



Know Your Customer (KYC) Credit Risk Assessment: A Study of the PBZ Ikhlas – Zanzibar

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Abstract

Risk cannot be avoided completely but its effect could be reduced where there is understanding on types of risks involved and setting mitigation measures. In financial institutions such as banks, the most common risk factor is Know Your Customer (KYC). How much information does the financial institution possess regarding new customers; what changes have occurred on existing customers. This study aims to find out what are the risk factors that cause the People's Bank of Zanzibar (PBZ) Ikhlas branches to have Non-Performing Finance (NPF), in particular the KYC factor. The 5Cs – Character, Capacity, Collateral, Capital and Conditions – principle are applied, which are intended not to harm debtors who later commit defaults, such as NPF. This is a survey study of PBZ Bank Ikhlas for 2022 operations only and it involves data collection mainly from available reports. The survey was conducted through consultative meetings and by use of questionnaire covering ten officers at PBZ including Shariah Advisory Committee (SAC) and the management members. Data was subjected to a qualitative analysis delving into non-numerical data, open-ended responses and deeper insights. Though this study does not aim to bring about changes in running PBZ, the findings and suggestions could help in understanding the challenges and mitigate the risks. The findings show that there is most likely a lack of an in-depth due diligence on KYC and regular training to both SAC and the PBZ Bank Ikhlas (PBZ) staff. In order to reduce credit risk at PBZ and hence move forward financial stability, PBZ is advised to consider customer background while assessing character. The 5Cs should be made a priority in appraising customers and most importantly engage customers with transparency about the PBZ Ikhlas services and conditionality.

Keywords: Zanzibar, Credit Risk, Know Your Customer, Non-Performing Finance, PBZ, Ikhlas.

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1. Introduction

The People's Bank of Zanzibar (PBZ Bank) was established in 1966 by the [Companies Decree Cap.153 \(1953\)](#) and it is a public trust with 100 percent shares by the Government of Zanzibar. Primarily, it was intended to become the Bank of Zanzibar with powers like any other central bank. However, being part of the United of Republic of Tanzania where fiscal policy is a union matter as per the first schedule of article 4 of the [Constitution of the United Republic of Tanzania \(1977\)](#), such ambitious expectations could not materialise.

PBZ Bank continued to offer services as Commercial Bank but it was the custodian of Zanzibar Government finances, both local and foreign currencies. In the period from 1966 to late 90s' there were only two banks operating in Zanzibar: PBZ Bank and the National Bank of Commerce (NBC) where Zanzibar Government has shares. The Central of Bank of Tanzania (BOT) has its branch in Zanzibar providing fiscal and other services. From early 2000s' Zanzibar Government was compelled to open accounts with BOT and

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hence PBZ Bank has no monopoly of Government funds. It is this case that led PBZ to diversify its business plan to include more products.

Zanzibar is predominantly a Muslim majority society where a call for halal products particularly at the PBZ Bank has been raised. In response, in 2000 PBZ Bank began preparations to introduce Islamic Banking but there was no legal and regulatory framework at the Bank of Tanzania (BOT). In 2012, PBZ Bank was granted license to operate Islamic Banking Division (Islamic Bank window-PBZ Bank Ikhlas) with expertise from Malaysia and Qatar. Subsequently a Shariah Advisory Committee (SAC) was established. The SAC has been functioning since the Islamic Window started full operation in 2012. The first SAC started immediately after launching Islamic Window while the second came in office in 2021. The Chairperson ended terms of office and the Deputy Chairperson took over the chairmanship; hence only two chairpersons have exchanged offices since its establishment. This arrangement has ensured continuity and maintains stability in Ikhlas operations.

This measure attracted more customers and in the 10 years period since the introduction of Islamic Division - Window (2012 – 2022), the Bank expanded its operations beyond Zanzibar. It has 8 branches and 3 service centers in Zanzibar and Tanzania Mainland (PBZ Finance Report, June 2022). Plans are underway to open more branches and service centers in Tanzania Mainland. Definitely, with shortage of local expertise in the Islamic Finance and Banking, the easiest business in a bank is financial services in the form of credit. However, this must be in accordance with Islamic Finance Standards Board (IFSB) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) aiming at achieving Shariah principles including Islamic values with other requirements. Other actions introduced by banking regulators is Know Your Customer – KYC principle.

This study examines how much “Know Your Customer – KYC” contributes to credit risk and what should be done in reducing risks in the banking business, challenges experienced and mitigation measures undertaken by the management. This study will examine the role of Shariah Advisory Committee (SAC) in minimising risks and measures to overcome such risks. In the end, suggestions will be given to cut down credit risk at PBZ Bank Ikhlas.

Know Your Customer – KYC practices in Islamic banks are particularly crucial given the growth of online transactions and associated fraud risks (Miskun et al., 2023). While these banks follow similar regulatory standards as conventional banks, they also align their practices with Shariah principles (Manan and Yusoff, 2024). This study explores the intersection between Know Your Customer (KYC) processes and credit risk management within the PBZ Bank Ikhlas of Zanzibar.

KYC is traditionally associated with regulatory compliance and anti-money laundering (AML). It plays an increasingly critical role in assessing and managing credit risk (Utami & Septivani, 2022; Isima & Khoirunnisa, 2023). By examining customer identification, verification, and profiling procedures, a robust KYC framework not only helps banking institutions comply with legal obligations but also provides valuable insights into the creditworthiness and risk profile of clients (Fitriyani, 2021 in Miskun et al., 2023). This study delves into how enhanced due diligence can uncover red flags, such as inconsistent income sources or suspicious transactions, that may indicate potential default risks.

Non-Performing Finance (NPF) reflect bad debts that can hurt profitability and slow economic growth. Islamic banks attempt to prevent NPFs through the KYC standards (Priyadi et al., 2021). Other methods to resolve NPFs include rescheduling, reconditioning, and restructuring (Indah Putri et al., 2024). Despite operating under Shariah-compliant principles, Islamic banks can experience higher credit risk due to the absence of tailored risk management tools, underscoring the need for more effective regulations and financial innovations to support their growth and stability (Haddad and Souissi, 2022).

This study is intended to examine how much KYC contributes in reducing risks at PBZ Bank IKHLAS. Secondly the findings will enrich the authors in the aspects of Risk Assessment and Mitigation while at the same time officers at PBZ Bank might use these findings to conduct detailed risk assessment studies in other operation areas.

This study is divided into seven sections: (i) Introduction, (ii) Objective of the study, (iii) Literature review, (iv) Research methodology, (v) PBZ Islamic Banking Window (Ikhlas) and business coverage, (vi) Data and analysis of the findings, and (vii) Conclusion and suggestions on mitigations measures against credit risk.

2. Literature Review

The current study aimed to identify the contribution of the “Know Your Customer” (KYC) principle to credit risk in minimising risks in the banking industry, challenges it faces and important measures to be taken by the management. The literature review focuses on exploring studies specifically related to credit risk, Non-Performing Financing and KYC. There has been growing recognition of the credit risk and how it relates to the NPF, relatively on the Islamic banking sector. The subsequent sections outline the arguments that form the basis for developing the study’s keywords.

2.1. Know-Your Customer (KYC)

The banking world recognises the principle of “Know Your Customer” (KYC) which is one of the most important principles in the world of banking and finance. This principle refers to the policies and procedures implemented by financial institutions to ensure the correct identity and characteristics of their customers before offering financial services to them. By ensuring that each customer has gone through a proper identity verification process, financial institutions can build a good image and increase public trust in their financial services (Miskun et al., 2023).

Financial institutions must ensure that the KYC system implemented complies with applicable regulations and is able to detect potential risks and take the necessary precautions to combat these risks (Iryana et al., 2017). This Know Your Customer principle allows banks to find out details about bank customers. The bank is given the power to decide whether the customer intends to enter into a legal relationship with the bank’s qualities and trust. Banks are therefore entitled to obtain information so that they can obtain an overview of their customers, monitor customer transactions and suspicious activity can be reported immediately (Miskun et al., 2023).

The application of the 5Cs principle is introduced so that the bank is not harmed by debtors who later commit defaults, such as Non-Performing Finance (Miskun et al., 2023). The commonly referred to as the 5Cs include: Character, Capacity, Collateral, Capital and Conditions (Sulistiyandari et al., 2024). The 5Cs provide understanding and awareness that the financing contract is a debt contract. For Islamic banks, the 5Cs exist in debt and receivable contracts as written in the Qur’an (Al-Baqarah, 2:280-283), which state that debts must be acknowledged, well written and must also be repaid except in certain emergency conditions (Indah Putri et al., 2024).

2.2. KYC in Islamic Banks

As banking operations heavily depend on internet and digital transactions, rampant banking crimes such as data theft and online fraud are escalating (Miskun et al., 2023). In order to address unfavourable credit levels and less stringent banking supervision, banking regulators continue to improve banking supervision and regulation to provide better protection to customers through Know Your Customer – KYC (Munni, 2024; Miskun et al., 2023).

Customers are required to fill the KYC application and this forms as an integral part of the Islamic banks information hub (Hossain, 2022). KYC assist, among others, to strengthen Islamic bank’s corporate social responsibility as the bank will incorporate social and environmental concerns into their business operations and interactions with their customers (Hossain, 2022). However, barriers to implementation are detected including customer dishonesty in providing information to the bank (Isima & Khoirunnisa, 2023).

The principle objective of KYC is to protect banking and financial institutions (including Islamic one’s) from the risks of fraud or terrorist financing (Miskun et al., 2023; Rahmiyati & Rimayanti, 2024). When applied to anti-money laundering, Islamic banks tend to modernise Know Your Customer (KYC) processes and improve risk mitigation and support outdated information technology systems (Utami & Septivani, 2022). In some other instances, the Know Your Customer (KYC) platform is based on blockchains which is built from mobile application and completed through deployment and testing (Minaz et al., 2023).

KYC is applied by both, in the conventional and Islamic banks. The Islamic banking sector is subjected to strict supervision to combat financial crime, just like conventional banks (Utami & Septivani, 2022; Isima & Khoirunnisa, 2023). All banks, whether conventional or Islamic, must comply and implement information disclosure clauses, and example anti-money laundering standards, such as the KYC (Utami & Septivani, 2022; Isima & Khoirunnisa, 2023).

2.3. Implementation of the KYC

The provisions of the *Banking and Financial Institutions Act (2006)* of Tanzania encompass the prudential principle in business activities related to fundraising. For instance, *Anti-Money Laundering Regulations (2022)*

addresses the implementation of Anti-Money Laundering (AML) and Prevention of Terrorism Financing (PPT) programs in the financial services sector. The anti-money laundering program is provided under regulations 8, 10 and 16 of the Anti-Money Laundering Regulations 2022. The implementation begins with the preparation of guidelines and standard practices for implementing Know Your Customer principles which are a prerequisite for Islamic banks to support the program (Sulistiyandari et al., 2024).

The guidelines stipulated by the Regulations in the application of Know Your Customer Principles cover at least the principles of acceptance and identification of prospective customers, practices for controlling customer accounts and transactions, and risk management practices (Fitriyani, 2021 in Miskun et al., 2023). These Regulations also require banks to obtain comprehensive information about customer identities, monitor transaction activities, and report any suspicious transactions. The goal is to better understand customer profiles, transactions, and business activities (Miskun et al., 2023; Sulistiyandari et al., 2024).

In practice, there have been violations of the prudential principle in Tanzanian banking activities that have led to banking crimes. This study indicates that violations stem from the failure of banks (and their managers) to conduct 5Cs analysis (Character, Capacity, Collateral, Capital and Conditions) for prospective customers. Instances of non-compliance include failure to conduct proper customer due diligence and file suspicious transaction reports to the Financial Intelligence Unit (FIU) (Bank of Tanzania, 2019; Sulistiyandari et al., 2024).

2.4. Credit Risk

Credit risk is the probability that a bank trading partner, borrower or partner, will fail in meeting his financial obligations as agreed with the bank (Jimoh et al., 2022; Scott et al., 2024; Budiarto, 2023; Manan and Yusoff 2024). Credit risks can also be defined as: “the change in the net value of assets due to the expected debtor’s ability to fulfill their contractual obligations to the lender in a timely manner” (Bahat and Darzi, 2019 in Abumatar, 2024).

Banks encounter credit risks in almost all of their operations because their relationship with customers is essentially a fiduciary or debtor-creditor relationship (Abumatar, 2024). Credit risks are considered as the most dangerous risks faced by financial institutions (Hussain and Al-Ajmi, 2012 in Jaelani et al., 2024). The higher the credit risk, the worse the bank performance (Manan and Yusoff, 2024). Factors contributing to credit risk include borrower credit worthiness, financial crisis or in economic downturn, industry trends, and regulatory environment (Scott et al., 2024; Abumatar 2024; Razif, 2015). Credit risk can also originate from business activities, such as acceptances, interbank transactions, lending, trade financing transactions, commitments and contingencies, bonds and exchange rates, and derivative transactions (Hassan et al., 2019 in Budiarto, 2023).

2.5. Credit Risk in Islamic Banks

As conventional banks are bigger in sizes and have stronger portfolio diversification, credit risk in Islamic banks are sophisticated (Manan and Yusoff, 2024; Marnouch and El Khamlichi, 2024; Chowdhury et al., 2023). However, in Bahrain the risk is rather lower due to resilient regulatory frameworks and devotion to Shariah standards (Manan and Yusoff, 2024). Credit risk and income diversification are the most common factors associated with Islamic bank insolvency (Marnouch and El Khamlichi, 2024; Abumatar 2024).

2.6. Credit Risk in Selected Islamic Bank Products

Credit risk comes in different forms in Islamic banks depending on the types of financial contracts. As Islamic banks provide different financial products, this section will examine on four basic services: murabahah, musharakah, istisna and ijarah.

Murabahah is a transaction by which the trader (Islamic Banks) buys a property for the purpose of selling it to the buyer on an agreed profit ratio plus cost (Van Greuning and Iqbal, 2008). In murabahah transactions, Islamic banks are exposed to credit risks when the bank delivers the asset to the client but does not receive payment from the client in time. In case of a nonbinding murabahah, where the client has the right to refuse delivery of the product purchased by the bank, the bank is further exposed to price and market risks (Van Greuning and Iqbal, 2008; Alkhawaja and Görmüş, 2019; Ijaiya et al., 2021).

The primary source of the risk is the murabahah financing, which represents the most significant portion of Islamic banking financing transactions (Adewale and Elena, 2019 in Ijaiya et al., 2021). This is due to the nature of Islamic banking in general and the nature of financing in particular, in which mark-up is added to the cost of financing depending on the risk associated with the transaction (Ijaiya et al., 2021). Murabahah financing represents the most significant portion of Islamic banking financing transaction.

Musharakah is defined as a profit-loss based on joint project or an enterprise in which partners share profit or loss according to predetermined ratio (Bhatti, 2011 in Alkhawaja and Görmüş, 2019). Credit risk in musharakah agreements come to existence as a result when the partner does not pay the profit shares to the bank or when the business outcomes vary from the banks expectations (Akkizidis and Kumar, 2008 in Alkhawaja and Görmüş, 2019).

Istisna is a contract made with a producer or a labour to create a good based on specific standards, some percentage of the payment can be advanced (Borhan, 2002). Credit risk occurs in istisna when a customer fails to make payment due for the manufactured goods as agreed. Credit risk can also arise as a result of the buyer incapacity to buy the agreed product or providing the installed payments after receiving the product (Akkizidis and Kumar, 2008 in Alkhawaja and Görmüş, 2019). As for ijarah contract, the lessor (the owner) gives the right to lease a specific property or a good for a fixed period of time against an agreed amount of money (Fatima, 2006). Credit risk arises in case the customer could not fulfil paying the agreed money to the bank (Vejsagic, 2014 in Alkhawaja and Görmüş, 2019).

2.7. Credit Risk and Islamic Banks in Africa

Islamic banks in Africa are characterised with technical inefficiencies and low efficiency linked to high exposure to different risk variables such as credit, liquidity and operational risks (Ijaiya et al., 2021). Other reasons include lack of valuable securities to be presented as collateral for bank lending, absence of good titles to properties, lack of presentable business plans, and lack of proper financial documentation (Ijaiya et al., 2021). The issue of regulation and compliance is another challenge for Islamic banks in Africa. According to Ariffin and Tafri (2014), some banks have some abstruse fees, which may be perceived as interests designed in the form of management fees which cumulate to the high cost of accessing financing of Islamic banks and eventual default in repayment (Ijaiya et al., 2021).

2.8. Credit Risk Management in Islamic Banks

Management of credit risk in Islamic banking can be worth referenced according to Islamic Financial Services Board (IFSB) which supplies strategies and known factors causing it (Kusnandar, 2022). The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. In order to have in place sound processes of credit risk management, the IFSB 2005 provides the following recommendations that Islamic banks must have:

- (a) an appropriate credit strategy, including pricing and tolerance for undertaking various credit risks;
- (b) a risk management structure with effective oversight of credit risk management;
- (c) credit policies and operational procedures including credit criteria and credit review processes, acceptable forms of risk mitigation, and limit setting;
- (d) an appropriate measurement and careful analysis of exposures, including market- and liquidity-sensitive exposures; and
- (e) a system (i) to monitor the condition of ongoing individual credits to ensure the financings are made in accordance with the IIFSs' policies and procedures, (ii) to manage problem credit situations according to an established remedial process; and (iii) to ensure adequate provisions are allocated.

In relation to Tanzania's banking regulatory framework, *Management of Risk Assets Regulations (2014)* were made under section 71 of the Banking and Financial Institutions Act 2006 for the purpose of ensuring that, banks and financial institutions including Islamic banks and Islamic financial institutions have adequate credit and investment policies. These rules are meant to identify, measure, monitor and manage the risk arising from financial businesses to ensure timely and adequate actions are taken on problem assets, maintain risk management standards that conform to the established international norms and promote and maintain public confidence in the banking sector (Suddy, 2021).

Although these Regulations provide a proper way through which management of risk assets will be conducted well, they fail to take into consideration the uniqueness of Islamic banks. Therefore, in order to allow Islamic banks to undergo management of risk assets, the government through the Minister responsible for Finance has to come up with regulations that will address the unique features of Islamic banking (Suddy, 2021).

A study by [Haddad and Souissi \(2022\)](#) probed into the impact of risk management practices on the effectiveness of Islamic banks in the United Arab Emirates (UAE). The researchers observed a noteworthy positive influence of risk management practices on the profitability of Islamic banks. This underscores the importance of integrating effective risk management measures to sustain profitability in the context of Islamic banking ([Ismail, 2023](#)). With the principles of risk-sharing and ethical finance inherent in Islamic banking, adopting robust risk management practices becomes particularly significant to safeguard stakeholders' interests and uphold the principles of Shariah. The study's findings suggest that Islamic banks should prioritise the implementation of sound risk management strategies to optimize their profitability and financial sustainability ([Haddad and Souissi, 2022 in Ismail, 2023](#)).

2.9. Non-Performing Finance (NPF)

Credit risk in Islamic banks is in the form of financing risk, namely Non-Performing Finance (NPF) which is influenced by the client's age, gender, occupation and type of contract ([Muhammad et al., 2020 in Hernawati et al., 2021](#)). Non-performing financing (NPF) is the term used in Islamic banking that refers to a bank loan that has been defaulted on or is unlikely to be paid back in full by the borrower. In conventional banking, it is known as a non-performing loan (NPL).

Non-Performing Finance (NPF) represents a tool to measure financing risks. Banking performance can be evaluated by measuring the level of NPF to indicate liquidity, profitability and solvability ratios ([Dwihandayani, 2017](#)). [Isaev and Masih \(2017\)](#) maintain that NPF plays a key role in determining the quality and performance of banks because financing is the main function of banks in contributing to economic development. NPF are also a key concern for the banking industry since they lower bank profitability and are sometimes seen as preventing banks from lending more to businesses and individuals which in turn will slow down economic growth ([Kumar et al., 2018 in Hernawati et al., 2021](#)).

NPF in Islamic banking is one of the risk measurements for bad credit ([Faiz, 2010](#)). Hence, Islamic banks need to specifically manage their NPF level because it will have an impact on their performance in competing with conventional banks ([Nugraheni and Muhammad, 2019 in Priyadi et al., 2021; Indah Putri et al., 2024](#)). To resolve NPF in Islamic banks, four procedures can be applied when the bank faces financial problems: rescheduling, reconditioning, restructuring and confiscation of collateral. However, in practice, Islamic banks often opt for rescheduling and reconditioning to resolve Non-Performing Financing. If the conditions turned difficult to repay the debt, the customer will be released. Moreover, by recording the receivables, they will be written off ([Indah Putri et al., 2024](#)).

Bad credit is a parameter of sluggishness in the real sector in response to broader economic conditions so that the banking sector is often affected and falls into crisis conditions. Despite the fact that Islamic banking has a unique system and application of Shariah principles, it is assumed that Islamic banking also carries a high risk. When compared to conventional banking, Islamic banking has a greater credit risk due to the lack of proper management instruments in managing risk ([Effendi and Yuniarti, 2018](#)). Even after the late 1990s monetary crisis, conventional banking's NPL level continued to fall, indicating an improved condition, whereas Islamic banking's NPF level remained stable on a range of 2 to 4% ([Iqbal, 2017 in Kusnandar, 2022; Chowdhury et al., 2023](#)).

3. Research Methodology

The methodology used in writing this study is the survey of PBZ Bank Ikhlas for 2022 operations only. The survey involves questionnaires distributed to participants as well as data collection mainly from literatures and available reports, discussion with two officers responsible with Shariah Compliance and authors' own experience at the Bank. No other companies are involved. The scope is therefore very narrow as the study is not intended to bring about changes in running PBZ Bank Ikhlas. However, the findings could help in understanding the challenges and hence move forward with a broader research into the area of risk assessment and mitigation. The survey was conducted by use of questionnaire covering the two areas that is Credit Risk related to KYC and Credit Risk related to Islamic Financial Transactions. Ten officers at PBZ Bank Ikhlas including SAC members and management were randomly selected to respond to the questionnaire. It is worth noting that author 1 of this study is the Chairman of Shariah Advisory Committee of PBZ Bank Ikhlas. Hence, he is obliged by Regulations not to disseminate confidential information. In this case, care has been taken to inform the public on factors that are general and useful for researchers.

4. PBZ Islamic Banking Window (Ikhlas) and Business Coverage

PBZ Ikhlas is a division which follows Shariah in its transactions and it has Shariah Advisory Committee (SAC) operating with the support of Shariah Compliance Manager (SCM). In its day-to-day operations, PBZ Bank conventional service centers also serve PBZ Ikhlas customers. It is not certain how much this arrangement could result into Shariah Non-Compliance Risk (SNCR). This aspect needs a detailed study.

PBZ Bank has formally defined relationships between its management, its Board of Directors, its Shariah Compliance Committee and its shareholders which is the Government of Zanzibar through the Treasury Registrar. In this way, PBZ Bank has a corporate structure as well as a culture through which its objectives and monitoring performance are determined. It is this corporate structure which provides trust to customers, shareholders and other stakeholders. The Executive Director of PBZ Bank is appointed by the President of Zanzibar as well as the Chairman of the Board of Directors. However, the Chairman of SAC is appointed by the Minister responsible for Finance while members of SAC are appointed by the Board. The Board and Management make sure that if one person sits in another Bank's SAC, such a person cannot be appointed at PBZ Ikhlas at the same time. In this way conflict of interest is eliminated, Shariah Governance Framework (SGF) is observed and hence limiting risks.

Islamic Banking Division collects its revenue from different Shariah compliant sources of income; these include profit from Islamic financing, bank commission and gain on foreign exchange. Table 1 provides a summary of banking operations in 2022. Cash from all Islamic branches was TZS 6,940 million which is an increase of 30.43% compared to TZS 5,321 million recorded in the previous period (1 USD = 2,567 Tanzania Shillings (TZS) as of July 24th, 2025). It is reported that PBZ Ikhlas has accumulated un-invested funds; in 2022 such amount was reduced from TZS 120 billion to TZS 106 billion; a decline by 11.75%.

In 2022, PBZ Islamic began to enter into a new area of business that is Islamic Bond (sukuk). There was one investment of this type to the tune of TZS 500 million from a microfinance organization with tenure of one year with profit rate of 7% and expected to mature in August 2022. In this sukuk while the returns are lucrative, there could be Shariah Non-Compliance Risk, not necessary credit risk because aspects of KYC were loosely analysed. This is not the scope of this study and this aspect will not be covered in this study.

The PBZ Bank Ikhlas Quarterly Report of June 2022 explains the amount of un-invested cash (UIC) in Islamic division which can effectively be utilised for the production of revenue in various Shariah compliance investments. The Report shows that the amount of UIC cash was reduced by 11.79% which indicates a diversified approach in business financing (e.g. murabahah, istisnaa, tawarruq, salaam and sukuk of the late). Since all these financing at the end imply funding of business activities, there is a likelihood of Non-Performing Finance which is a credit risk.

In June 2022, the total financing portfolio stood at TZS 68,120 million compared to TZS 68,619 million reported in the quarter ended March, 2022 recording a decrease of 0.73% of the general financing portfolio. The decrease was contributed by written off of Non-Performing Financing during the quarter amounting TZS 2,472 million. It was observed that this act of writing off non-performing financing is mostly the result of credit risk.

The following is an analysis of the PBZ credit risk and its link with: (i) Know Your Customer (KYC) and (ii) Islamic Financial Transactions:

4.1. Know Your Customers from the point of Credit Risk

Credit risk, which is also called counter-part risk, is a situation whereby Islamic financial institution enters into an agreement with a customer and the customer fails to meet the payment obligations (Abumatar, 2024). Normally a bank should know the customer very well before entering into such agreements (this is called Know Your Customer – KYC). When a bank enters into such agreements the principle motive is to realise profits and in this regard the bank is investing (Alkhawaja and Görmüş, 2019). Under a normal situation, an investor will not surrender their money if the project or the activity is not secured since this could lead to high risk; this also applies to Islamic Financial Institutions. Save with slight discussion on anti-money laundering activities in relation to KYC, this study does not deal in detail with issues of terrorism and illegal businesses. It is the Shariah compliant businesses that are of interest since customers may have different Non-Shariah Compliant Risk motives from the beginning even when the products or activities are acceptable.

KYC does not only refer to knowledge of customers from available documents, but such information should be analysed on quality assurance perspective. It is essential to obtain information on the type of business

involved and to examine the customer’s business history, including their banking relationships. Originality of customers such as where they come from, their residence and association with politicians could also indicate their reliability in repayment and conducting proper business. Some countries or some geographical location has prevalence of risk and hence more care is needed (Indah Putri et al., 2024).

4.2. Islamic Financing Transactions Financing (Portfolio Composition and Performance)

At PBZ Bank Ikhlas Financing Portfolio in 2022 stood at TZS 68.12 billion showing a slight decrease of 0.73% in comparison to TZS 68.618 million recorded in the three months period in the same year. Cumulative total disbursement as at 30th June 2022 was TZS 14.33 billion equivalent to 100.96%, achievement of the cumulative budget of TZS 14.20 billion. The main financing transactions for the portfolio during this period are illustrated in Table 1 below.

Table 1: Disbursements under Islamic Financial Transactions

S/No.	Islamic Financial Transactions	Explanation of Disbursements
1.	Mudharabah	Individual Financing disbursement was TZS 12.34 billion compared to budgeted amount of TZS 8.37 billion as at 30 th June, 2022. This is 147.43% against the budgeted amount
2.	Musharakah	No disbursement on both Musharakah and Salaam Financing. Reasons: (a) changes in cashew nuts season. (b) Prioritisation was placed on repayment collections for Non performing agriculture financing at Mtwara PBZ Branch. Reported NPF was 2.97%.
3.	Murabahah	Murabahah Corporate Financing (MCF) registered disbursement was TZS 1.99 billion representing performance of 56.53% of the budget amount on this segment as at 30 th June, 2022 which was TZS 3.52 billion.
4.	Istisna	Istisna Financing segment recorded no new disbursement during this period. Most of commercial financing received was in the form of working capital under Murabahah Facility.

Source: Analysed from PBZ Bank Ikhlas Quarterly Report, June 2022

5. Data and Analysis of Findings

The survey is intended to supplement information from the literature. The target population is staff at PBZ Bank Ikhlas, Members of Shariah Advisory Committee and Management where questionnaires were distributed after a brief telephone contact to confirm their willingness to participate in this survey. The findings were further enriched by consultative meetings. Data was subjected to a qualitative analysis delving into non-numerical data, open-ended responses and deeper insights.

5.1. Non-Performing Finance (NPF) as an outcome of Credit Risk

Tazara Branch registered Non-Performing Finance (NPF) of TZS 419.74 million; that is 9.30% while the limit set by BOT is 5%. Table 2 provides a summary of NPF at PBZ Bank branches across the county.

Table 2: Non-Performing Finance at PBZ Bank Branches

S/No.	PBZ Branch	Non-Performing Finance in TZS
1.	Chakechake	403.71 million equal to 3.96%,
2.	Dodoma	None
3.	Lindi	Not Reported
4.	Lumbumba	29.72 million equal to 0.37%
5.	Mtwara	84.3 million (2.975)
6.	Mpirani	386.47(2.07%)
7.	Mwanawakwerekwe	678.21 million (2.98%),
8.	Tazara	419.74 million (9.30%).
9.	Wete	None

Source: Analysed from PBZ Bank Ikhlas Quarterly Report, June 2022

When staff at PBZ Bank Ikhlas were interviewed, the response was that non-performing finance (NPF) is

an outcome of non-repayment by borrowers who fail to honor their debt obligations on what has been agreed by the Bank. They also emphasize that non-performing finance represents Credit Risk at the Bank and hence reduction on profits. Higher NPF represents lower profit margin and higher Credit Risk; normally NPF of 5% or below is acceptable or palatable. From Table 2 above Tazara Branch NPF was 9.30%, almost 5 points above palatable limit or 36% above acceptable limit.

Most of the financial transactions were in the form of Mudharabah. This is a very serious occurrence and the management has to investigate causes and come with immediate mitigation measures. Although the rest of the branches recorded NPF level at acceptable limits; any unpaid funds imply a reduction of profits to shareholders. Referring to Table 2 above, the overall NPF was 2.93% for June 2022 and 5.38% for March, 2022. The performance for credit repayment for quarter ending March, 2022 was above acceptable limits but was reduced to 2.93% by June the same year.

Regardless of the level of credit risk, a persistent proportion of NPF, if left unaddressed, could undermine the reputation of a bank and ultimately lead to a loss of customers. Further inquiries at PBZ Bank found that Mudharabah has high propensity of having Credit Riks at PBZ Bank Ikhlas with NPF at 3.52% (Table 3 above).

5.2. Islamic Financial Transactions that have high possibility of Causing Credit Risk

Officers of PBZ Bank Ikhlas were asked to rate the possibility of the following Islamic Financial Transactions in causing Credit risk. The results are presented in Table 3 below.

Table 3: Islamic Financial Transactions in causing Credit risk

S/No.	Islamic Financial Transactions	Possibility Credit Risk			
		1	2	3	None
1.	Mudharabah	4	2	5	0
2.	Murabahah	1	2	7	1
3.	Ijarah	0	5	5	1
4.	Salaam	4	5	0	2
5.	Tijara	2	3	1	1
6.	Tawarruq	3	3	4	1
7.	Istisna	2	6	1	2

Total Responses: 11

The table above shows that Mudharabah was ranked top in causing Credit Risk while Salaam and Tawarruq were ranked second. 5 respondents (45%) ranked Mudharabah and Ijarah third in causing Credit Risk; six ranked Murabahah third. Four respondents (40%) did not have any opinion on Tijarah which implies that Ijarah, Tijarah and Istisna have less likelihood of causing Credit Risk. Even with these findings, the Bank ought to be careful in dealing with Muradhabah, Salaam and Tawarruq against Credit Risk.

5.3. Application of 5Cs in Screening for Know Your Customer (KYC) and the Need to Reduce Credit Risk at PBZ Bank Ikhlas

In analyzing Credit Risk, there are five important characteristics related to customers (Know You Customers) that require observation. These are: Character of the customer; Capacity to handle the loan and business; availability of Collateral; Capital adequacy and Condition. These are known as 5Cs. Each customer should be analyzed properly to reduce none compliance in loan repayment. Table 4 below represents finding with regard to 5Cs.

Table 4: Best Applied 5Cs

S/No.	5Cs	Best Applied 5Cs			
		1	2	3	None
1.	Character	8	2	0	1
2.	Capacity	6	2	2	1
3.	Collateral	6	3	1	1
4.	Capital	3	2	4	1
5.	Condition	2	4	3	1

Total Responses: 11

Responses from PBZ Bank concerning 5Cs is that, Character is the most preferred followed by Capacity and Collateral (60% of 5Cs) while Capital and Condition (40% of 5Cs) are less preferred. This indicates lack of comprehensive screening for customers and opening doors for Credit Risk due to improper handling of KYC. Four respondents (36%) regard Capital less important in causing Credit Risk; hence they give it less importance – it is surprising. In general, Character is very important in assessing KYC. Character is also linked to political affiliation and historical background which are both high risk areas. Character may be caused by country of originality which is mostly ranked cause of Credit Risk.

5.4. Shariah Governance Issues

With respect to Shariah Governance, it was reported that this has no effect on Credit Risk. What this implies is that SAC is more careful in its deliberation and advice even though it was reported by the Board members that a major role of Risk-taking lies with Board of Directors. Table 5 below illustrates the findings.

Table 5: Shariah Governing Issues

S/No.	Issues in Shariah Governance (ISG)	Applicability at PBZ Bank Ikhlas			
		1	2	3	None
1.	Independence of SAC	3	1	4	3
2.	Confidentiality	3	4	1	3
3.	Competence of SAC	4	2	1	4
4.	Consistency of decisions at SAC	4	2	0	4
5.	Disclosure	6	0	1	4

Total Responses: 11

The findings on Table 5 above reveal that five respondents (45%) regard SAC firm in disclosure while four (45%) show low level of consistency. 45% of respondents did not have any opinion on Competence of SAC, Consistency of Decisions and Disclosure in decision making. This is very strange given that 60% of respondents were PBZ Bank staff associated with Shariah compliance in difference ways. The findings could imply less knowledge on the functions of SAC or that SAC lacks required competency. Finally, the Bank should be advised to enhance regular training to its staff and members of SAC to overcome competency challenges.

6. Conclusion and Suggestions on Mitigation Measures against Credit Risk

From the above findings and analysis, it is evident that Credit Risk prevails in most of People’s Bank of Zanzibar (PBZ) bank branches. Reasons for such occurrences vary but most likely it is lack of in-depth due diligence on Know Your Customer (KYC) and regular training to both Shariah Advisory Committee (SAC) and Bank staff.

The following are suggestions to reduce Credit Risk at PBZ Bank Ikhlas. These findings could help in understanding the challenges and hence move forward with a broader research in the area of Risk Assessment and Mitigation. The succeeding recommendations were derived from the above analysis of findings and respondents’ views. One of the most important suggestions to the Bank is to introduce Credit Rating. As this could be a challenging task, outsourcing is advised.

Unlike conventional banks which have long experience in networking, PBZ Islamic has not fully opened up its relations with organisations such as Islamic Finance Standards Board (IFSB) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). PBZ Ikhlas’s participation in annual IFS activities is very low. Hence, it is recommended for PBZ Bank to strengthen collaboration with International Islamic Banks in order to benefit from their experience and expertise. Thus, the Management should enhance the Bank’s participation in international forums as a way of revamping human capacity and learning from experience of others. This could also be part of continuous training for staff, management, Board and SAC members. As there is very limited scope for Islamic products in the country, exposure to international forums will enhance Bank staff competency to expand or diversified marketing approach and creation of more customer-oriented products. Thus, PBZ should create a vibrant market initiative through regular learning and interactions that will enhance business but will also reduce redundant finance.

While dynamic marketing approach could expand business, the need to enhance staff as well as community training on aspects of Islamic Banking and Finance is essential. It should not be taken for granted that banking functions and technicalities are similar all around; Islamic Banking business is generally new and

there is low level of understanding by staff, community as well as Muslim Jurisprudents. Furthermore, there should be stakeholders' engagement and transparency about Bank services and conditionality. The areas that are mostly misunderstood are Islamic Contracts and Islamic Financial Transactions.

The other area in "Knowing Your Customer", is 'due diligence' and has to be taken more seriously. The 5Cs (Character, Capacity, Collateral, Capital and Conditions) should be considered as requirements and should be made a priority in appraising customers (KYC). It is advised to consider Customer background while assessing Character to limit risk. The Bank should avoid applying 'one size fits all' approach since each individual may require different set of conditions.

'Risk-based pricing' and 'Risk-based sharing' are important considerations in mitigation against Credit Risk. In addition, there should be proper credit analysis and close customer follow up to control Credit Risk. Hence, the Bank staff need to be continuously trained and updated on different Risks areas. For both new customers and current customers, an analysis of relevant income statements and calculated debt-income ratio is necessary. This will add efforts in due diligence and KYC. Finally, customer documentation is among the priority areas.

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