MALAYSIA'S POTENTIAL AS A GLOBAL HUB FOR ISLAMIC FUND ADMINISTRATION: CHALLENGES, PROSPECTS AND SOLUTIONS

Ziyaad Mahomed and Shamsher Mohamad
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Executive Summary

In today’s competitive environment, fund managers often outsource non-core functions in order to gain efficiencies and reduce costs. While fund administration outsourcing is commonplace in the conventional fund space, Islamic fund administration outsourcing remains in its infancy. This is largely due to the fact that the global Islamic fund market is fragmented, and Islamic fund administration can only be carried out by service providers with the relevant skill sets.

Malaysia has earned the status of being a global Islamic finance powerhouse in recent years, and successfully attracted both conventional and Islamic asset managers to set up operations in the country. The stability and resiliency of the economy can be largely credited to the prudence of the Malaysian regulators, who have invested heavily in improving the country’s infrastructure and continues to actively promote its development.

On the fund administration end, the time is now ripe for Malaysia to make a push and cement itself as a global Islamic fund administration hub. The country is home to leading Islamic asset managers, and has pioneered numerous innovations in the Islamic finance market. It should leverage on existing knowledge and experience working with local Islamic managers, and upskill its workforce to transform itself into a trailblazer in the market.

As a pioneer with deep understanding of both the conventional and Islamic finance markets, Malaysia should endeavor to connect disparate Islamic markets, and tap on its knowledge of Islamic principles to simplify and integrate religious requirements into existing systems and processes for sustained growth.

We believe that Malaysia is experienced and well-positioned to become a global Islamic fund administration hub, and aim to support its ambition. To this end, we will present statistics on Malaysia’s vibrant Islamic market and showcase the expanding pool of Islamic fund assets that Malaysia can potentially gain access to as a leading administration center.

We will also illustrate the case for outsourcing specifically for the Islamic fund market, and conduct an in-depth analysis on Malaysia’s standing today vis-à-vis its closest competitors in the Islamic space. To conclude, we will outline some of the best practices from leading fund administrators, and initiatives which could help to catalyze Malaysia’s development in Islamic fund administration.
Introduction

After weathering the 1997 Asian Financial Crisis, Malaysia’s regulators introduced the Capital Markets Masterplan (“CMP”) – a roadmap outlining key recommendations to develop the country’s capital market infrastructure – which has yielded considerable success. CMP1, which was launched to facilitate capital market growth from 2001 to 2010, spurred strong industry growth with the financial sector expanding at an annual rate of 7.3%.

Following the success of CMP1, a second 10-year plan, CMP2, was introduced to globalize the local market and enable domestic players to compete effectively outside of Malaysia. According to the regulators, CMP2 is expected to drive the growth of the country’s capital market, which is projected to reach at least RM 4.5 trillion (USD1.1 trillion) in assets by 2020. The Malaysian Islamic capital market, on the other hand, is expected to hit RM 2.8 trillion (USD690.1 billion) by 2020, almost ten times its size in 2000.

Building a Strong Islamic Fund Centre

Figure 1: Ecosystem of a successful fund centre

Today, Malaysia is widely known as a global leader in Islamic finance and was ranked first in the Islamic Finance Development Landscape Index in 2017. On the quantitative end, its accolades span from being the world’s largest Sukuk issuer to being a leading destination for Islamic fund managers to register their products. While it enjoys its status as a pioneer in the space, Malaysia’s regulators have a strong drive to accelerate the growth of the Islamic fund and wealth management market.

The development of a successful fund market takes a multi-layered approach, as indicated in Figure 1. Firstly, it is heavily dependent on a resilient infrastructure to attract and retain organisations and talent over a sustainable timeframe. It also requires a wide range of service providers – from custodians to administrators -- to support the investment activities of fund managers and distributors. Most importantly, it requires a robust regulator which is able to provide a strong yet flexible regulatory framework to facilitate participation in the market.

Malaysia’s regulators have demonstrated foresight and provided clear guidance on the development of the Islamic Market. In 2017 for instance, the Islamic Fund and Wealth Management Blueprint – a five-year plan illustrating key goals to develop Malaysia into an Islamic powerhouse – was launched. Among the several thrusts of the plan was the promotion of Malaysia as a global administration hub to attract both local and global players to domicile their Islamic and Socially Responsible Investment (“SRI”) funds in the country.

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Source: PwC Analysis
Islamic Finance Regulatory Framework in Malaysia

Regulatory Framework

The historical development of the Islamic financial industry in Malaysia can be divided into three phases. Firstly, initiatives were focused on building a foundation for the financial eco-system. In the second phase from 1993 to 2000, regulators worked to ensure the robustness of the industry. Finally, programs were introduced to accelerate the internationalisation of the Malaysian economy.

**Phase I:** Forming the building blocks

- The Islamic Banking Act 1983 (Act 276) was introduced to establish a full-fledged Islamic bank.
- The Takaful Act, 1984 to set up the first takaful company – Syarikat Takaful Malaysia in 1985.

**Phase II:** Building an efficient and resilient financial system

- Publication of the Central Bank’s (Bank Negara Malaysia) Financial Sector Master Plan (“FSMP”) to develop a financial system which is resilient across interest-based and Islamic banking sectors.
- Introduction of regulation allowing the emergence of Islamic windows via a scheme known as Interest-free Banking Scheme [Skim Perbankan Tanpa Faedah] in 1993. This led to the rapid expansion in Islamic banking product development and the development of the Islamic capital market in Malaysia on a global scale.

**Phase III:** Internationalisation of the financial system

- Establishment of the Malaysian International Islamic Financial Centre ("MIFC") which liberalised the Islamic financial sector with licenses to foreign banks and establishment of Islamic subsidiaries.
- A world first, dedicated International Centre for Education in Islamic Finance ("INCEIF") launched in 2006, to meet the increasing demand for qualified human resources in the Islamic financial industry.
- Introduction of a Shariah governance framework (2010) to provide guidelines for Islamic Financial Institutions ("IFIs") on matters related to Shariah investments.
- The Islamic Financial Services Act ("IFSA") was introduced in 2013 to repeal the Islamic Banking Act and Takaful Act introduced in the 1980s. The main objective of this act is to provide a platform for the better implementation of Shariah and operational standards for the industry.
Islamic Finance Landscape in Malaysia

Malaysian Islamic Capital Market

The Malaysian Islamic capital market has seen rapid development in recent years, and grown at a much faster pace compared to the overall capital market. From 2001 to 2010, the overall stock market saw a compound annual growth rate ("CAGR") of 11.1%, while bonds in the country experienced a CAGR of 10.8% over the same period. Comparatively, the Islamic capital market saw assets quadruple in dollar terms from RM293.7 billion (USD77.3 billion) to RM1.1 trillion (USD342.3 billion) over the ten-year period.

Figure 2: Islamic capital market assets in Malaysia, 2010 – 2020E

![Islamic Capital Market 2010 - 2020E (RM billions)]

As of 2017, Shariah compliant securities and Sukuk issuances comprised 59.2% of the country’s capital market, up from 57.5% in 2014. During the year, the Islamic capital market in Malaysia grew 11.9% in local currency terms, fueled largely by a 14.9% expansion in the Sukuk market.

In relative terms, 76% of the companies listed on the Malaysia’s main exchange, Bursa Malaysia, were Shariah compliant, and Sukuk issuances made up 58.8% of the value of outstanding bonds in the country. Malaysia is estimated to issue at least half of the world’s Sukuk and is widely recognised as a leader in the Sukuk space. Case in point: the country pioneered the world’s first green Sukuk in 2017, an innovation which combines both Islamic and Environmental, Social and Governance ("ESG") principles.

Source: Securities Commission

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4 Ibid.
Meanwhile, Islamic fund assets, which include mutual funds – wholesale and retail, real estate investment trusts (REITs), Private Retirement Scheme (PRS) and exchange-traded funds (ETFs) in Malaysia grew 145.3% in local currency terms between 2012 and 2017. During the same period, the number of Islamic fund products has also increased from 227 to 325 fund products.

Islamic wholesale funds and REITs saw the most significant growth in assets over the five year period between 2012 and 2017. Islamic wholesale funds, which are funds sold to sophisticated investors, saw assets double from RM16.2 billion (USD5.4 billion) to RM37.7 billion (USD9.3 billion), while Islamic REITs have grown from a small base of RM3.5 billion (USD1.2 billion) to over RM 19 billion (USD4.7 billion).

**Islamic Banking and Takaful Market in Malaysia**

To support the growth of the Islamic market, 16 Islamic banks – six local and 10 foreign – have been set up to provide a wide range of financial products and services for investors in Malaysia. The assets managed by Islamic banks have been on an upward trajectory, and occupied an estimated 28% of the country’s banking system in 2016, up 420 bps from 2012. In local currency terms, Islamic banking assets grew by 50% from 2012 to 2016.
According to the Islamic Financial Services Board ("IFSB") Secretariat, Malaysia was the third largest country by Islamic banking assets, contributing 9.3% of global Islamic banking assets in 2016, trailing Iran (33%) and Saudi Arabia (20.6%).

While Takaful assets make up a small proportion of Islamic assets in Malaysia, it has seen a steady year-on-year growth since 2012. In 2017, there were 11 Takaful operators in the market staffed with 3,766 employees, up from 2,758 in 2012. As Takaful assets grow, these operators, like conventional insurers, will inevitably have to outsource their assets to external asset managers, providing Shariah managers with a bigger pool of institutional assets to manage.
Institutional Support

At the same time, the country’s two leading pension providers – Employees Provident Fund (“EPF”) and Kumpulan Wang Persaraan (“KWAP”) – have been instrumental in bolstering the growth of Islamic finance in the country.

In 2016, EPF, the country’s largest pension with assets of USD165.6 billion, became the first pension globally to offer a Shariah-compliant retirement savings option with an initial fund allocation of USD22.3 billion. According to EPF, 45% of EPF’s current investments were Shariah-compliant in 2016, and are expected to grow at USD6.6 billion per year.

KWAP, on the other hand, has gone a step further, and announced its aim to be fully-shariah compliant in its investments. Of its investment portfolio, 11.7% was outsourced to external managers at the end of 2016. Of the Islamic managers that KWAP worked with, there were a handful of Malaysia-based Islamic managers including i-VCAP Management, CIMB-Principal Islamic Asset Management, AimsIslamic Asset Management, AIIMAN Asset Management, and MIDF Amanah Asset Management.

Though these key institutions have shown strong commitment to Islamic investments, a significant increase in allocation needs to be supported by a broad and deep Islamic capital market. Currently, international Islamic investments have been hampered by inconsistent frameworks across various jurisdictions, and will require greater standardisation from a legal and product perspective to incentivise large institutional investors to continue increasing allocations.

Global Islamic Finance Landscape

While the global Islamic finance market remains small compared to conventional assets, it has witnessed rapid growth in recent years. From 2012 to 2016, the global Islamic market saw growth of 19.5%, from USD1.6 trillion to USD1.9 trillion, according to the Islamic Financial Services Board (“IFSB”).

With the exception of Islamic funds, all other segments of the Islamic finance market have expanded. In particular, Takaful contributions, which occupied a mere 1.3% of global Islamic market assets, have seen assets increase by 45.9% from 2012 to 2016, while Sukuk assets have grown by 38.8% during the same period.

Figure 6: Global Islamic assets, 2012-2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Global Islamic Assets, 2012-2016 (USD billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>Islamic Banking</td>
</tr>
<tr>
<td>2013</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
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<tr>
<td>2015</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td></td>
</tr>
</tbody>
</table>

Source: ISIFB
A closer look by region reveals a shift in market share—while Middle East and North Africa ex-Gulf Cooperation Council (“MENA ex-GCC”) countries held the largest proportion of Islamic assets in 2012, GCC countries have caught up as the largest regional player, and comprised 42.3% of Islamic assets globally in 2016.

Figure 7: Split of global Islamic assets, 2012-2016

Growing Demand for Shariah-compliant Assets

The demand of global Islamic assets is likely to continue to expand, supported by the growth of the Muslim population globally. In relative terms, the Muslim population is expected to make up 29.7% of global population in 2050 or 2.8 billion individuals, up from 1.6 billion individuals in 2010. At the same time, Islamic assets are also expected to be on an upward trajectory and amount to USD3.8 trillion by 2022 according to Thomson Reuters’ estimates.

Figure 8: Global Islamic population, 2010-2050E

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The global Islamic fund industry shrank for the second consecutive year in 2016, largely due to volatile market conditions. While the number of Islamic funds remain relatively unchanged, the size of each fund shrank from USD65.3 million to USD48.1 million by the end of 2016.
Saudi Arabia and Malaysia – the top two domiciles by Islamic fund assets – saw industry assets shrink from USD28.5 billion and USD20 billion respectively in 2015, to USD21.3 billion and USD16.3 billion respectively in 2016. Conversely, Ireland and Luxembourg, the two main jurisdictions preferred for the listing of traditional cross-border collective investment schemes, had market share of just 8% and 5% respectively.

Compared to Saudi Arabia, Malaysia has been more proactive in establishing cross-border fund initiatives. The Malaysian regulators inked mutual recognition agreements with Dubai and Hong Kong in 2007 and 2009 respectively, allowing local managers to extend their reach beyond the Malaysian market.

Fund managers who have tapped these cross-border initiatives include Public Mutual and RHB Asset Management, with each launching one Islamic fund in Hong Kong respectively. To further internationalise the market, authorities have signed agreements with regulators in Ireland and Luxembourg to facilitate the offering of Islamic Undertakings for Collective Investment in Transferable Securities (“UCITs”), which will enable managers to distribute their products with greater ease in Europe.

Figure 11: Takaful assets in Southeast Asia, 2014-2016

Total Takaful Assets in Southeast Asia, 2014-2016 (USD billion)

In Southeast Asia, the key countries with Takaful offerings are Malaysia, Brunei, and Indonesia. As of 2016, Malaysia led with USD6 billion in Takaful assets, split between family – USD5.2 billion – and general insurance assets – USD0.8 billion. While Takaful assets have decreased in USD terms due to local currency depreciation, they grew 17.8% in local currency terms from 2014 to 2016. Takaful assets in the region are currently marginal, but regulatory pushes in Indonesia and Malaysia for insurers to spin-off their Takaful arm will likely spur the growth of these assets in the Southeast Asian market.
The Case for Fund Administration Outsourcing

Since the Global Financial Crisis, asset managers have been subjected to increased global regulatory scrutiny. This has pressured business across various fronts: frontline staff now have to invest more time and effort to grow the client base, middle office employees are expected to report more frequently to internal and external stakeholders, and back-office employees are required to provide greater support to the key functions of the firm.

When cost-income ratios rise, businesses often turn to outsourcing their non-core functions as a means to reduce costs. Labour arbitrage used to be a key consideration in the past, though businesses today tend to be focused on the strategic significance of establishing offshore business centres – they are more concerned with how third-party vendors can support their operations as the business expands, and how adaptable they are with market and regulatory changes.

Outsourcing can take place both onshore and offshore, and activities can be broadly classified into three categories: business process outsourcing ("BPO"), information technology outsourcing ("ITO"), and knowledge process outsourcing ("KPO").

BPO refers to the centralisation of internal functions such as call centres, finance, and accounting, while information technology outsourcing encompasses the outsourcing of IT functions ranging from IT support to data centres. KPO is the most sophisticated form of outsourcing, and refers to the reliance on external support in specialised areas such as legal and consultancy services.

Below we highlight some key drivers for asset managers to outsource their fund administration operations, with a particular focus on Asia:

- **Regulatory changes**
  In recent years, regulations such as the Foreign Account Tax Compliance Act ("FATCA"), Markets in Financial Instruments Directive II ("MiFID II"), and Common Reporting Standards ("CRS") have been introduced to enhance transparency and increase sharing of information. While these initiatives help protect investors’ interests, they also create additional layers of regulatory burden for asset managers.

  To meet these regulatory requirements, asset managers often incur additional costs to enhance their compliance competencies. This is even more apparent among global asset managers – not only do they have to comply with a multitude of regulations across different jurisdictions, they also have to manage a diverse investor base which is subjected to different taxation agreements.

  On the other hand, in emerging Asia, local asset managers face a different set of problems. These markets are moving towards greater financial liberalisation – from the abolishment of overseas investment limits to the introduction of new alternative investment vehicles – at such a rapid pace that the local workforce may not be equipped to deal with changes. In these cases, fund administration is often outsourced to parties with relevant skill sets and competencies.

- **Fragmented distribution landscape in Asia-Pacific**
  In addition to contending with regulatory barriers, the fragmented nature of markets across Asia-Pacific can be challenging for regional and global asset managers alike. While the UCITS scheme allows managers to distribute their products across Europe, the Asia-Pacific region has yet to achieve the same level of success in fund passporting – though several potential programmes are being developed. Hence, asset managers doing business in the region often have to make significant investments to hire talent with relevant expertise and linguistic abilities to help navigate each local market.
• Rising labour and office costs
An additional factor is rising labour and rental costs, which have increased significantly across the Asia-Pacific region, especially in developed countries such as Hong Kong, Singapore, Korea, Taiwan, and Japan, which rank among the most costly cities for prime office space. According to Cushman & Wakefield – a commercial real estate services company – from 2017 to 2019 office rental prices are set to rise in all major Asian cities except Tokyo. Over this period, office rentals in Singapore are expected to increase by 25% – the highest in the region – and rentals in other major cities such as Beijing, Hong Kong, Sydney, Ho Chi Minh, and Shenzhen are expected to rise by at least 10%.

• Pressure to innovate in the IT space
Given the rapid pace of disruption in the information technology space, asset managers are under huge pressure to innovate. Gone are the days of simply maintaining a robust IT infrastructure to combat cyber threats. Asset managers today need to innovate to cope with the introduction of various disruptive technologies from blockchain to automation. To keep up with the pace of innovation, asset managers will inevitably have to invest in areas ranging from building incubation hubs to hiring developers. Many of these can be optimised using outsourced functions, which is already evident in the marketplace.

Case Studies
The following case studies on Fidelity and Manulife illustrate examples of financial services providers who have set up offshore offices in Asia to support their global business. In both instances, the selection of these jurisdictions are often centered on a few themes: good local governmental support, economic stability, strong IT infrastructure, and a relevant and well-built work force.

Fidelity is one of the largest asset managers globally. In Asia, it has operations in China, Hong Kong, Japan, Korea, Singapore and Taiwan. It has set up two offshore centres in China and India to service its global offices.

India: Fidelity’s India outsourced operations started in 2003, and has expanded to two offices in Bangalore and Chennai undertaking a wide range of services ranging from IT development (artificial intelligence, machine learning, cyber security, etc.) to support services (corporate audit, HR, compliance, etc.) to support its US business.

China: Fidelity was the first foreign asset manager to launch a back-office in China to provide investment services and fund accounting to Japan in 2007. Dalian was selected primarily due to its reputation as an IT hub, as well as the linguistic ability of locals. Since its establishment, the Dalian venture has evolved to support Fidelity’s offices in North Asia. The Dalian operation now provides services including IT system management and development, finance accounting, and investment research.
Manulife is a Canadian-headquartered, global insurer which provides services ranging from insurance to investment management. In Asia, Manulife operates in 12 countries including Hong Kong, Macau, China, Taiwan, Japan, Indonesia, Philippines, Malaysia, Singapore, Thailand, Vietnam and Cambodia. It has set up two business processing centres in Philippines and China to support Manulife’s global business operations.

**Philippines**: The offshore centre in Manila was established in 2006, and has grown into a team of 1,750 employees supporting Manulife's back-end operations including fund administration, compliance operation, and research support around the clock. Prior to establishing the office, Manulife operated from 15 different offices. With the introduction of the business centre in Manila, Manulife has been able to reconcile back end processes and migrate to automated processes.

**China**: In 2010, Manulife set up its second business processing services centre in Chengdu. Chengdu was chosen as is touted as a major financial services, software and business processing operations hub, and had a Chinese-speaking talent pool to help support the growth of Manulife’s business globally.

**The Case for Islamic Fund Administration Outsourcing**

Islamic fund administration outsourcing is arguably much more arduous compared to conventional fund administration outsourcing. Besides finding the right vendors, managers are also expected to ensure that the entire process of outsourcing – from signing the contract to client delivery by the vendor – is Shariah compliant. The added complexity is a limiting factor for countries which are not part of the Organisation of Islamic Cooperation ("OIC"), and puts Malaysia in a prime position to service the market as it has a strong Islamic ecosystem and relevant workforce to service Islamic managers.

**Differing Interpretations and Application of the Shariah**

Ensuring Shariah compliance can be an uphill task for vendors without in-depth knowledge of Shariah law (Islamic law), which may have different interpretations based on the opinions of scholars that provide Shariah oversight for fund management companies.

Stocks that are to be included in the Shariah-compliant pool of investable stocks must pass through a screen that is primarily based on negative filtering. For example, companies involved in what is considered impermissible in the Shariah will not pass the screen. However, there are differences in interpretation and Malaysian Shariah screening criteria are more often considered liberal in the application of filters as compared to the DJII or the FTSE Islamic Index, for example. This means that stocks that may be permitted in Malaysia may not be permitted elsewhere, presenting a challenge for global funds intending to be domiciled in Malaysia, but with markets in the Middle East.

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18 Companies that have their primary income derived from the sale or manufacture of liquor, pork, vulgar material, etc.
An enabling fund administration environment therefore, will have to cater for diverse requirements based on investor profiles and appetite. Adequate skill will be required for Malaysia to offer any filtering mechanism, if the jurisdiction intends to be globally competitive.

**Compliance with Shariah Principles**

To further complicate matters, vendors used to serving conventional asset managers may lack the infrastructure to service Islamic fund managers in even the most basic ways. Serving a Shariah fund manager requires vendors to understand the Islamic calendar, as well as to account for Islamic practices.

From an operational viewpoint, investment income paid out to investors of a Shariah instrument should also be purified, meaning that interest income or income from activities which are not permissible under the Shariah framework should be removed. This means fund administrators have an added responsibility to check the sources of income for investment assets, and segregate Shariah-compliant sources with those which are not.

**Size of Asset Managers**

In addition to Shariah compliance, Islamic fund managers often also struggle to raise funds – the average size of an Islamic fund was less than USD50 million in 2016. This means that Islamic fund managers face greater cost pressure compared to conventional managers, further supporting the case for them to outsource and gain greater cost efficiency.

The multitude of challenges faced by Islamic fund managers creates a strong case for outsourcing to service providers whom can navigate the complexities of the industry. It is imperative for managers to find vendors with a strong understanding of Shariah principles that can help to alleviate their current challenges and help to facilitate growth plans as the market evolves.
Comparison of Major Fund Administration Centres

Figure 12: A closer look at business innovation, regulations, tax regime and infrastructure of Malaysia and its competitors

<table>
<thead>
<tr>
<th>Business innovation</th>
<th>Regulatory</th>
<th>Tax Specific</th>
<th>Infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ireland</strong></td>
<td>New fund vehicles to attract registrations</td>
<td>VAT exemptions for fund management, administration, and custody services</td>
<td>Leading drive for standardisation of fund processing</td>
</tr>
<tr>
<td>Establishment of digital service institutions, data service centres, and research centres</td>
<td>Early implementation of UCITS and AIFMD regimes. Innovative fund and legal entity structures.</td>
<td>General tax exemption for funds</td>
<td>Boasts wide-range of specialist service providers and encourages cluster-industries to develop</td>
</tr>
<tr>
<td><strong>Singapore</strong></td>
<td>Engagement with ASEAN CIS, new fund vehicles to attract registrations, enhancement of external asset manager regime</td>
<td>Specific tax treatment for offshore and onshore funds</td>
<td>Sound financial infrastructure and open economy to differentiate itself from neighbouring countries</td>
</tr>
<tr>
<td><strong>Hong Kong</strong></td>
<td>Promotion of cross-border programmes with China (stock connects and MRF), and others (Switzerland and France), new fund vehicles</td>
<td>General tax exemption for funds</td>
<td>Sound financial infrastructure and open economy, positioned as gateway to China</td>
</tr>
<tr>
<td><strong>DIFC</strong></td>
<td>Recent regulations to promote collective investment schemes, openness to foreign fund managers, fund passporting, etc.</td>
<td>None as yet but investors can enjoy tax-free regime and extensive DTA network</td>
<td>Large number of international banks, international exchanges, generally considered an open economy</td>
</tr>
</tbody>
</table>
While there can be strong push-factors from an Asset and Wealth Manager ("AWM") to outsource, there needs to be suitable pull-factors as well regarding the quality of outsourcing services performed to ensure quality and standards are maintained. Suitable concentrations of skills, technology, and human capital are needed along with a regulatory environment which provides transparent and innovative guidance in ensuring that standards are maintained and risks and responsibilities are adequately balanced. At a firm level, AWMS need to ensure that they buy-in to the service provider’s business model, that the service provider is able to deal with regulatory change, and that there is transparency across the process of selection and the performance of outsourced services.

The fund centres of Dublin and Luxembourg provide examples of how global and regional fund centres are able to leverage high core and non-core industry concentration, talent, and a permissive regulatory environment for outsourcing fund administration services – their examples do not lend themselves specifically to Islamic funds or Islamic financing. It should be noted that these centres are being compared as fund management centres, not as fund centres as a comparison of fund centres would encompass a wider and more diverse range of locales than the two covered here.

These two locations benefit from having a high-concentration of funds domiciled in them – Ireland has over 7,000 funds listed, nearly 50% of the ETF market, and over EUR11tr in AUM, Luxembourg has over EUR4tr in AUM, and over 14,000 fund units. From this high-concentration of funds grew peripheral services; accounting firms, law practices, and fund administration practitioners, to service the concentration of fund managers operating in the two jurisdictions.

In addition to the highly-clustered asset and wealth management services industry, Ireland and Luxembourg benefit from permissive and open regulators. Both are open to areas like implementing new products and allowing the outsourcing of fund administration services.

Ireland’s asset management regulator, the Central Bank of Ireland ("CBI") recently undertook a review of the outsourcing of fund administration activities. When the review was undertaken, it was estimated that between 48%-61% of fund administration services were outsourced, though CBI noted that in many instances the activities were outsourced to entities within the same group of companies, i.e. Mega Bank Asset Management would outsource to Mega Bank Securities Services.

Following the review, CBI has provided recommendations regarding the outsourcing of fund administration services. These recommendations are permissive to allowing outsourcing to continue to expand and ensures that clear roles, responsibilities, and risk management practices are embedded within the outsourcer and the outsource firms. Similarly, Luxembourg has developed and nurtured its fund administration industry over 30 years and has underpinned investments in the relevant infrastructure to ensure that it remains a leading fund servicing centre for Europe and the world.

Malaysia scores highly in the assessment of Islamic finance when compared to other jurisdictions operating in the market, as demonstrated in Figure 13. Specifically, in addition to having over USD400 billion across various branches of Islamic Finance and products, Malaysia scores highly in terms of governance, which considers regulation; shariah governance; and corporate governance, and knowledge; which considers education – measuring the number of universities and degree-offering institutions – and research – examining the number of published research papers and peer-reviewed journal articles.
Malaysia’s strength in Islamic finance promotes industry concentration and development as a fund administration centre as of 2017

Figure 13: Comparison of Malaysia’s strengths as an Islamic finance centre against others

<table>
<thead>
<tr>
<th>Rank</th>
<th>Governance</th>
<th>Knowledge</th>
<th>Islamic banking</th>
<th>Takaful</th>
<th>Other Islamic financial institutions</th>
<th>Sukuk</th>
<th>Islamic funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bahrain</td>
<td>Malaysia</td>
<td>Iran USD 463 bn</td>
<td>Saudi Arabia USD 15 bn</td>
<td>Malaysia USD 43 bn</td>
<td>Malaysia USD 168.9 bn</td>
<td>Iran USD 37.7 bn</td>
</tr>
<tr>
<td>2</td>
<td>Malaysia</td>
<td>Jordan</td>
<td>Saudi Arabia USD 371 bn</td>
<td>Iran USD 11 bn</td>
<td>Iran USD 31.6 bn</td>
<td>Saudi Arabia USD 52.5 bn</td>
<td>Saudi Arabia USD 20.6 bn</td>
</tr>
<tr>
<td>3</td>
<td>Oman</td>
<td>Tunisia</td>
<td>Malaysia USD 165 bn</td>
<td>Malaysia USD 8 bn</td>
<td>Saudi Arabia USD 13.2 bn</td>
<td>Indonesia USD 37 bn</td>
<td>Malaysia USD 20.1 bn</td>
</tr>
<tr>
<td>4</td>
<td>Kuwait</td>
<td>Brunei</td>
<td>UAE USD 163 bn</td>
<td>UAE USD 2 bn</td>
<td>Kuwait USD 10.37 bn</td>
<td>UAE USD 32 bn</td>
<td>United States USD 2.3 bn</td>
</tr>
<tr>
<td>5</td>
<td>Pakistan</td>
<td>Bahrain</td>
<td>Qatar USD 90 bn</td>
<td>Indonesia USD 1.7 bn</td>
<td>Qatar USD 8.7 bn</td>
<td>Qatar USD 19.6 bn</td>
<td>Pakistan USD 2.3 bn</td>
</tr>
<tr>
<td>6</td>
<td>UAE</td>
<td>Pakistan</td>
<td>Kuwait USD 87 bn</td>
<td>Qatar USD 0.9 bn</td>
<td>Switzerland USD 6.9 bn</td>
<td>Turkey USD 11.3 bn</td>
<td>Luxembourg USD 2 bn</td>
</tr>
<tr>
<td>7</td>
<td>Indonesia</td>
<td>UAE</td>
<td>Bahrain USD 74 bn</td>
<td>Bangladesh USD 0.6 bn</td>
<td>UAE USD 5.6 bn</td>
<td>Pakistan USD 6.8 bn</td>
<td>South Africa USD 1.8 bn</td>
</tr>
<tr>
<td>8</td>
<td>Sudan</td>
<td>Indonesia</td>
<td>Turkey USD 37 bn</td>
<td>Turkey USD 0.5 bn</td>
<td>Indonesia USD 2 bn</td>
<td>Bahrain USD 5.3 bn</td>
<td>Indonesia USD 1 bn</td>
</tr>
<tr>
<td>9</td>
<td>Nigeria</td>
<td>Saudi Arabia</td>
<td>Bangladesh USD 29 bn</td>
<td>Bahrain USD 0.4 bn</td>
<td>Bahrain USD 0.7 bn</td>
<td>Hong Kong USD 2 bn</td>
<td>Kuwait USD 0.9 bn</td>
</tr>
<tr>
<td>10</td>
<td>Maldives</td>
<td>Sri Lanka</td>
<td>Indonesia USD 26 bn</td>
<td>Brunei USD 0.3 bn</td>
<td>Singapore USD 0.7 bn</td>
<td>United Kingdom USD 1.9 bn</td>
<td>United Kingdom USD 0.6 bn</td>
</tr>
</tbody>
</table>

Source: IDC-Thomson Reuters Islamic Finance Development report 2017, PwC Analysis

Following the models of Luxembourg and Dublin, Malaysia is well-positioned to leverage the concentration of its Islamic Finance sector and supporting players to develop itself as a fund administration outsourcing centre. The concentration of providers of Islamic funds, Islamic banking, Takaful, Sukuk, and other Islamic finance investments such as Ijara leasing arrangements provides strong technical capabilities and attracts other industry players to enjoy the halo benefits of being in such a concentrated industry.
Challenges and Threats to Malaysia

In order to provide the mutual funds industry, and subsequently the fund administration sector, with the structure to expand, Malaysia needs to ensure that the implementation of its financial roadmaps are conducive to growth, and at the same time competitive compared to its peers.

The existing regulatory environment may not be conducive to accomplishing this due to limitations on cross-border funds which cannot be offered to the public without a local feeder fund authorised by the Securities Commission. These processes can take several months depending on the complexity of the funds. Accordingly, Malaysia's challenge is to allow for more accommodating regulations that whilst maintaining effective monitoring, also increases the number of funds to be registered in the country. Such a regulatory framework could provide cost-effective and increased options for both local and global investors.

For example, funds with large subscriptions are generally cheaper as these funds can distribute their expenses across a larger asset base and allow for more subscribers. The benefits of such a framework could thus include more investment options for investors through increased cross-border investment choices, increased competition, lower cost, greater diversification and competition in terms of innovation, and increased use of technology. All of these would aid in increasing its global competitiveness.

Further challenges include:
- The closed-currency nature of the Ringgit increases complexity and makes it difficult for global fund managers to invest in Malaysia.
- A lack of company-form funds results in Malaysia lagging behind other regional players. Both Singapore and Hong Kong have introduced company-form fund regimes recently.
- A scarcity of talent to effectively manage fund outsourcing activities. While the talent pool is deepening, the development of industry talent capable of providing these services at cost-effective rates would likely prove a strong draw-card.
- Creating a meaningful value proposition for Islamic funds to foreign fund owners which centres around leveraging Malaysia’s role as a leading global outsourcing centre, its technical talent in Islamic fund, and its deepening pool of fund administration talent.
- The lack of a centralised regulator to govern fund trustees and custodians is seen by the industry as an impediment to Malaysia’s fund administration hub ambitions.

Although these challenges may not be exhaustive, providing effective solutions for some of these will potentially have exponential spill-over effects and contribute positioning the Malaysian value-proposition to global players.
Recommendations

Recommendations have been grouped into two categories: internal developments and improvements that Malaysia can undertake and external opportunities to seize.

Internal Developments

- **Fund registration and competency standards**
  We suggest that Malaysia develop and implement fund administration and competency standards to provide a level playing field for service providers. This would enable Malaysia to provide assurances regarding the capability of its standards and the industry which it is aiming to create in order to service Islamic funds.

- **Labour, education, and skills training**
  While the low labour costs may prove to be a short-term incentive for Islamic finance players to outsource administrative functions, fund managers will invariably require increasingly skilled labour as the market matures. In order to move beyond being a destination for the outsourcing of repetitive business functions, Malaysia needs to nurture and continuously develop a highly-skilled workforce. Statistics reported by the International Labour Organisation in the last few years have been encouraging showing the proportion of employees with basic or lower education has fallen from 38.9% in 2009 to 33.2%.

Malaysia may also build on its established position in academic programmes, published reports, and peer-reviewed articles focussing on Islamic finance. It should ensure robust and relevant industry-specific courses are available to individuals will help ensure a growing talent pool exists.

This is partly being achieved through institutions like the International Centre for Education in Islamic Finance (INCEIF), the Islamic Banking and Finance Institute Malaysia, the Chartered Institute of Islamic Finance Professionals, and the Association of Shariah Advisors under the direction of the Bank Negara Malaysia and their mandate to deepen the talent pool for Islamic banking in Malaysia. In addition to promoting the development of industry-specific qualifications and Islamic finance tertiary education in general, Malaysia should increase efforts to improve Arabic language skills and abilities among workers in these sectors so that they are able to offer their services to a wider range of clientele.

- **Development of economic zones**
  Malaysia could leverage its current – and growing – list of Special Economic Zones ("SEZ’s") to provide various incentives for fund administrators to establish themselves in a cluster – similar to how Luxembourg and Dublin’s fund administration industries grew. The Medini Smart City, which includes financial services in its six sectors of focus, could potentially fulfil this role. Malaysia already has an existing framework of SEZ’s and is promoting the development of several more. Such SEZ’s have been used with great effect in other countries, such as China, to develop niche industries and promote foreign investment. Professional service firms with experience in advising on and tracking the progress of such SEZ’s can be engaged to provide a comparison and recommendations for the development of SEZ’s in Malaysia.

- **Centralised regulator**
  Ensuring fund administrators are adequately regulated, and that government initiatives and incentives are consistently applied from a central authority would benefit the industry and provide a central point of reference for the industry which is likely to make adhering to regulations easier for industry players. Such a simplified and centralised regulatory body would likely accelerate regulatory procedures and lower associated costs. The case for having a centralised regulator is reflected in successful fund administration hubs like Luxembourg and Ireland. Such centralisation could not only
benefit Islamic finance players in Malaysia but also aid engagement between regulators. Professional service firms with cross-jurisdictional regulatory experience can be engaged to provide a comparison and recommendations for the development of a single regulatory body in Malaysia.

- **Encouraging integrated offerings**
  Enabling entities to provide both trustee and custodian services as a ‘one-stop-shop’, with custodian services separated from banks, would be beneficial as it would likely provide an advantage to focussed domestic and global marketing initiatives. Having the services performed by a single entity would also increase ease of regulation and reduce the scope for regulatory arbitrage.

Addressing the areas Malaysia lacks comparison to other regional and global fund centres, [refer to Figure 14 for an assessment and jurisdictional comparison] would benefit the Islamic funds industry directly and Malaysia’s economy. Specific areas which could be improved include human capital (addressed in the recommendation earlier), market access, overall development, government effectiveness, control of corruption, ease of doing business, ease of paying taxes, and reduced currency controls / increased flexibility of buying funds domestically in foreign currency. Such improvements would make Malaysia a more attractive investment destination and would help lay the necessary infrastructure to support a funds administration centre.

Similarly, creating a centralised point for eKYC (know your customer) and fund transfers would reduce costs borne by the industry and promote consolidation of associated talent into said location. Such concentration of talent would further Malaysia’s case for developing as a fund administration outsourcing centre. It should be noted that SWIFT is working with Bank Negara Malaysia and Bursa to introduce an automation system to avoid various parties needing to input entries manually and some fund operators view

the introduction of this system as leading to increased costs.

- **Automate and consolidate business registration**
  Malaysia has implemented a series of reforms aimed at easing the regulatory burden for businesses. Such initiatives include the overhaul of the 1965 Companies Act in 2016, and the introduction of other business-friendly measures such as the establishment of a modern collateral registry to provide greater access to credit.

Establishing a new business in Malaysia can be challenging due to the myriad of agencies involved in the establishment process. For example, for a business to register and comply with Goods and Services Tax (“GST”) requirements, two agencies must be involved and the process takes, on average, 14 days to complete. To ensure Malaysia can compete more effectively, authorities could consider implementing a one-stop system to facilitate new business registrations.

Singapore provides an example of this in the form of Bizfile, an online platform providing a whole suite of services spanning from company and GST registration, to corporate bank account applications. The time to process the various procedures takes less than a day, and approvals can be passported across all relevant agencies in the country.

- **Reducing cumbersome screening process**
  Malaysia is perceived as a liberal domicile in managing Islamic funds and while it has legal and operational infrastructure to manage funds domiciled within its jurisdiction, the screening criteria for such funds are unique within the Islamic funds world. Accordingly, many foreign investors perceive the screening process as being too cumbersome – despite the criteria being voluntary for foreign fund managers. Accordingly, reducing the real and/or perceived burden of the screening process could prove beneficial for Malaysia. Professional service firms with experience in international fund compliance can be engaged to provide recommendations for how the regulatory and compliance burden can be reduced.
External Opportunities to Seize

• **Improved distribution and cross-border sales**
  Malaysia could seek out other Islamic countries and enter into mutual recognition of funds arrangements. This will help increase the distribution of funds already domiciled in Malaysia and will increase incentives for other funds to be domiciled there. Such arrangements will need to have suitable taxation and other operational benefits attached to them. Once there is sufficient traction with Islamic countries, additional arrangements could be sought out with European and North American countries. As there are already three fund passporting arrangements across Asia-Pacific, being Mutual Recognition of Funds ("MRF"), ASEAN Collective Investment Scheme ("ASEAN CIS"), and Asia Region Fund Passport ("ARFP") – in various phases of readiness – Malaysia should work to ensure the programmes it is signing up to have provisions for Islamic funds and Islamic finance.

• **Focus on SRI**
  A concerted effort should be made, to increase awareness and transparency around Islamic funds and their similarities to Environment, Social, and Governance investing and Socially Responsible Investing products – both of which are expected to receive significant inflows in the coming years and are similar to Islamic funds in terms of prohibitions around investing in ‘unethical’ companies or securities. SRI products in particular are expected to attract significant inflows from individual and institutional investors in the future, thus, Malaysia should focus on this component to ensure that Islamic funds can receive mandates from SWFs and other institutional investors, and individual investors who are interested in SRI products. Malaysia already boasts of being the second largest SRI product market in Asia. The new guidelines, widen the range of products available. Therefore, the SRI stretch from Shariah will enable Malaysia to gather further scale thereby creating opportunity for efficiency.

• **Labour, education, and skills training**
  About 6,000 accounting professionals graduate in Malaysia annually. Thereby creating a ready pool of skilled labour to be offered at these service centres. With the U.K’s decision to leave the E.U. via the Brexit referendum, it is expected that the visa process for attaining both work and education in the U.K. will become difficult to obtain. Since the U.K. is also regarded as a leader in Islamic finance education, Malaysia could stand to benefit from an increased pool of Islamic education trained students who are looking for opportunities in Islamic finance elsewhere.

• **Comparison with other fund centres**
  Malaysia has been widely recognised as a key jurisdiction for outsourcing, and was ranked third by A.T. Kearney as the third most attractive destination for shared services based on its financial attractiveness, talent skills and availability, and business environment. Malaysia should leverage this strength, particularly in comparison to other potential Islamic finance centres such as the UAE.

Across other measurements, Malaysia is an average performer. Though it tends to do better than Indonesia across several key benchmarks, the UAE tends to rank above Malaysia for these criteria. Malaysia can use its other advantages to offset this imbalance and if it raised itself in rankings sufficiently, it could expect to reap the associated rewards.
### Perception and Relative Indices of Major Fund Centres

**Figure 14: Jurisdictional comparison of major fund centres**

**Note:** Calculated as an average of neighbouring, similar countries

**Source:** World Bank, WEP, AT Kearney, ICT Development Index, PwC Analysis

<table>
<thead>
<tr>
<th></th>
<th>Belgium</th>
<th>Ireland</th>
<th>Singapore</th>
<th>Hong Kong</th>
<th>Indonesia</th>
<th>United Arab Emirates</th>
<th>Malaysia</th>
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<tr>
<td><strong>Political Stability</strong></td>
<td>0.97</td>
<td>0.92</td>
<td>0.97</td>
<td>0.92</td>
<td>0.43</td>
<td>0.89</td>
<td>0.62</td>
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<td></td>
<td>93%</td>
<td>89%</td>
<td>100%</td>
<td>98%</td>
<td>53%</td>
<td>91%</td>
<td>76%</td>
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<td>9/176</td>
<td>20/176</td>
<td>18/176</td>
<td>6/176</td>
<td>111/176</td>
<td>40/176</td>
<td>63/176</td>
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<tr>
<td>and Access</td>
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<td></td>
<td></td>
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<tr>
<td><strong>Index: Overall</strong></td>
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<td></td>
<td></td>
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<td></td>
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<tr>
<td><strong>ICT Development</strong></td>
<td>74/176</td>
<td>12/176</td>
<td>37/176</td>
<td>22/176</td>
<td>109/176</td>
<td>108/176</td>
<td>101/176</td>
</tr>
<tr>
<td><strong>Index: Access</strong></td>
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<tr>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td></td>
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<td>Yes</td>
<td>Yes</td>
<td>No</td>
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<td><strong>Business/Tax Advantages</strong></td>
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<tr>
<td>Ease of Doing Business</td>
<td>63/190</td>
<td>17/190</td>
<td>2/190</td>
<td>5/190</td>
<td>72/190</td>
<td>21/190</td>
<td>24/190</td>
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<td>Ease of Paying Taxes</td>
<td>21/190</td>
<td>4/190</td>
<td>7/190</td>
<td>3/190</td>
<td>114/190</td>
<td>1/190</td>
<td>73/190</td>
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<td><strong>Rule of Law Index</strong></td>
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<td>0.8**</td>
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<td>0.52</td>
<td>0.65</td>
<td>0.54</td>
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<tr>
<td><strong>Business process</strong></td>
<td>53/65</td>
<td>51/65</td>
<td>4/65</td>
<td>32/65</td>
<td>3/55</td>
<td></td>
<td></td>
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<td>outsourcing friendliness</td>
<td></td>
<td></td>
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<td></td>
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</tbody>
</table>

**Legend:**
- **Best-in-class**
- **Average**
- **Not stated**
Conclusion

Malaysia has an enviable position straddling both the Islamic world and the West, and must continue to develop a strong yet flexible framework for Islamic fund administration. In the short term, it needs to maintain its standing as a destination for business process outsourcing services by providing Islamic fund managers with reliable and cost efficient back office functions.

In the longer term, fund administrators need to adapt to the changing needs of Islamic managers -- while Islamic fund assets may be plain vanilla today, new innovations in the traditional and alternative space will likely require service providers to grow in sophistication. Furthermore, labour arbitrage will inevitably erode, prompting fund managers to uproot outsourced functions to cheaper destinations, as experienced by the Indian market.

To remain relevant and attractive, Malaysia needs to nimbly address its weaknesses as outlined – cumbersome processes need to be simplified, fragmented systems need to be better aligned, and automation – a clear and resounding theme globally – needs to be integrated into the industry. Over time, the fund administration centre should ideally transform from a low-skilled market to a high-skilled knowledge process outsourcing centre recognized by Islamic fund managers globally.

Along with the development of the Islamic fund administration capabilities, the regulators should also promote the awareness of SRI investments, which has been a growing theme among investors. Penetration of SRI investments are currently marginal in Asia, but could grow to levels in Europe, presenting service providers with an enlarged market.

As illustrated, the Malaysian fund administration market is brimming with opportunities. Its success however, will lie greatly on the expert guidance of the regulators to refine the existing framework to provide ease of entry and a stable environment for market players. The implementation of these changes will be challenging but extremely crucial as other major fund administration centres close in on the competition. In light of these challenges, it is worth remembering that it was only in 2001 that the first CMP was introduced and achieved remarkable success. The country is now in an excellent position to seize the opportunities presented and propel itself to a world class centre of excellence in Islamic fund administration.


10. Securities Commission Malaysia

11. Bank Negara Malaysia

12. Islamic Financial Services Board

13. Pew Research Centre

14. Otoritas Jasa Keuangan [OJK]

15. Autoriti Moneteri Brunei Darussalam [AMBD]

16. ICD-Thomson Reuters

17. World Bank

18. World Justice Project

19. AT Kearney

20. ICT Development Index

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