan has benefited from the reestablishment of a stable macro-economic environment in Malaysia following the stresses arising from the 'Asian' crisis in 1997. The Malaysian government has sponsored development of the offshore center in Labuan by channeling substantial resources into infrastructure, education and amenities, as well as by introducing tax and legal incentives for offshore financial operations. Competent professional accounting and auditing services are readily available in Labuan. A mix of local and international accounting standards is used by offshore banks for financial reporting purposes. The well developed Malaysian legal and judicial system, based on common law principles,

underpins financial operations in Labuan, which also have the benefit of separate laws covering offshore activities and which are applicable only in Labuan.

Main findings: Principle-by-principle assessment

43. The following highlights the principal strengths and weaknesses encountered in the banking supervision and regulation arrangements for the Labuan IOFC. The detailed assessment is contained in Volume II.

Objectives, autonomy, powers, and resources (CP 1)

44. The responsibilities and objectives of LOFSA are clearly specified in the LOFSAA and the OBA, which provide a suitable framework—covering licensing, ongoing supervision, powers to address compliance, and legal protection for supervisors—for prudential standards for banks. Operational independence is adequate. Publication of consolidated information on the banking system is included in LOFSA’s published annual report. There are undesirable constraints on LOFSA’s ability to access, and share, customer-specific information with other supervisors, which should be corrected through legislative amendment at an early stage. LOFSA staff resources for the compliance function are currently insufficient to conduct effective on and off-site supervision across the whole offshore industry. Although banking supervision has been the priority LOFSA activity up to the present time, additional staff are required to increase the number of on-site bank examinations/reviews carried out each year.

Licensing and structure (CPs 2–5)

45. The permissible activities of licensed and supervised offshore banks are defined in law. License criteria are set out in guidelines issued by LOFSA, and include fit and proper person assessment, sound track record, credit rating, and adequate home-country supervision. Some criteria are less rigorous for investment bank applicants that will not be licensed to accept deposits. Other requirements include approval from the home supervisory authority and a guarantee of financial obligations from the parent bank or a similar letter of undertaking from the head office of foreign bank applicants. Prior approval is required for any changes in ownership of a substantial interest in a Labuan-incorporated offshore bank, and to open offices or operate subsidiaries outside Labuan (none exist at present).

Prudential regulations and requirements (CPs 6–15)

46. Prudential requirements are primarily set out in guidelines issued by LOFSA, and are not specifically provided for in the legislation. Minimum capital requirements are set out in guidelines but diverge significantly from the Basel standard by allowing concessional risk weights for most categories. Specific guidelines and detailed internal audit guidelines set out requirements for policies and procedures for granting credit, assessing asset quality, setting limits on large exposures and connected lending. The internal audit guidelines also cover other areas of prudent risk management, such as liquidity, treasury operations, information systems and fraud/operational risks. No guidance is provided on country risk. Quarterly

reporting of capital adequacy, asset quality and liquidity mismatches is required. Limited on-site review has been conducted to date and primary reliance is placed on the internal audit process and supervisory follow-up to monitor compliance.

47. Comprehensive guidelines have been issued on customer due diligence, record-keeping and suspicious transactions reporting. The national anti-money laundering legislation applies to offshore banks in Labuan although not all provisions have been invoked yet. An AML questionnaire has been established to review AML policies and procedures in management meetings with each bank. Directives have been issued to all banks to freeze terrorist assets in compliance with United Nations Security Council Resolutions.

48. Going forward the Capital adequacy framework should be revised to be consistent with the Basel standards, by removing the risk weight concession. Regular formal reporting of large exposures of both subsidiary and branch banks should be considered to allow the banks and LOFSA to monitor compliance with the guideline. Guidelines on loan classification and provisioning should also be strengthened to conform with international best practice. More frequent periodic on-site review should be performed to verify the adequacy and implementation of the above-mentioned policies and procedures. Guidance on best practices in interest rate risk monitoring and reporting should be provided to banks.

Methods of ongoing supervision (CPs16–20)

49. Much of the framework is in place for effective on- and off-site supervision, and LOFSA is in frequent contact with bank management on industry-wide and institution-specific issues. Off-site analysis of returns using the CAMEL framework highlights areas of potential concern for review by LOFSA management and follow-up action. It also provides a risk-based focus for prudential meetings and on-site examinations. Approval of a licensed bank's external auditor is required, but there are no provisions to require the audit review of returns. Consideration should be given to making further use of external auditors to complement supervision by LOFSA. Since there are no foreign branches or subsidiaries of Labuan-incorporated offshore banks, there is no need for LOFSA to carry out consolidated supervision.

50. Lack of sufficient compliance staff has been a major impediment to performing on-site validation of supervisory information. Joint examinations with BNM commenced in 2001 and five have been conducted so far on subsidiaries of Malaysian banks. Additional resources are being committed to examinations which would include targeted reviews of foreign banks.

Information requirements (CP 21)

51. Offshore banks are not currently required to publish audited annual financial statements, but are required to provide them to LOFSA. Malaysian auditing standards are used for the most part, modified where appropriate to reflect parent banks' reporting requirements. LOFSA should consider issuing guidance to banks on the accounting standards

to be used for reporting purposes. Consideration should be given to requiring publication of annual financial statements by Labuan-incorporated banks.

Formal powers of supervisors (CP 22)

52. LOFSA has summary procedures for dealing with compliance issues and can issue broad-ranging directives to banks if matters of concern are not adequately addressed. Monetary penalties can be imposed for non-compliance. The introduction of a prompt corrective action framework is recommended.

Cross-border banking (CPs 23–25)

53. Outward consolidated supervision is not relevant at this time for banking supervision in Labuan. LOFSA serves as host country supervisor for all offshore banks that are branches or subsidiaries of overseas financial services entities. Close cooperation is maintained with the Malaysian banking supervisor. LOFSA meets with home country supervisors occasionally, and permits inward examinations. Inward license applications require the consent of the home supervisory authority. There are currently no formal communication channels with home country supervisors of foreign bank branches, and LOFSA should endeavor to establish effective arrangements for information sharing where possible. Current constraints on information sharing should be removed as a matter of urgency.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
Objectives, Autonomy, Powers, and Resources (CP 1)	Criteria for appointment of Board members of LOFSA should be clarified to avoid potential conflicts of interest. Additional staff should be added to the compliance function to strengthen capacity for on-site examinations. Constraints on LOFSA's ability to access customer-specific information except in cases where crime or fraud has been committed, and to share such information with other supervisors, should be removed.
Prudential Regulations and Requirements (CPs 6–15)	Capital adequacy risk weight rules should be revised to Basel standards. Loan classification and provisioning rules should be more rigorous. Large exposures reporting should be introduced.
Methods of Ongoing Supervision (CPs16–20)	Guidelines should be issued on corporate governance and role of the external auditor. Consideration should be given to making further use of external auditors to complement supervision by LOFSA. on-site examination/verification of implementation of guidelines should be increased, and should include foreign banks.
Formal Powers of Supervisors (CP 22)	A prompt corrective action framework should be introduced for remedial action following breaches of guidelines or other requirements.
Cross-Border Banking (CPs 23–25)	Arrangements should be established for exchange of information with home supervisory authorities, with legislative amendment to allow uninhibited flow of information where adequate protection is assured.

Authorities Comments

As the offshore banking business remains one of the core industries of Labuan IOFC, LOFSA would continue to focus its effort to review the existing supervisory and regulatory framework in line with the international standards and the recommendations made by the IMF. The existing legal and supervisory framework, together with the promulgation of various legislation such as the Anti Money Laundering Act 2001 (AMLA), the Mutual Assistance in Criminal Matters Act 2002 (MACMA), amendment to Section 125A of the Penal Code in relation to anti money laundering measures and Countering the Financing of Terrorism would continue to minimize the risk of Labuan IOFC from being used as an entry point for money laundering or terrorist financing activities. With the expected increase in manpower for the supervision and compliance division, LOFSA would be able to enhance its supervisory functions and facilitate the review of the existing framework more effectively and diligently.

B. Summary of the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Assessment

Introduction

54. This Report on the Observance of Standards and Codes for the *FATF 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations Combating the Financing of Terrorism* was prepared by a team composed of staff of the International Monetary Fund and another expert not under the supervision of Fund and Bank staff who was selected from a roster of experts in the assessment of criminal law enforcement and non-prudentially regulated financial activities.⁸

55. The report provides a summary of the level of observance with the FATF 40+8 Recommendations as of the time of the assessment, and provides recommendations to strengthen observance and improve the AML/CFT framework

Information and methodology used for the assessment

56. In preparing the detailed assessment, the IMF team reviewed the relevant AML/CFT laws and regulations, and supervisory and regulatory systems in place to deter money laundering (ML) and financing of terrorism (FT) among prudentially regulated financial institutions. The Fund staff also reviewed the regulatory systems in place for non-prudentially regulated sectors that are macro-relevant, specifically offshore companies, trust companies, offshore trusts and offshore limited partnerships. The IAE reviewed the capacity and implementation of the criminal law enforcement systems.⁹

57. The AML/CFT assessment was based on the draft Methodology for Assessing Compliance with Anti-Money Laundering and Combating the Financing of Terrorism Standards (FATF Secretariat Draft of August 26, 2002) (AML/CFT Methodology). The AML/CFT Methodology was still in draft form at the time of the initial mission to Labuan. The presentation of the detailed assessment also follows the draft template available at the time of the first mission rather than the (slightly revised) final templates. Minor differences

⁸ The IMF assessors were Mr. John Abbott (Mission Chief, MFD), Mr. Kiyotaka Sasaki (MFD) and Mr. Cheong-Ann Png (LEG). The independent AML expert (IAE) was Ms. Sue Takasu of the Ministry of Justice of Japan and public prosecutor of the Tokyo District Public Prosecutors Office. The roster of experts for the IAE is based on the names of competent persons identified by the FATF, FSRBs, the United Nations, and the Egmont Group. Sections prepared by the IAE are presented in italics.

⁹ In Malaysia, anti-money laundering is primarily a federal responsibility. Hence, for purposes of this assessment it was necessary to consider the laws, regulations and practices at the federal level as well as those applicable only to Labuan.

between the draft and final methodologies had no substantive impact on the conclusions of the assessment and this ROSC follows the template introduced in December 2002.

58. The AML/CFT assessment was carried out during two on-site missions. The IMF team carried out its evaluation between September 30 and October 11, 2002. The IAE mission took place July 14–22, 2003. The conclusions of the IMF portions of the assessment are based largely on information available by the end of the first mission, October 11, 2002, updated to reflect significant legislation that came into effect in early 2003, prior to the IAE mission. The sections dealing with criminal justice aspects are based on information available as of the time of the IAE mission, July 14–22, 2003.

Main findings

59. The legal and institutional framework for addressing money laundering in Labuan, and indeed for Malaysia, was substantially strengthened with enactment of the Anti-Money Laundering Act 2001 (AMLA). AMLA came into force with effect from January 15, 2002. However, Part IV, dealing with preventive measures, was invoked in stages and all of the reporting obligations in Part IV were invoked on offshore entities with effect from April 15, 2003. AMLA is federal legislation which provides inter alia for: criminalization of the offence of money laundering; establishment of the financial intelligence unit; reporting obligations for financial institutions (including offshore financial institutions); and powers for investigation and enforcement. All financial institutions operating in the Labuan IOFC are now subject to AMLA and are required to satisfy the broad scope of preventive measures laid out in Part IV of the Act. The anti-money laundering regime was further reinforced by enactment of the Mutual Assistance in Criminal Matters Act 2002, which came into effect on May 1, 2003 and which allows comprehensive international assistance by Malaysia in criminal matters.

60. An important gap in the Malaysian AML/CFT regime at the time of the assessment was lack of legislation dealing explicitly with the financing of terrorism. Existing statutes addressed only selected elements of the FT standards called for in the FATF 40+8 Recommendations. The mission recommended that *specific new legislation criminalizing FT, with sound and severe punishment, should be introduced as soon as possible*. (Legislation addressing these terrorist financing recommendations was adopted after conclusion of this assessment. In 2003 the Penal Code was amended to criminalize terrorist financing. Also, AMLA was amended effective December 25, 2003 to extend its freezing, seizure and forfeiture powers to terrorist property, although enforcement of these provisions awaits amendments to the Criminal Procedures Code. The analysis and recommendations of this assessment do not reflect these more recent developments.)

61. The legal and institutional framework of anti-money laundering is generally well implemented. An active FIU is in place, law enforcement has effective processes for investigating and prosecuting money laundering cases (particularly drug money laundering), including freezing and confiscation of the proceeds of crime. LOFSA has active programs for ensuring compliance with the preventive measures mandated by AMLA. Adoption of a

broader network of bilateral and multi-lateral treaties, agreements and MOUs should make international cooperation more effective, although some residual secrecy provisions are an impediment to fully effective cooperation.

62. With respect to the regime for anti-money laundering, deficiencies noted in the assessment generally address details where the Malaysia regime does not cover the full scope of the criteria in the methodology or where administration of the regime could be made more robust. Introduction of effective terrorist financing, now in train, will go a long way toward correcting most of the gaps in Malaysia's overall compliance with the FATF 40+8 Recommendations.

Criminal justice measures and international cooperation

Criminalization of ML and FT

63. ML is criminalized in Malaysia in a manner that is broadly consistent with the Vienna Convention, which has been signed and ratified. Although Malaysia has signed the Palermo convention, that convention has not yet been ratified, pending passage of legislation that would effectively criminalize financing of terrorism. Under AMLA (a) "unlawful activity" means any activity which is related, directly or indirectly to any serious offence or foreign serious offence; and (b) "proceeds of unlawful activity" means any property derived or obtained, directly or indirectly, by any person as a result of any unlawful activity. The definition of "serious offence" is reasonably wide, including specification of 150 specific offences, as well as attempts to commit, or abatement of, those offences. The mental elements requirement under AMLA are "knows or has reasonable grounds to believe." *Questions of fact in proceedings under AMLA shall be decided on the balance of probabilities, while the standard of "Beyond a Reasonable Doubt" must be applied to convict the accused in other criminal cases.* Punishment for a money laundering offence under AMLA is a fine not exceeding 5 million ringgit or imprisonment for a term not exceeding five years, or both. *Punishment for money laundering offences related to drugs and corruption is much more severe. Very serious offences are included in the predicate offences under AMLA and Malaysia should consider making punishment for money laundering offences harsher.*

Confiscation of proceeds of crime or property used to finance terrorism

64. **Legal provisions and protection.** AMLA provides that an enforcement agency, where it has reasonable grounds to suspect that a money laundering offence has been or is about to be committed by any person, may issue an order freezing any property of that person. AMLA also provides authority for an investigating officer, with supervisory approval, to seize moveable property, where he has reasonable ground to suspect it is the subject matter of a money laundering offence. Related powers are also provided for Public Prosecutors to issue freeze or seizure orders related to both moveable or immovable property related to investigations of money laundering offences. AMLA provides that, upon conviction, courts shall make an order for forfeiture for any property which is proved, subject

to standards of civil proceedings, to be the subject matter of the offence or to have been used in the commission of an offence. Forfeiture may also be ordered in the absence of a conviction if the court is satisfied that the accused is not the lawful owner of the property and no other ownership is established. AMLA includes powers to facilitate identification and tracing of property. Protection of the rights of bona fide third parties is also provided for, although exercising these rights could place a considerable burden on the third party. There are no provisions for rendering contracts void or unenforceable where it is foreseeable that ability to recover financial claims under AMLA could be prejudiced. Nor are there provisions for an asset forfeiture fund or for sharing mechanisms, which would not be permissible under the Federal Constitution which requires all moneys raised or received by the Federation to be paid into the Federal Consolidated Fund. The AMLA provisions above relating to the freezing, seizure and forfeiture provisions did not originally apply to assets related to terrorist financing, although this is being addressed by amendments to AMLA that were adopted after the conclusion of the assessment and will soon be brought into force. (See paragraph 60 above.) *However, the Exchange Control Act of 1953 provides authority to freeze money, gold and securities of terrorists who finance terrorism and terrorists organizations, in accordance with UN resolutions.* When brought into force, the amendments to AMLA will extend the provisions for freezing, seizure and forfeiture to property that is used or intended to be used for FT, and to other serious offences, as recommended by the mission.

Keeping Statistics and Enforcement

65. *Respective law enforcement authorities and prosecutorial agencies are responsible for compiling statistics on the amounts of property frozen, seized, and confiscated in relation to ML and the predicate offence. However, as there are tens of specialized investigative agencies or departments inside law enforcement agencies, it is difficult to have a clear understanding of those statistics made by the respective relevant agencies. It is recommended that they establish a competent unified authority which gathers and classifies the data, and establishes explicit statistics.*

The FIU and processes for receiving, analyzing, and disseminating intelligence:

66. **Functions and Authority.** Under the provisions of AMLA the Financial Intelligence Unit of Bank Negara Malaysia has been appointed by the Finance Minister as the competent anti-money laundering authority, including for Labuan, for receiving and analyzing suspicious transaction reports, and for disseminating intelligence reports to *enforcement* agencies. The FIU, with a staff of approximately 18, functions autonomously under AMLA, and does not require the Minister's approval for its day-to-day operations. Reporting institutions are required, subject to criminal penalties, to report promptly to the FIU transactions that give reasons to suspect that the transaction involves proceeds of any unlawful activity. In the case of Labuan, suspicious transaction reports are filed with LOFSA, which relays them to the FIU. This structure poses some risks to the integrity of the reporting regime and direct reporting to the FIU would be preferable. LOFSA has issued STR reporting guidelines to offshore banks, and draft guidelines to offshore insurance companies. AMLA calls for the FIU and other enforcement agencies to coordinate and cooperate with

any other enforcement agency in and outside Malaysia with respect to an investigation into any serious offence or foreign serious offence. More routine information exchanges with foreign authorities are subject to the existence of satisfactory bilateral or multilateral, which are not yet well developed.

67. **Law Enforcement Considerations.** *The FIU has rather strong powers to gather intelligence and information from various governmental organizations. With the power to gather various kinds of confidential information including criminal records, financial history, etc, the six financial analysts of the FIU act like criminal investigators. They also decide which STR should be disseminated to which law enforcement agency. Given the volume of work, the number of analysts should be increased and it would be useful to introduce some criminal investigative experts. Beginning in January 2002, when the mandatory reporting requirements of AMLA came into effect, the FIU has maintained statistics on the number and disposition of STRs, as well as instances of information requests from domestic and foreign authorities. While a notable number of STRs have been reported nationally, relatively few originated from Labuan. While the FIU has responded to all domestic and foreign information requests it has not spontaneously referred STRs to foreign agencies, in part, apparently because the required formal arrangements were not in place.*

68. *From a law enforcement perspective, it seems that more STRs should be disseminated to law enforcement agencies as long as confidentiality is secured. Wider and more timely dissemination of STRs might be fruitful when combined with other confidential information exclusively kept by the law enforcement agencies.*

Law enforcement and prosecution authorities, powers, and duties

69. *The law enforcement agencies that are authorized to investigate ML and FT in Malaysia, including in Labuan, are the Police (RMP), Anti-Corruption Agency (ACA), the Customs service (RMC) and the BNM depending on the offence. ML related to drug offences may be investigated by the Police, and by the Customs service when drugs are smuggled through customs. But only the Police have the power to forfeit the property in drug offences. ML related to corruption may be investigated by the Police or the ACA. In practice, the ACA investigates almost all corruption cases. BNM may investigate ML under the AMLA and offences under the BAFIA. FT is investigated by the Police. While these agencies have skilled staffs, to keep up with the trend toward more sophisticated crime, personnel of the respective investigative agencies should be increased. Given its small size and the relatively low incidence of crime in Labuan, these agencies presence and activity in Labuan is small.*

70. *Power of prosecution is invested in the Deputy Public Prosecutors of the AGC or prosecuting officers of the law enforcement agencies, depending on the character or seriousness of the crime. In order to institute prosecutions effectively, some DPPs are seconded to some investigative agencies such as the ACA or BNM. Statistics on the number of investigations and prosecutions for ML related offences were not available at the time of the mission.*

71. *Malaysian investigative agencies are highly specialized and subdivided into many investigative departments. Agencies appear to cooperate and coordinate effectively with one another in task forces organized to investigate individual cases. The National Coordination Committee to Counter Money Laundering (NCC), comprising 13 law enforcement agencies and regulator bodies, plays an important role in this respect. Special investigative techniques, such as controlled delivery, lawful interception, and undercover operations, subject to appropriate safeguards, are frequently used in the course of investigations of drug trafficking offences and these techniques could be more widely extended to money laundering investigations. The relevant powers of investigation and enforcement should be extended to the proposed CFT legislation and a sufficient legal basis for investigative techniques in terrorist cases should be secured. Ongoing training programs of the respective government agencies include instruction in techniques to investigate and prosecute ML and FT. From a preventive perspective, it would be useful for the agencies to review and study typologies and trends in current ML and FT methods and techniques, drawing on both experience in Malaysia and foreign case studies.*

International Cooperation

72. *The Mutual Assistance in Criminal Matters Act 2002 (MACMA) provides for a wide range of legal assistance, but in principle requires a treaty or other agreement with a foreign country. Legal assistance without such a treaty or other agreement in place may be available at the discretion of the Minister. As MACMA only came into force on May 1, 2003, no treaties or agreements were in place at the time of the assessment. However, negotiations were underway with 9 ASEAN countries. Although no requests for mutual legal assistance under MACMA had been received as of July 2003, there appears to be a strong political will to act in a timely manner and effectively follow up if such requests are made. Extradition for money laundering offences is possible, subject to some limitations. Beyond formal mutual legal assistance, AMLA provides that the competent authority (the FIU) and the relevant enforcement agency (LOFSA) shall co-ordinate and cooperate with any other enforcement agency with respect to an investigation into any serious offence or foreign serious offence. A few bilateral MOUs with foreign agencies have been concluded or are under discussion but law enforcement agencies did not provide data on the number, source and purpose of requests for information and their resolution. Malaysia is encouraged to conclude bilateral or multilateral treaties or agreements with as many foreign countries as necessary and to follow-up on requests for legal assistance from foreign countries in a timely and effective manner. Current restrictions on LOFSA's access to customer information are an impediment to spontaneous or "upon request" international exchanges of information between competent authorities.*

Preventive Measures for financial institutions

Prudentially regulated sectors

73. *AMLA establishes an array of preventive measures for financial institutions, including offshore financial institutions in Labuan, as a legal obligation. Among other things,*

these obligations cover record keeping, suspicious transactions reporting, identification of account holders, retention of records, compliance programs, overriding of secrecy obligations, obligations and enforcement powers of supervisory or licensing authority, protection for reporting, examination of a reporting institution or person. As the supervisory authority for offshore financial services, LOFSA is responsible for ensuring that Labuan offshore financial entities comply with these requirements and it has issued a variety of guidance to secure compliance.

74. In most respects the preventive measures obligations under AMLA, and amplified by mandatory guidelines, adhere to the standards established for the FATF 40+8 Recommendations. With respect to customer identification, stricter guidance should be developed for renewal of customer identification, identification of the beneficiaries of offshore trusts should be required, and accurate and meaningful originator information on wire transfers should be required. The requirements of AMLA for ongoing monitoring of transactions are limited but are supplemented by enforceable guidelines issued by BNM. Guidelines with respect to monitoring of suspicious transactions with jurisdictions with weak AML/CFT regimes should be updated more frequently. More detailed and comprehensive guidance should be developed for insurance companies, for securities companies, and for trust activities.

75. While LOFSA generally has a well developed program for off-site monitoring and on-site examination for compliance with AML requirements, that effort focuses primarily on offshore banks. New guidelines should be issued, and compliance monitoring should be augmented, with respect to offshore insurance companies, securities companies and the trust and company service sector to ensure that the preventive measures regime is fully implemented. A residual secrecy provision in the LOFSA Act appears to significantly impede LOFSA's ability to proactively monitor compliance in an ongoing and routine manner and to co-operate informally with overseas authorities. The Act restricts LOFSA's power to access information of a particular customer to those clients obtaining credit facilities from banks and when LOFSA is satisfied, based on evidence made available to it, that fraud or a criminal offence has been or is likely to be committed. These restrictions should be eliminated.

Trust and Company Service Providers

76. While not directly subject to prudential regulation, trust companies perform essential services within the regulatory framework of the IOFC. These include the incorporation and registration of offshore companies, registration of offshore trusts and registration of offshore limited partnerships. All documents that are required to be filed or lodged with LOFSA have to be made through a trust company. These companies are tasked with the responsibility of conducting due diligence with respect to the identities and businesses of their customers, particularly for anti-money laundering purposes. Particularly now that the preventive measures required by AMLA have come into force, more proactive oversight of these firms by LOFSA, including on-site examinations, is needed to ensure compliance with AML requirements.

Summary assessment against the FATF Recommendations

77. Labuan formally complies with most of the FATF 40+8 Recommendations. Significant shortcomings arise primarily as a result of the absence of specific legislation dealing with terrorist financing, a gap the authorities are working to correct. Laws and regulations need to be extended or amplified in several places to achieve compliance with the full scope of the Recommendations, and a number of administrative steps should be taken to strengthen implementation of the regime.

78. Table 3 summarizes recommended actions in areas related to the FATF 40+8 Recommendations, while Table 4 contains other recommendation to further enhance the AML/CFT regime.

Table 3. Recommended Action Plan to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
40 Recommendations for AML	
General framework of the Recommendations (FATF 1–3)	LOFSA should be empowered to access any information on any customer of offshore firms. <i>Personnel of the respective investigative agencies should be increased in line with the increased prevalence of sophisticated crime.</i>
Scope of the criminal offense of money laundering (FATF 4–6)	<i>Consideration should be given to making punishment of money laundering offences harsher, in line with other serious crimes that are predicate offences, such as for drug and corruption offences.</i>
Provisional measures and confiscation (FATF 7)	Additional provisions should be considered for: (a) confiscation of property of organizations that are primarily criminal in nature; (b) rendering contracts void or unenforceable where it is foreseeable that the authorities would be prejudiced in their ability to recover financial claims under AMLA; (c) establishment of an asset forfeiture fund with respect to confiscated property; and (d) (as contemplated in subsequent amendments to AMLA) extending the provisions for freezing, seizure and forfeiture to property that is used or intended to be used for FT. Review the rights of <i>bona fide</i> third parties to ensure they are sufficiently protected under Section 61 of AMLA.
General role of financial system in combating ML (FATF 8–9)	Guidance applicable to insurance, securities and trust companies should be developed or expanded and oversight of these firms' compliance with AML/CFT preventive measures should be enhanced.

Reference FATF Recommendation	Recommended Action
Measures to cope with countries with insufficient AML measures (FATF 20–21)	Update guidelines for monitoring and reporting of transactions with jurisdictions that do not have adequate AML/CFT regimes.
Other measures (FATF 22–25)	
Implementation & role of regulatory and other administrative authorities (FATF 26–29)	
Administrative Cooperation – Exchange of general information (FATF 30–31)	
Administrative Cooperation—Exchange of information relating to suspicious transactions (FATF 32)	
Other forms of cooperation – Basis & means of cooperation in confiscation, mutual assistance, and extradition (FATF 33–35)	<i>To monitor and ensure expeditious responses, statistics on how long it took to fill requests, and what kind of legal assistance was requested, etc., should be compiled.</i>
Other forms of cooperation – Focus of improved mutual assistance on money laundering issues (FATF 36–40)	<i>Since, in principle, legal assistance requires a treaty or other agreement with a foreign country, Malaysia should conclude bilateral or multilateral agreements with as many foreign countries as necessary.</i>
8 Special recommendations on terrorist financing	
I. Ratification and implementation of UN Instruments	
II. Criminalizing the financing of terrorism and associated money laundering	<i>Specific new legislation criminalizing FT, with sound and severe punishment should be introduced as soon as possible. The proposed CFT legislation (which was subsequently adopted) should adhere to the standards set by the International Convention for the Suppression of the Financing of Terrorism. Additional provisions should be included in the proposed legislation to ensure that the relevant powers of investigation and enforcement are extended to CFT and that a sufficient legal basis is provided for investigative techniques.</i>
III. Freezing and confiscating terrorist assets	Amendments to AMLA (subsequently adopted) should introduce provisions to allow the freezing without delay of funds or other property of terrorists, or those who finance terrorism, or terrorist organizations. Extend the provisions for freezing, seizure and forfeiture to property that is used or intended to be used for FT.
IV. Reporting suspicious transactions related to terrorism	
V. International Cooperation	
VI. Alternative remittance	
VII. Wire transfers	Banks should be required to include accurate and meaningful originator information and related messages on wire transfers and to conduct enhanced due diligence on wire transfers that do not include such information.
VIII. Non-profit organizations	

Table 4. Other Recommended Actions

Reference	Recommended Action
Law enforcement and international cooperation	<i>A competent unified authority should be established to gather and classify AML/CFT data and establish explicit statistics.</i>
FIU	<p><i>The number of analysts in the FIU should be increased and criminal investigative experts should be added to the FIU staff.</i></p> <p><i>More STRs should be disseminated to law enforcement agencies as long as the confidentiality of STRs is secured.</i></p> <p><i>The FIU should be required to publish periodic reports.</i></p>
Suspicious transaction reporting	Considerations should be given to having Labuan reporting institutions send STRs directly to BNM, rather than to LOFSA

Authorities' response

The IMF assessment team has conducted a fair assessment with regard to the AML/CFT measures. As pointed out by the assessors, the issue of money laundering has been tackled and given significant focus even before AMLA was enacted. LOFSA, as the body that is responsible for the development of Labuan has singly or jointly with other authorities in Malaysia made efforts to address issues relating to anti-money laundering measures. This is evidenced by LOFSA's participation at meetings at national, regional and international level, issue of guidelines which recognized KYC Policy as an important element of banking operations and the existence of provisions in the offshore legislation that emphasized due diligence and AML measures.

With the invocation of Part IV of the AML Act early in 2004, the Act provides regulator/supervisors and enforcement agencies with powerful tools to combat money laundering. The Act, being a fairly new legislation, is considered to be quite comprehensive. However, LOFSA and all the other authorities that are responsible for the implementation of this Act recognize that the criminals are getting more sophisticated and shifting away from the traditional financial institutions to launder the proceeds of their illegal activities. As such, it is important our officers are trained and exposed to new money-laundering methodologies to enable them to keep abreast with latest development and issue new guidelines to address latest issues.

On this basis, LOFSA would continuously be reviewing its guidelines/circulars on measures against money laundering and expanding the scope of its guidelines. Currently the guidelines have been focused on banking activities, new guidelines are in the pipeline for insurance and we would consider the IMF's recommendation to have similar guidelines for trust companies and the activities in the securities industry. AMLA itself is dynamic in nature and its scope would be expanded from time to time.

The absence of a legislation that criminalizes terrorist financing would indicate that there's less focus on measures against terrorist financing. This however is not true. Pending the enactment of legislation on combating financing of terrorism, the act of waging war against any power in alliance with the Head of the Federation has been declared to be one of the predicate offence in the AML Act. This is an interim effort to ensure that an act to finance terrorism from proceeds of illegal activities would come within the ambit of AMLA. At the same time, soon Malaysia would be acceding to the International Convention for the Suppression of the Financing of Terrorism and enacting a legislation on combating financing of terrorism.

While actions are being taken to accede to the Convention for the Suppression of the Financing of Terrorism and enacting legislation on combating financing of terrorism, LOFSA has been issuing directions to the offshore banks, insurance and trust companies to freeze accounts of persons associated with Osama Bin Laden, the Taliban and the Al-Qaida based on the United Nations Security Council Resolutions.

In conclusion, efforts are being intensified to ensure adequate measures against money laundering and financing of terrorism. Such efforts would include improving national and international co-operation. LOFSA would continue to play an active role in issuing new guidelines and conduct review of existing guidelines to ensure they are updated and comprehensive, based on international standards. Such efforts would be conducted on consultation basis, with input from the industry as well as from other relevant government agencies. The assessment is considered to be beneficial to LOFSA—it provided LOFSA an independent assessment of where Labuan IOFC is today and provided guidance on new things to consider for the future—all in the interest of the IOFC.

C. Insurance Core Principles and Transparency of Insurance Regulation

General

79. The following is a summary of an assessment of compliance with the IAIS Insurance Core Principles, which was performed in the context of the IMF's Offshore Financial Center (OFC) program. The assessment covers the practices of the Labuan Offshore Financial Services Authority (LOFSA) with respect to offshore insurers licensed in the International Offshore Financial Centre (IOFC) of the Federal Territory of Labuan. The IAIS Insurance Core Principles assessment has been prepared by Mr. Lonny McPherson, Senior Advisor, International Advisory Group, Office of the Superintendent of Financial Institutions, Canada. The review of the IAIS core principles involved the review of the self-assessment prepared by the LOFSA, comparison with the IAIS Core Principles and the Core Principles Methodology and a review of parts of the insurance laws in Labuan.

80. During the on-site assessment, a series of meetings and presentations were held in Labuan with LOFSA, in Kuala Lumpur with Bank Negara Malaysia (the central bank regulator for banking and insurance in Malaysia) and industry representatives. Aside from LOFSA, meetings were held with selected insurers, brokers, an insurance manager, an audit

firm and the Labuan International Insurance Association (LIIA). Assistance provided by these organizations is gratefully acknowledged.

Institutional and macroprudential setting—Overview

81. While there are a number of insurance and insurance-related entities in Labuan¹⁰ the industry in Labuan is a small but growing market, with total gross premiums in 2001 of \$230 million¹¹ (\$135 million in 2000). The gross premiums were split \$195 million general and \$35 million life. Total industry assets were \$513 million at the end of 2001, which represents approximately 3.2 percent of the total insurance fund assets in Malaysia and approximately 5 percent of the total insurance premiums written in Malaysia. By comparison, the 54 Labuan offshore banks had total deposits of \$3.8 billion and total assets of \$18.1 billion at the end of 2001. The relative small size of the Labuan insurance market (less than 3 percent of the Labuan bank assets) is reflected in the relatively lower level of supervisory activities by LOFSA compared to the overall level of supervision in the banking sector.

82. The industry is well capitalized with paid up capital of \$298.9 million in 2001 (59.4 percent held by Malaysians), which is partly due to the minimal income tax requirements in Labuan as an offshore center and partly due to Labuan being free from foreign exchange restrictions which apply in Malaysia.

83. The Labuan insurance industry is predominately a reinsurance center (87 percent of total general premiums are reinsurance), of primarily large and special risks consisting of fire (47 percent), marine (12.5 percent), engineering (9.8 percent), motor (14.3 percent) and other risks. Approximately half the total general business is written inside of Malaysia. There was a slight decline in the overall net retention ratio of general insurers to 76.9 percent in 2001, however, the industry underwriting loss increased from \$13.9 million (116 percent) in 2000 to \$43.1 million (134 percent) in 2001, largely due to increased claims and commissions. The life business is written directly and consists primarily of offshore investment-linked products to high net worth Malaysians. The industry is dominated by a few large players, one general reinsurer (an affiliate of a large national domestic reinsurance company) writes

¹⁰ The number of firms licensed to do offshore insurance and insurance related business reached 98 in 2001, an increase from 83 at the end of 2000. Of the total, 47 were insurers and the balance were insurance related brokers (36) and managers (15). Companies are permitted to operate as Labuan incorporated entities or as branches of foreign licensed insurers. Of the licensed insurers, 2 were life, 3 general, 1 composite, 22 reinsurance, and 19 captives.

¹¹ All amounts are reported in US dollars. \$1 = RM3.80 Malaysian ringgit. Note, Labuan figures are quoted from the 2001 LOFSA Annual Report and Malaysia figures are quoted from the Bank Negara Malaysia 2001 Insurance Annual Report.

approximately 1/3 of total gross premiums and one life insurer (subsidiary of a domestic banking and insurance group that is supervised by Bank Negara Malaysia) that writes the majority of the \$35 million investment-linked life business in Labuan. There are a number of captives¹² (largely general insurance), however they represent a small amount of the total business written, \$8.3 million premiums or about 2 percent of the total gross general premiums. Due to confidentiality restrictions, the mission was unable to get data on individual companies and there appears to be minimal analysis available within LOFSA on the industry.

84. Off shore insurance brokers earnings from brokerage fees increased by 78.9 percent to \$6.8 million in 2001. These fees are largely from placing business overseas, with general insurance accounting for 65.5 percent of total brokerage fees. There were no statistics available on earnings by insurance managers, however we learned that one large insurance manager performs various levels of administrative activities for almost half the insurance licensees in Labuan. The larger insurers however have staff performing their own administrative activities.

85. There are no standards or requirements in Labuan for the valuation of liabilities (including technical provisions), although an actuary's report is required for life insurers. In the absence of a professional actuarial association in Malaysia, a list of qualified actuarial associations in foreign jurisdictions is provided in the Offshore Insurance Act.

General preconditions for effective insurance supervision

86. The responsibilities and objectives for LOFSA are clearly specified in the LOFSAA and the Offshore Insurance Act, which provide a suitable framework covering licensing, supervision, sanctions and legal protection for supervisors. The legal system operates under common law principles, as Malaysia is a former British colony.

87. The Chairman of LOFSA, Dr. Zeti Akhtar Aziz, is also the Governor of BNM, the central bank and regulator of banks and insurers in Malaysia.

88. LOFSA is empowered to make recommendations to the Minister of Finance to revoke any license and to take over the administration of insolvent companies per the Offshore Insurance Act (OIA). There are also provisions in the legislation that impose monetary penalties and possibility of imprisonment for any violations under the OIA.

¹² Captive insurance is business where the insured is a related or associated company or person. All captive insurance business must be placed with a direct Malaysian insurer and is then ceded to the captive, it cannot be written directly with Malaysians.

89. A major weakness in the insurance supervisory regime is the lack of accounting standards and standards for the valuation of liabilities, including technical provisions. Under Section 24 (1)c of the Offshore Insurance Act 1990, every insurer must follow accepted international accounting standards or such other standards as may be approved by LOFSA. Since LOFSA has not issued any guidelines in this respect, insurers are free to adopt any accounting standards, since there are no international standards for insurance accounting (the International Accounting Standards Board is currently working on this). The Malaysian Accounting Standards Board (MASB) has issued accounting standards on insurance,¹³ which LOFSA should consider adopting.

90. Since the valuation of liabilities (including technical provisions) is a key part of the supervisory regime when assessing the financial condition of an insurance company, it is very important that LOFSA issue requirements in this area. In the absence of a professional actuarial association in Malaysia that issues standards for valuation of technical provisions, consideration should be given to adopting the requirements outlined in the MASB pronouncements and the guidance on valuations issued by BNM.

Main findings

91. LOFSA has a regulatory and supervisory structure that has the form of prudential supervision in many aspects. It has the authority and the ability to exercise it, in most instances, in order to meet most of the IAIS core principles for insurance. The principles regarding Organization of an Insurance Supervisor, Licensing, Change of Ownership, Sanctions and Confidentiality appear to be the strongest aspects of LOFSA's supervisory regime. However there are several key principles that are not, or not fully, observed as they have not yet been implemented and enforced by LOFSA. Additional staffing and skills are required. Filling other regulatory gaps can be expedited, since it appears that BNM has issued guidelines and procedures in many of the areas where LOFSA does not fully observe the core principles. LOFSA is encouraged to review the BNM guidance in these areas and seek expert assistance from BNM where required (note that a detailed assessment of the BNM material was not conducted).

Organization of an insurance supervisor CP 1

92. The legislation should be revised to provide LOFSA with unrestricted access to all company information, including access to information on customer accounts.

93. LOFSA commenced on-site examinations in 2001, however only three full examinations have been conducted (largely with resources from BNM). We were unable to

¹³ MASB 17 *General Insurance* and MASB 18 *Life Insurance* (as modified by BNM guidelines).

review the examination files as they were not completed. There is a need for additional resources and expertise in insurance supervision and actuarial affairs. While there are plans to hire four additional supervisory staff, in the interim consideration should be given to additional use of BNM examination staff and actuarial experts (or engaging outside actuarial and audit experts) until permanent staff can be hired in Labuan. Many staff were formerly with BNM. We found the directors and managers we interviewed to be quite experienced and knowledgeable.

94. Consideration should be given to altering the supervisory structure and mandate to make LOFSA solely an independent financial regulator, with the primary role the protection of depositors and policyholders and promotion of financial system stability.

95. While LOFSA publishes an annual report, which is available on the website, not all guidelines and procedures are available publicly. Transparency of the supervisory process would be enhanced by making all guidelines and procedures available publicly and by making drafts available for public consultation before they are issued.

Licensing and changes in control CP 2,3

96. LOFSA is observant of the principles on licensing and changes in control. Two minor recommendations were made in this area.

Corporate governance and internal controls CP 4,5

97. LOFSA has not issued standards on corporate governance and internal controls. However, LOFSA's supervisory activities include quarterly meetings with the industry, which are used to provide informal guidance and which all companies are required to attend. Consideration should be given to reviewing guidance and procedures issued by BNM in order to improve observance of the essential criteria. Refer to comments in Principle 13 on-site Inspection.

Prudential rules CP 6–10

98. To improve compliance with the core principle on assets, standards should be developed to address the essential criteria including: prudential investment limits, safekeeping, matching of assets and liabilities, liquidity, and risk management policies in accordance with the *IAIS Supervisory Standard on Asset Management by Insurance Companies*.

99. The lack of accounting standards and standards on valuation of liabilities, including technical provisions is weaknesses that lower the assessment for the core principles on liabilities, reinsurance, financial reporting, and capital adequacy and solvency. Additionally, there are no requirements with respect to reinsurance contracts and the amount of credit taken for reinsurance ceded. This is a weakness in the solvency test that is discussed in Principle 8 Capital Adequacy and Solvency.

Market conduct CP 11

100. LOFSA has not issued standards with respect to market conduct. As noted in Principle 1 Organization of an Insurance Supervisor, since LOFSA is not permitted access to customer information under restrictions in the LOFSAA, they would be unable to assess compliance by insurers with the essential criteria on market conduct. However, LOFSA holds quarterly meetings with the industry, which all companies are required to attend, to discuss industry issues including market conduct related issues.

Monitoring, inspection and sanctions CP 12–14

101. The financial reporting by insurers can be greatly enhanced by stipulating accounting standards and standards for valuation of liabilities, including technical provision, as discussed in the Preconditions for Effective Supervision section above.

102. There is minimal analysis performed on individual company and industry financial data submitted, albeit the industry is relatively small with a few dominant players. It is recommended that monitoring tools such as: early warning tests, key indicators and benchmark studies be developed to enhance the continuous monitoring of insurers. The development of these types of monitoring tools, with the assistance of experts from Bank Negara Malaysia, can significantly strengthen LOFSA's ability to identify problem companies and risk areas where their limited supervisory resources can be focused.

103. Refer to comments in Principle 1 Organization of an Insurance Supervisor regarding the on-site supervision Principle.

104. LOFSA should develop a range of supervisory intervention tools for use at an early stage, so that it is not limited to instances where there are breaches of the legislation. The range of supervisory intervention tools should permit LOFSA to take early corrective action when there are unsafe or unsound practices or when institutions are experiencing other problems. The range of supervisory interventions should also be communicated publicly, to enhance transparency of the regulatory process and market discipline.

Cross border operations, supervisory coordination and cooperation, confidentiality CP 15–17

105. Since none of the insurers that LOFSA supervises have established branches and subsidiaries outside of Labuan, the principle on Cross Border Business Operations is not applicable. However, LOFSA should continue to closely monitor these activities.

106. LOFSA should have access to all company information including customer information and be able to share all supervisory information on individual institutions with home supervisory authorities, (refer to Principle 1 Organization of Insurance Supervisor).

107. Since not all foreign insurers are regulated by their home “monetary” authority, the legislation should be revised to permit LOFSA to more broadly share information with the home “supervisory” authority of the institution. We understand that revisions to the legislation are being drafted.

108. The Confidentiality Principle is observed. However, market discipline of insurers would be enhanced by requiring company information on directors and officers and audited financial statements to be available to the public. LOFSA should publish summary financial data (perhaps on the website) on an individual company basis (as done by BNM).

Table 5. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
<p>Organization of an Insurance Supervisor i.e., CP 1</p>	<p>Legislation should be revised to provide LOFSA with unrestricted access to all company information, including access to information on customer accounts.</p> <p>There is a need for additional resources and expertise in insurance supervision and actuarial affairs to enhance LOFSA’s on-site examinations.</p>
<p>Licensing and Changes in Control i.e., CPs 2–3</p>	
<p>Corporate Governance and Internal Controls i.e., CPs 4–5</p>	<p>Standards on corporate governance and internal controls should be developed for the industry.</p>
<p>Prudential Rules i.e., CPs 6–10</p>	<p>Standards should be developed to address the essential criteria on assets including: prudential investment limits, safekeeping, matching of assets and liabilities, liquidity, and risk management policies.</p> <p>For foreign branches, consideration should be given to requiring assets, or an acceptable form of collateral, be maintained in Labuan to cover liabilities and the solvency margin.</p> <p>Clarify requirements regarding use of accounting standards to those issued by the Malaysian Accounting Standards Board (MASB), as modified by requirements issued by the BNM, where appropriate.</p> <p>Issue requirements regarding valuation of liabilities, including technical provisions. In the absence of a professional actuarial association in Malaysia that issues standards for valuation of technical provisions, consideration should be given to adopting the requirements outlined in the MASB pronouncements and the guidance on valuations issued by BNM.</p> <p>Issue requirements with respect to reinsurance contracts and the amount of credit taken for reinsurance ceded (including unlicensed reinsurance) and modify the solvency test where appropriate.</p>

Reference Principle	Recommended Action
Market Conduct i.e., CP 11	Issue standards with respect to market conduct and evaluate company compliance.
Monitoring, Inspection, and Sanctions i.e., CPs 12–14	Monitoring tools such as: early warning tests, key indicators and benchmark studies should be developed to enhance the continuous monitoring of insurers. Consider developing a range of supervisory intervention tools for use at an early stage, so that it is not limited to instances where there are breaches of the legislation.
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality i.e., CPs 15–17	LOFSA should have access to all company information including customer information and be able to share all supervisory information on individual institutions with home supervisory authorities (refer to Principle 1 Organization of Insurance Supervisor). Legislation should be revised to permit LOFSA to more broadly share information with the home “supervisory” authority of the institution. Market discipline of insurers would be enhanced by requiring company information on directors and officers and audited financial statements to be available to the public. LOFSA should consider publishing summary financial data (perhaps on the website) on an individual company basis.

Authorities’ response

Generally, we are of the view that the assessment was quite fair and objective. We noted that the recommendations made by the IMF concentrated mainly on the necessity of LOFSA as a regulatory authority to improve its regulatory aspects of the offshore insurance industry. It was nevertheless admitted by the IMF that the unavailability of certain supervisory tools or guidelines is due to the fact that the industry is rather small compared to the banking industry or domestic insurance, therefore the risk is minimum. In this regard, the recommendation made by the IMF would be further deliberated by the management of LOFSA and decisions would be made on the implementation of the recommendations.

While we agree that several changes to the regulatory regime are required, we have also highlighted some of the proposed amendments to be made to the report for consideration. In the course of review some comments were changed to reflect a fairer view and some inaccurate or irrelevant material was deleted. While we will give full consideration to all the recommendations, on a few points we do not fully share the viewpoint of the assessors. These areas include observations on the investment-linked products, the concern on the conflict of interest in the dual role of LOFSA as a regulator and promoter as well as some points with respect to corporate governance. In addition, to enable LOFSA to consider the implementation of the various recommendations, we would like to seek the cooperation of the IMF to provide guidance on action plans that have been done or being done by other jurisdictions that have been evaluated. This is to assist LOFSA to assess the necessity to

implement the recommendations. It is also to ensure that Labuan would not be at a disadvantage if we decide to implement certain recommendation.

D. IOSCO Objectives and Principles of Securities Regulation

General

109. The Labuan, Malaysia securities regulatory system was assessed for its observance of the IOSCO Objectives and Principles of Securities Regulation as part of the IMF OFC mission to Labuan during September and October 2002. The assessment is of the legislative framework, the operations of the securities regulatory authority—LOFSA—and the Labuan International Financial Exchange—LFX—that make up the overall regulatory environment.

Information and methodology used for the assessment

110. The assessment was based on: interviews with staff of LOFSA, LFX, the Association of Labuan Trust Companies, Bank Negara Malaysia, the Malaysian Securities Commission and individual industry members; a review of laws, rules, guidance and procedures with respect to the securities regulatory regime; and the self-assessments provided by LOFSA. The assessment used the IMF and World Bank Guidance Note for Assessing Implementation of IOSCO's Objectives and Principles of Securities Regulation.

Structure and role of the securities industry

111. The functions and powers of the Authority under the Act establish LOFSA as the financial supervisor for the IOFC. The Act gives LOFSA authority to administer, enforce, carry out and give effect to the provisions of the various laws related to the offshore financial services in Labuan. The Act authorizes LOFSA to conduct examinations of financial institutions and corporations, to impose levies, and to impose and collect fees. The legal system operates under common law principles.

112. The securities industry does not yet play a pivotal role in Labuan. The Labuan International Financial Exchange (LFX) lists nine issues, however, only one trade has been effected on the trading system. These listings include five open-end mutual funds, three Sukuk (Islamic) instruments, and one secondary listing of a floating rate note. As at August 2002, the market value of the listed securities was \$1.2 billion. Apart from issues listed on the LFX, a number of private and public funds, mostly closed-end, have been authorized. In 2001 a total of 17 mutual funds were approved with a fund size of \$815 million. There are two investment banks currently in operation while another four were licensed and expected to commence business in 2003. The activities that do take place are largely with sophisticated clients—institutions, corporations, and high net worth individuals.

113. The LFX was launched in November 2000. It is an Internet based financial exchange to provide listing and trading facilities for a wide range of financial instruments, including Islamic products. The LFX is a wholly owned subsidiary of the Kuala Lumpur Stock

Exchange (KLSE). The LFX is governed by the Labuan Offshore Securities Industry Act (LOSIA) and operated as a self-regulatory organization. As of 26 August 2002, there were eight listing sponsors and six trading agents that have been licensed by the LFX to provide services to the financial markets.

114. The LFX is a self-regulatory organization with responsibility for the regulation of companies listed on its exchange and its dealer members. It carries out prospectus review as well as sets listing requirements. The LFX licenses listing sponsors and trading agents. Listing sponsors are responsible to the Exchange for the fulfillment of pre and post-listing responsibilities by the listed companies. Trading agents conduct trading on the exchange, provide advice to investors and ensure proper settlement of trades. The exchange is also responsible for the regulation of market conduct, including setting trading rules and market surveillance. Trades are cleared by the LFX and settled on a delivery against payment basis with a designated settlement agent bank.

General preconditions for effective securities regulation

115. The general preconditions for effective securities regulation in Labuan appear to be present. There are no significant barriers to entry and exit for market participants. Competition is encouraged and foreign participation is welcomed. The legal system, including the courts and the bankruptcy law, supports effective regulation of securities markets and intermediaries. The regulator has legally enforceable powers of decision and action. The taxation and accounting frameworks are effective.

Main findings

116. In general, the regulatory system that governs the securities market in Labuan appears to function fairly well. Legislation and guidelines combine to form a sound foundation for regulation and LOFSA has most of the authority it requires to carry out its regulatory functions.

117. LOFSA would benefit from additional powers in several areas. The most urgent need is for additional authority for inspections and enforcement activities and to share information with other supervisors. The crux of the problem is the secrecy and confidentiality provisions that are contained in the LOFSAA, 1996 and the various pieces of legislation that LOFSA administers. These provisions hamper effective inspections and enforcement activities because they limit the ability of LOFSA to look at information relating to the identity, affairs or accounts of customers of offshore financial institutions. They also severely restrict the ability of LOFSA to share information with domestic and foreign supervisory and law enforcement agencies.

118. When the market has had an opportunity to develop further, LOFSA likely will need additional authority to authorize and oversee exchanges, trading systems and securities clearing and settlement systems.

119. The other urgent need is for more resources for supervision and oversight activities. LOFSA adopts a risk-based approach to inspections and has been concentrating its efforts first on the banks and lately this has been extended to the insurance companies. No inspections of fund managers or the LFX have been conducted yet. A sound system of securities regulation requires effective systems of on and off-site examinations and oversight of market participants including self-regulatory organizations, exchanges and intermediaries. LOFSA is planning to develop a comprehensive framework for the oversight of the LFX over the next 24 months, in consultation with the LFX, the KLSE, and the Malaysian Securities Commission.

120. There is some need for enhancements to the disclosure rules applicable to mutual funds and unlisted public companies, particularly regarding continuous disclosure obligations. Business conduct rules, and requirements for books and records, internal controls and risk management systems for all market intermediaries should be strengthened. All market intermediaries should be required to segregate client assets.

Summary of principle-by-principle assessment

Strength of the regulator

121. The responsibilities of LOFSA are clear and objective. It is operationally independent and accountable to the Minister of Finance and the administrative courts in the exercise of its functions. The staff of LOFSA meet high expectations of professionalism in their work. All of the laws that LOFSA administers are available to the public via the agency's website as are most of the guidelines that govern licensing. LOFSA does, however, need additional staff resources so that it could implement an effective system of oversight of fund managers and the LFX. Its investigation, enforcement and information sharing powers are limited by secrecy provisions that need to be revised. LOFSA might also want to consider additional transparency regarding the processes followed, particularly regarding its consultation process. This might benefit from being made more open and inclusive in order to get input from the public, not just current market participants.

Self-regulation

122. The regulatory system in Labuan makes extensive use of its one self-regulatory organization, the LFX. LOFSA's reliance on the LFX is not inappropriate. However, self-regulation works most effectively where it complements, not replaces the role of the regulator. Any supervision function assumed by the SRO should be subject to an effective oversight program by the regulator. LOFSA needs to develop and implement a comprehensive framework for oversight of the LFX's supervisory functions.

Issuer regulation

123. The initial disclosure requirements for unlisted public companies are not very detailed and should be enhanced. Continuous disclosure requirements, other than the delivery of

audited annual financial statements within 6 months of the year-end, apply only to listed companies. The requirements for fair treatment of minority shareholders are minimal, even for listed companies and there is a need to mandate more information and time be given to minority shareholders before they are asked to vote on corporate matters. Accounting standards are high and generally in compliance with International Accounting Standards (IAS).

Mutual fund regulation

124. Entry standards for fund managers are generally satisfactory, as are initial disclosure requirements for public mutual funds. The rules governing conflicts of interest between fund managers, their related companies and the funds that they manage need to be addressed more comprehensively. Requirements regarding books and records, calculation of net asset values and valuation rules should be enhanced. The continuous disclosure obligations of mutual funds need to be improved, in particular, the disclosure should be more timely. LOFSA should establish a supervision program for fund managers, which would combine periodic receipt and review of net asset calculation and on-site visits.

Market intermediary regulation

125. Full licensing and initial capital requirements are in place for market intermediaries in Labuan. The applications are subject to a comprehensive desk review prior to licensing. LOFSA has the power to inspect fund managers and investment banks, although the scope of this power is limited by secrecy provisions and has not been exercised owing to resource constraints. Except for investment banks, ongoing capital requirements are not risk based—they are expressed as net asset amounts. There are no early warning thresholds and only trading agents are obliged to give immediate notice of capital deficiencies. The business conduct rules designed to protect investors, such as conflict or trading priority rules, need to be strengthened and applied to all market intermediaries. Effective regulation of market intermediaries must include direct regulatory oversight through a program of on and off-site examinations.

Secondary markets regulation

126. LOFSA has the authority to oversee the activities of the LFX, appoint its Exchange Committee and obtain extensive information from the exchange, its members and third parties regarding trading in securities. The legislation does not give LOFSA any express authority over exchanges or trading systems more generally and LOFSA does not have the authority to impose terms and conditions on the LFX or withdraw its license to operate. A comprehensive framework for oversight of the LFX should be developed and implemented, including a program of inspections, and standards and processes for reviewing rules. The LFX is transparent and has rules in place to deter improper and unfair trading practices, such as insider trading. LOFSA should extend these rules and make them applicable to transactions on and off the exchange. As market volumes increase, LOFSA and the LFX will

need to develop rules to manage large exposures and default risk. LOFSA will also need additional powers to oversee the clearing and settlement system.

Recommended actions and authorities’ response to the assessment

Table 6. Recommended Action Plan to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principle 3.	<p>Give LOFSA the power of the ability to examine market participants unfettered by secrecy limitations, but subject to the appropriate confidentiality requirements.</p> <p>Grant LOFSA express authority to regulate and supervise trading systems and securities clearing and settlement systems.</p> <p>Increase resources available for direct oversight of securities market intermediaries and the LFX.</p>
Principle 7.	The development and implementation of a framework for the oversight of the LFX should be given priority.
Principles 8., 9. &10	A program of periodic on-site inspections of fund managers and other market intermediaries should be instituted.
Principle 9.	Consideration should be given to making the fines that may be imposed by LOFSA consistent across the legislation administered.
Principles 11, 12 & 13	<p>LOFSA should be given the power to share information with other foreign and domestic supervisory authorities and law enforcement agencies, regardless of industry sector supervised, subject to ensuring the preservation of confidentiality of the information.</p> <p>Once the law is amended, LOFSA should establish information sharing mechanisms with domestic and foreign counterparts.</p>
Principle 14	<p>When the market for public issues improves, LOFSA should issue a regulation governing the form of prospectus for public offers by unlisted companies.</p> <p>The Offshore Companies Act (OCA) should be amended to impose timely continuous disclosure requirements on all public companies, whether or not listed.</p>
Principle 15.	Enhance minority shareholders' rights under the OCA.
Principle 17.	<p>Require full disclosure of all relationships between a fund, its fund manager and other service providers.</p> <p>Institute an oversight program for mutual funds and their managers.</p>

Principle 18.	<p>Enhance the books and records requirements for fund managers.</p> <p>Require all fund managers, administrators and other service providers to ensure effective segregation of mutual fund assets.</p>
Principle 19.	<p>Mutual funds should be subject to requirements to make immediate disclosure of any material changes—consideration might be given to posting such notices on LOFSA website. The prospectus should be amended promptly and filed with LOFSA with a short period of time (at most a few days) after the change.</p> <p>The financial disclosure requirements of the LFX offering documents should also apply to initial and ongoing disclosure by all mutual funds.</p>
Principle 21	<p>The framework for oversight of the LFX should include reviewing their licensing activities. The books and records requirements for fund managers and trading agents should provide more details of what is required.</p>
Principle 22.	<p>Fund managers should be required to give LOFSA immediate notice of any capital deficiency or other material adverse change in financial position.</p> <p>As the market volumes and range of products and services offered increase, serious consideration must be given to adopting a capital adequacy requirement for trading agents that fully reflects the risks of business undertaken. This capital requirement should incorporate an early warning threshold that will give regulators some notice of declines in financial position.</p>
Principle 23.	<p>LOFSA and the LFX should set at least some high-level guidelines for risk management and internal controls for fund managers and trading agents respectively.</p> <p>A guideline or regulation should be developed setting minimum business conduct duties owed clients, including conflict of interest disclosure, account documentation and reporting obligations, suitability of investment advice, etc.</p>
Principle 24.	<p>LOFSA should consider what its role and responsibilities would be in the event that a licensee became insolvent and identify what other supervisors would need to be involved.</p>
Principle 25	<p>LOFSA should be given specific authority to license or approve other exchanges or trading system.</p>
Principle 26	<p>The authority given to LOFSA to authorize and oversee all trading systems should include the power to impose terms and conditions on the exchange or trading system.</p>

Authorities Response

LOFSA, as the agency responsible for the supervision of the securities industry in Labuan IOFC, has and would continue to update its supervisory framework in tandem with the development of the securities industry. The comments and recommendations of the IMF would be used as a benchmark in our effort to comply with the international best practices, the standards developed by IOSCO and other relevant international supervisory bodies. Indeed, the admission of LOFSA as an associate member of IOSCO would provide an excellent platform for LOFSA to work together with IOSCO members to heighten the standard of supervision of the offshore securities. These collaborative efforts would further enhance the growth of the securities industry in Labuan IOFC without compromising any supervisory and compliance issues.

E. Good Practices for Company and Trust Service Providers

127. As with the offshore banking and insurance sectors, the work of trust companies is an important driver in the International Offshore Financial Centre (IOFC) in Labuan. Trust companies also perform an essential role in the regulatory framework of the IOFC, such as in the incorporation and registration of offshore companies, registration of offshore trusts and registration of offshore limited partnerships; for instance, all the documents that are required to be filed or lodged have to be made through a trust company. In this regard, trust companies are also tasked with the responsibility of conducting due diligence with respect to the identities and businesses of their customers, particularly for anti-money laundering and increasingly financing of terrorism, purposes. It is therefore important for LOFSA to continue playing an active role in the supervision of trust companies, particularly through regular examinations, on top of the channels of communication that are already in place.

I. Principal Legislation for the Labuan International Offshore Financial Centre

The offshore financial services activities in Labuan are governed by various pieces of legislation designed for the functioning of Labuan as an international offshore financial centre, namely: (a) the Offshore Banking Act 1990; (b) the Offshore Insurance Act 1990; (c) the Offshore Companies Act 1990; (d) the Labuan Offshore Business Activity Tax Act 1990; (e) the Labuan Trust Companies Act 1990; (f) the Labuan Offshore Financial Services Authority Act 1996; (g) the Labuan Offshore Trusts Act 1996; (h) the Labuan Offshore Limited Partnership Act 1997; and (i) the Labuan Offshore Securities Industry Act 1998 (together the IOFC legislation).

Offshore Banking Act 1990

The Offshore Banking Act 1990 provides for the licensing and regulation of persons carrying on offshore banking business and registration of offshore financial businesses.

Offshore Insurance Act 1990

The Offshore Insurance Act 1990 provides for the licensing and regulation of persons carrying on offshore insurance business and offshore insurance-related activities.

Offshore Companies Act 1990

The Offshore Companies Act 1990 provides for the incorporation and administration of offshore companies, including provisions on share capital, general meetings, directors and company secretaries, accounts and annual returns, and filing requirements.

Labuan Offshore Business Activity Tax Act 1990

The Labuan Offshore Business Activity Tax Act 1990 provides for the imposition, assessment and collection of tax on offshore business activity carried on by an offshore company.

Labuan Trust Companies Act 1990

The Labuan Trust Companies Act 1990 provides for the registration and administration of trust companies and the powers of trust companies to carry on business as trustees, executors and administrators.

Labuan Offshore Financial Services Authority Act 1996

The Labuan Offshore Financial Services Authority Act 1996 provides for the establishment of the Labuan Offshore Financial Services Authority (LOFSA) as the regulator and supervisor of the offshore financial institutions (where relevant), including the powers of LOFSA to pass regulations, request information from the offshore financial institutions, conduct examinations and investigations.

Labuan Offshore Trusts Act 1996

The Labuan Offshore Trusts Act 1996 provides for the creation and registration of offshore trusts and the appointment and duties of trustees of offshore trusts.

Labuan Offshore Limited Partnership Act 1997

The Labuan Offshore Limited Partnership Act 1997 provides for the establishment and regulation of offshore limited partnerships.

Labuan Offshore Securities Industry Act 1998

The Labuan Offshore Securities Industry Act 1998 provides for the regulation of securities and the establishment of the Labuan International Financial Exchange.

Anti-Money Laundering and Countering the Financing of Terrorism

For the purpose of money laundering and financing of terrorism, the IOFC legislation are to be read with the Dangerous Drugs (Forfeiture of Property) Act 1988, the Extradition Act 1992, the Anti-Corruption Act 1997, the Anti-Money Laundering Act 2001, the Mutual Assistance in Criminal Matters Act 2002 and the Penal Code.