



ISLAMIC FINANCE IN CAMBODIA

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“Local expertise with international experience makes us the advisor of choice”

Introduction

Currently, there are approximately 400,000 to 800,000 Muslims living in Cambodia and many of them are living in either poverty or low income families. As such, they form a group that are most in need of financial assistance to support basic living standards and to conduct business.

The year 2006 was declared to be the “Year of Microfinance” by the Royal Government of Cambodia (the “RGC”) and with an emphasis on financial inclusion, new financial institutions started being established in Cambodia. Today there are a substantial number of financial institutions offering financial products to lower income families. However, such financial products remain out of the reach of Muslims. Muslims are bound by the *sharia* and, in particular, the charging of interest is incompatible with the *sharia*. This restricts Muslims from entering into conventional interest-bearing loans.

Of course, in addition to the financial assistance required for maintaining basic living standards, there is a growing number of SMEs owned or operated by Cambodian Muslims that require access to *sharia*-compliant financial products (“SCFPs”).

Islamic Finance and the Financial Sector in Cambodia

It would appear that there are no financial institutions in Cambodia that offer SCFPs. Interestingly, there are a number of financial institutions originating from majority Muslim countries which have set up branches or subsidiaries in Cambodia. However, such financial institutions appear to offer only conventional financial products which are not *Sharia*-compliant.

To date, there have only been a handful of organizations that offer any form of financial assistance (let alone, SCFPs) to Cambodian Muslims, one of which being Muslim Aid Cambodia (“MAC”). MAC is known as the first institution offering access to SCFPs. MAC has seen a dramatic increase in its customer base suggesting that the demand for SCFPs remains high in Cambodia.

Investment from Predominantly Muslim Countries

Cambodia is a country that has experienced extraordinary economic growth in recent years. The laws applicable to foreign investors are non-discriminatory and businesses from all over the world can establish a presence in Cambodia. In addition, the RGC has, on behalf of the people of Cambodia, been very active in forming mutually beneficial investment and trade relationships with foreign countries. Notably, the RGC entered into an Agreement Between the Kingdom of Cambodia and the United Arab Emirates on the Promotion and Reciprocal Protection of Investments (the “**UAE Agreement**”) in July 2017. The UAE Agreement sets out the rights of investors and the obligations that each contracting party has with respect to such investors and, in particular, requires that each contracting party shall “create favorable conditions and shall admit such investments in accordance with its laws and regulations” (UAE Agreement, Art. 2).

As is the case in any country, foreign investors prefer to use financial institutions from the country in which they are located. As investment from predominantly Muslim countries increases, so to we would expect to see an increase in demand for banks from such countries to establish subsidiaries or branches in Cambodia.

Expected Growth of Islamic Finance in Cambodia

In light of the above, it would seem likely that there the demand for SCFPs in Cambodia will increase over time. Interestingly, there is no restriction on conventional banks in Cambodia from offering SCFPs either as a matter of Cambodian law or the *Sharia* itself. Notwithstanding this, it would be prudent for a conventional financial institution offering SCFPs to:

- (a) ensure that the funds it receives in respect of SCFPs are not mixed with funds received in respect of Non-SCFPs as funds received in connection with Non-SCFPs may be viewed as impure if they contravene the restrictions on engaging in *riba*, *gharar* or *haram* activities (discussed below);
- (b) establish a Sharia Advisory Board to review products to ensure compliance with the *Sharia* (discussed below); and
- (c) publicize the above so that customers looking for SCFPs feel comfortable that the financial institution complies with the *Sharia*.

The term “Islamic finance” is sometimes misunderstood as meaning finance that is available only to Muslims. This is not the case and provided that the activity being financed does not contravene the restrictions noted above, SCFPs may be accessed by anyone. This is a further incentive for conventional financial institutions to offer SCFPs.

What are the requirements of a Sharia Advisory Board?

A financial institution that wants to offer Islamic products will need to have advisors that are independent and specialized jurists in [*fiqh al-mu'amalat*](#) (Islamic commercial jurisprudence) to:

- advise the financial institution with regards to the compliance of financial products it proposes offering with the *Sharia*;
- certify transactions (particularly for large projects in which the financial institution maybe involved) as being compliant with the *Sharia*; and

- advise the financial institution on the distribution of income between investors and shareholders;
- ensure compliance of the financial institutions operational and financial procedures with the *Sharia* and the mitigation of the risk of non-compliance with the *Sharia*.

As a matter of Cambodian law, there are no requirements regarding the structure of the Sharia Advisory Board. However, it would be prudent for any financial institution offering SCFPs to obtain the advice of an Islamic scholar regarding the structure.

When is a financial product *Sharia*-complaint?

“Islamic Finance” is a relatively new phenomenon which appears to have originated in the mid-twentieth century. However, given the long history and complexity of the *Sharia* it is not possible to describe all of the aspects of the *Sharia* that may be relevant to the structuring of a financial product. Rather, the below highlights some of the more common restrictions applicable under the *Sharia*.

- Riba** – The *Sharia* prohibits the requirement of payment of any amount in addition to the principal amount of a loan (*riba*). There is some debate regarding the scope of what may constitute *riba*. However, there appears to be consensus that the charging of interest, whether, fixed, floating or variable would constitute *riba*.
- Haram** – An activity is *Haram* if it is prohibited by the *Sharia*. The *Sharia* strictly prohibits some activities (e.g. producing and selling alcohol or pork) and any financial product made available to finance such an activity would not comply with the *Sharia*.
- Maisir** – The *Sharia* prohibits all forms of gambling (*Maisir*). However, it is important to distinguish between taking risks that would not otherwise arise in daily life and those that do. Of course, taking a risk by starting a business would not appear to constitute *Maisir* whereas speculating on risk (e.g. a Contract for Differences) where an underlying risk is not being hedged may do.
- Gharar** – This is probably one of the most complicated restrictions under the *Sharia* and in essence refers to uncertainty regarding goods/services being sold or the consequences of a contract.

In addition to taking account of the abovementioned restrictions Islamic Finance is based on the following principles of the *Sharia*:

- Material finality of the transaction:** this refers to the need for a financial transaction to have a direct or indirect connection to a real economic transaction.
- Profit and loss sharing:** The *Sharia* prohibits usury on the basis that it is exploitative of the borrower. The flipside of this is the *Sharia* principle that the parties to a financial transaction should share in the profits or losses made from the transaction being financed in proportion to their investment.

Examples of SCFPs

There are many different types of SCFPs with new products being engineered regularly. It is beyond the scope of this article to describe all such products and the following is merely a sample of the more common SCFPs.

- **Qard ul-Hasan** (Benevolent Loan): As one might expect, given the prohibition of *riba* under the *Sharia*, an interest-bearing loan would not constitute a SCFP. A *Qard ul-Hasan* is a loan made without interest applicable and only a requirement to repay the principal. However, the borrower may make a repayment of the principal together with an excess (tangible item, benefit, service, etc.) as long as such an excess is neither expressly stipulated nor implicitly provided for in the relevant loan agreement. Such loans are not typically made by banks, rather they tend to be made in small amounts by employers to employees in financial need. As such it may be seen as being similar to microcredit.

Under Cambodian law, there is no prohibition on the making of an interest free loan and it is permitted as long as the parties agree to it. However, Cambodia enacted its transfer pricing laws on 10 October 2017 with the issuance by the Ministry of Economy and Finance of Prakas 986 (which has been supplemented by Instruction 11946 and Notification 4630 released by the General Department of Taxation (the “GDT”). Since then there has been some debate regarding the ability of a lender to make a zero-interest loan to a related party and the position remains unclear. This will obviously impact on loans made by offshore entities in majority Muslim countries to their Cambodian subsidiaries. Further with regards to zero interest-bearing loans made between non-related parties, there remain some requirements under Circular 151 and 1701 issued by the GDT that need to be considered, particularly the need to register such loans with the GDT.

- **An Ijarah** (Lease-based mode) refers to an agreement which involves the provision of products or services on a lease or rental basis for an agreed period against specified installments of lease payments / rental. An Ijarah contract could offer the lessee the option to purchase the asset either at the end of the lease period by means of a gift or a token consideration, or by installments of a specified amount during the lease period.

Similarly, the Law on Financial Leasing (the “LFL”) in Cambodia also provides the lessee and the lessor to have a mutual agreement on the leased asset and there is no provision that appears to be contrary to an Ijarah. However, in order to operate a financial leasing business, an institution is required to apply for a license from the National Bank of Cambodia (the LFL, Art. 34).

- **Musharaka** (profit-lost-sharing): This is a partnership or joint venture structure entered into by two or more parties and is a type of *shirkah al-amwal* (“sharing”). Under such an arrangement, the parties each contribute various percentages of all three factors of economic production (capital, labor, and entrepreneurship) and share in the profits and losses in proportion to the size of their respective investments.

Musharaka is the typical structure used by investors where one of them has limited capital and is typically used in real estate transactions, providing credit and investment projects to start or process the business operation.

- **Mudarabah** (profit-lost-sharing): This is a partnership structure in which one partner is the financier (investor or silent partner) and the other partner (fund manager or working partner) manages the financier’s investment in an economic activity. This structure is one of the most widely used Islamic finance structures.

Under the Law of Commercial Enterprises (2005), there is recognition of a partnership business where one party (the financier) is known as a limited partner, who has limited liability with respect to the entity, while another party (the fund manager or working partner) is known as a general partner with unlimited liability. Nevertheless, we note that not many partnerships have been established in Cambodia and this could be because not many parties wish to be general partners with unlimited liability.

- **Sukuk**: A *sukuk* is an Islamic financial certificate, similar to a bond, that is *Shariah* compliant and excludes any obligation to pay interest. The issuer of a *sukuk* sells an investor group a certificate, and then uses the proceeds to purchase an asset, of which the investor group has partial ownership. The issuer must also make a contractual promise to buy back the bond at a future date at par value.

Conclusion

Given the impact of the Covid-19 pandemic and the increased difficulty that Cambodian Muslims are experiencing in making ends meet, it is hoped that financial institutions in Cambodia will develop a range of SCFPs to meet their financial needs. The offering of such products falls to the financial institutions but, as discussed above, while there are no legal issues that prevent such an offering, some discussion with the General Department of Taxation will be required to address the tax issues that arise.

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