

CREDIT RISK MANAGEMENT PRACTICES AND ASSET QUALITY OF DEPOSIT TAKING MICROFINANCE INSTITUTIONS IN KENYA

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ABSTRACT

Deposit Taking Microfinance Institutions in Kenya faces insistent challenges in realizing sound asset quality, with non-performing loans eroding institutional stability and threatening long-run viability. This research determined the effect of credit risk management practices on the asset quality of Kenyan Deposit Taking Microfinance Institutions, concentrating on credit risk identification, credit risk assessment, credit risk monitoring, and credit risk control practices. The research was done on the period between 2019 and 2024 and underpinned on the Asymmetric Information Theory, Credit Rationing Theory, Modern Portfolio Theory, and Agency Theory. A descriptive research method was employed, targeting operations managers, credit managers, and risk managers drawn from all thirteen licensed DTMFIs in Kenya. The research employed both primary and secondary data. Primary data was acquired through structured questionnaires whilst secondary data gathered utilizing data gathering sheets. Diagnostic tests including Normality Test and Multicollinearity Test were done to ensure robustness of the regression model. Data were analysed utilizing SPSS, for both descriptive and inferential statistics. Descriptive statistics adopted frequencies, means, and standard deviations, whereas inferential analysis included Pearson's correlation and panel regression techniques. The regression analysis indicated that credit risk identification, credit risk assessment,

and credit risk monitoring had statistically positive significant effect on asset quality, concluding that structured screening, rigorous assessment, and continuous monitoring enhance portfolio stability and reduce non-performing loans. Similarly, credit risk control practices had an adverse significant effect on asset quality. The research concluded that effective credit risk identification, assessment, and monitoring practices were core in sustainment of asset quality in Deposit Taking Microfinance Institutions, whereas extreme dependence on rigid control mechanisms undermined Deposit Taking Microfinance Institutions success. The research recommended that Deposit Taking Microfinance Institutions should embrace proactive and technology-driven risk identification and monitoring tools, strengthening borrower appraisal frameworks, and complement enforcement with adaptive strategies such as flexible loan repayment arrangements and financial literacy initiatives. Regulators should also improve supervisory monitoring and promote the integration of predictive analytics to ensure financial stability in the sector. The research adhered to all ethical deliberations by obtaining research license and respondent consents.

Key words: Asset Quality, Credit Risk Assessment, Credit Risk Control, Credit risk Identification, Credit Risk Monitoring.

INTRODUCTION

Credit risk management is also essential to DTMFIs because it directly influences the quality of their asset, their profit, and the overall effectiveness of the institution. A proper credit risk management system makes sure that the regulations are followed and increases investor trust, besides helping to minimize financial losses (European Banking Authority, 2021). By introducing the credit risk management methods, institutions can maintain their capital and manage economic shocks, as well as increase the loan recovery rates. The CBK emphasizes that the poor management of the credit risk contributes to the financial problems, liquidity problems, and higher rates of the loan write-offs, which is damaging to the financial system stability (CBK, 2023). In this way, risk management plans that are well implemented are essential to financial sustainability.

The most important tenets of credit risk management strategies are credit risk identification processes, credit risk assessment procedures, credit risk monitoring practices, and credit risk control practices. According to such regulatory initiatives as the Basel Accords and CBK (Basel Committee on Banking Supervision, 2019; CBK, 2016), these strategies are indispensable in decreasing credit risk and maintaining the quality of assets. The credit risk identification involves classifying the potential risks before lending decisions are made and the assessment systems are focused on determining the likelihood of default. Risk control methods are used to reduce possible losses whereas monitoring methods make sure that the performance of loans is constantly being controlled. These are the key ideas in credit risks management and help in enhancing the financial stability of DTMFIs.

Maintaining good asset quality is quite important since DTMFIs directly influence their sustainability and profitability. High NPL levels might lead to loan loss clauses, therefore reducing the institution's income and maybe generating financial instability (Kamau & Waweru, 2022). Many studies have found out that DTMFIs with a high NPL ratio seemingly suffers very poor financial performance due to low investor confidence and liquidity difficulties (Kariuki, 2021). The quality of assets management is good and efficient implies that DTMFIs still provides financial services to low-income and rural communities, thereupon motivating financial inclusiveness and economic growth (Mugenda et al 2020). Additionally, the adequate credit risk management approaches are detailed appraisals of borrowers and regular monitoring of loans, therefore, improving the financial performance and quality of assets (Nyamu et al, 2019).

Trends suggested that the quality of assets of Kenyan DTMFI has been reducing alarmingly. The NPLs/gross loans ratio increased to 11.9% compared to the 6.3% that indicates an alarming deterioration in asset quality (CBK, 2023). Growing loan loss provisions rising from this upward trend have additionally taxed MFIs financial success between 2018 and 2022 (MFI Report, 2022). Numerous researches have been conducted on economic downturns, insufficient borrower repayment capacity, and poor risk management techniques to an increased NPLs (Mutua & Mwangi, 2021). The long-term viability of DTMFIs is at risk as a result of the impact of decline in asset quality on financial success metrics such as ROE and ROA (Kilonzo &

Wanjohi, 2023). Financial institutions need to advance data-driven lending models, credit surveillance tools, and credit risk assessment systems so as to effectively handle this issue (Kariuki & Maina, 2020).

Extensive researches have been done on the connection between asset quality and financial success, with researches recurrently demonstrating an adverse link between higher NPLs and profitability (Wanjiri & Kamau, 2022). Financial institutions have been experiencing lower returns due to asset quality deteriorations as a result of higher provisioning expenses and rising credit risk (Muturi & Kimani, 2021). However, SACCOs effectively managing their loan portfolios through stringent borrower screening and risk-reduction strategies typically maintain higher profitability (Njuguna & Kibet, 2020). Consequently, high asset quality does not only improve institutional stability, but also boosts investor confidence and regulatory compliance (Otieno & Mwenda, 2021). To have financial performance, DTMFIs have to establish new credit management practices, they have to apply technology to assess credit risk, and they have to align their lending policies to macroeconomic changes (Ng'ang'a & Waweru, 2023).

Table 1 Asset Quality

VARIABLE	2015	2016	2017	2018	2019	2020	2021	2022	Annual Change(%)
Total Assets (KSh Mn)	69,465	72,510	67,597	70,754	76,353	74,879	73,964	70,427	-4.78
Net Advances/Loans (KSh Mn)	45,749	47,047	42,847	44,179	46,651	44,179	40,115	39,334	-1.95
Gross NPLs (KSh mn)	4,264	7,288	9,300	9,891	9,817	12,980	12,895	12,502	-3.05
Total Deposits (KSh Mn)	40,589	40,198	38,916	40,961	43,941	49,356	50,413	46,492	-7.78
Borrowings (KSh Mn)	13,220	16,435	13,413	14,607	14,934	11,340	9,082	9,328	2.71
Capital & Shareholders Funds (KSh Mn)	11,633	11,622	11,301	10,443	11,177	8,113	9,235	8,752	-5.23
Profits Before Tax (KSh Mn)	592	-377.0	-622.0	-1437.0	-339.0	-2240.0	(722)	(980)	35.77
ROAs (percent)	1.0	-0.5	-0.9	-5.5	-0.4	-3.8	-0.96	-1.39	-0.43*
ROEs (percent)	5.0	-3.2	-5.5	-13.8	-3.0	-36.3	-7.75	-11.20	-3.45*

Source: CBK

This increases in the NPL rates indicating that the financial stability of DTMFIs is being threatened seriously by the declining quality of their assets in Kenya. The gross NPLs have increased since 2015 to Ksh. 12,502 million in 2022, which is a sign of the growing credit risk problem. Quality of assets, which is one of the main financial health indicators, has dropped drastically (CBK, 2023). Weak quality of assets forces banks to charge extra provisions against loan losses, thus reducing the capital to be used in lending and cost of operation (IMF, 2022). The fact that the net advances and loans declined because of the 2015 figure of Ksh. 45,749 million, to 2022 figure of Ksh. 39,334 million, indicates that the bad loan burden is causing institutions to be risk averse or the liquidity constraint is imposed (World Bank, 2023). This reduction in lending reduces access to finance and economic development because MFIs play such an important role in funding low income borrowers and SMEs. Weakening of the financial performance of DTMFI is also supported in the negative impacts of inadequate system of asset assessment, strict loan monitoring policies, and increased risk management requirements. It has significant effect of deteriorating asset quality on financial sustainability as EBIT dropped to Ksh. 592 million in 2015 to Ksh. 980 million loss in 2022 (CBK, 2023). The ROA and ROE have been undesirable, reaching -1.39% and -11.20%, respectively, in 2022, hence signifying

substantial value loss (AfDB, 2023). As asset quality declines, financial institutions are being forced to increase interest rates or tighten lending standards so as to reduce more risks, consequently aggravating financial exclusion for borrowers with restricted credit access (IMF, 2022). DTMFIs have to tighten their credit techniques to reverse this trend and guarantee long-run financial viability by doing so improving asset quality (World Bank, 2023).

The financial position of the DTMFIs in Kenya has worsened mainly because of reduced quality of the assets and increase in the NPLs. Gross NPLs highly affected profitability as they went up to Ksh. 4, 264 million to Ksh. 12, 502 million in 2015 and 2022 respectively (CBK, 2023). Consequently, ROE was down to -11.20% in 2022 and ROA was down 1.0% in 2015 and -1.39% in 2022, which is a sign of a terrible financial crisis (AfDB, 2023). High loan loss clauses have also negatively impacted the capacity of DTMFIs to expand credit, and thus, net advances have fallen between Ksh. 45,749 million in 2015 and Ksh. 39,334 million in 2022 (World Bank, 2023). Such trends prove that DTMFIs have to improve credit risk management by employing better methods of assessing borrowers, proper monitoring of loan repayment and diversification of the sources of funding to ensure long-term sustainability.

Statement of the Problem

Deposit-taking microfinance institutions (DTMFIs) are important to Kenya's financial system in promoting financial inclusion and supporting SMEs, which are the core drivers of economic growth (World Bank, 2020). The microfinance sector helps Kenya's GDP by making it easier for people to get loans, saving money, and starting businesses, especially in low-income areas (IMF, 2021). DTMFIs are an important part of the financial system because they help connect poor people with official banks, which helps people become more financially free and less poor (CBK, 2022). Still, these groups need to maintain their financial health in order to stay effective. This means having good asset quality, smart risk management, and following the regulations ([KNBS, 2023).

Although DTMFIs play an economic role in Kenya, the quality of their assets continues to be a challenge to their sustainability and overall performance. The remarkably high NPLs have remained in the financial stability and profitability (CBK, 2023). CBK statistics indicate that gross NPLs increased significantly between KSh. 9.8 billion in 2018 and KSh. 12.5 billion in 2022, and therefore emphasize the diminishing credit risk management (CBK, 2023). This is further worsened by the fact that the asset base continued to shrink in 2022 with the total assets declining by 4.8 to KSh 70.4 billion; this is mainly due to the reduction of gross loans and advances by 3.1% (KNBS, 2023). Additionally, key profitability indicators have deteriorated, with ROA declining from -0.96% in 2021 to -1.39% in 2022 and ROE falling from -7.75% to -11.2% over the same period (IMF, 2023). These financial weaknesses highlight the urgent need for; strengthened risk mitigation strategies to safeguard the sector's long-term viability. Wambua (2020) researched the effect of credit risk identification on DTMFIs in Kenya, a conceptual gap is identified; as the study only focused on risk identification ignoring other aspects of credit risk management also a methodological gap is identified whereby the study only relied on secondary data.

Wanjiru (2021) researched the influence of credit risk assessment methodologies on asset quality in Nairobi County DTMFIs, a geographical gap is identified; as the research was confined only to Nairobi City County only. Njeri (2020) in her study to investigate the rule of credit risk monitoring frameworks in improving asset quality among Kenyan DTMFIs a conceptual gap is identified; whereby the research was only restricted to a few microfinance banks. This research utilized questionnaires to provide primary insights and also the study expanded to a national level for broader insights.

Objectives of the study

The research was guided by the subsequent objectives:

General Objective

The general objective was to determine the effect of Credit Risk Management Practices on Asset Quality of deposit-taking microfinance institutions in Kenya.

Specific objectives

The research specific objectives were to:

- i. Assess the influence of credit risk identification practices on asset quality of DTMFIs in Kenya.
- ii. Analyse the effect of credit risk assessment practices on asset quality of DTMFIs, in Kenya.
- iii. Ascertain the effects of credit risk monitoring practices on asset quality of DTMFIs in Kenya.
- iv. Examine the effect of risk control practices in enhancing the asset quality of DTMFIs, in Kenya.

Research Hypotheses

The research tested the following hypothesis:

- i. **H₀₁**: Credit risk identification has no statistically significant effect on asset quality of DTMFIs in Kenya.
- ii. **H₀₂**: A Credit risk assessment practice has no statistically significant effect on asset quality of DTMFIs in Kenya.
- iii. **H₀₃**: Credit risk monitoring practices has insignificant effect on asset quality of DTMFIs in Kenya.
- iv. **H₀₄**: Risk control practices have no statistically significant effect on asset quality of DTMFIs in Kenya.

Theoretical Framework

Asymmetric Information Theory

The Asymmetric Information Theory was proposed by George Akerlof in 1970 in his work, The Market for "Lemons": Quality Uncertainty and the Market Mechanism. The theory explains how information imbalances between parties in a transaction resulted to adverse selection and market inefficiencies. Akerlof illustrated this using the used car market, where sellers have more information about the quality of their cars than buyers. This lack of

transparency in these institutions leads to market failures, as buyers assume all cars are of lower quality and adjust their willingness to pay, discouraging sellers of high-quality cars from participating. The theory is typically relevant to the financial industry, especially in credit markets where borrowers know more about their creditworthiness than lenders, and transcends the automotive market.

The theory had a direct impact on the asset quality and credit risk management policies of MFIs. The vulnerability of loan default of DTMFIs was that the borrowers usually had a clear understanding of their financial positions than their lenders. These challenges and reduced quality of assets were increased by ineffective credit monitoring and screening. Borrower surveillance, credit information disclosure, and credit evaluation models are some of the best risk management methods that helped DTMFIs to minimize ethical risks and adverse selection, thus enhancing the performance of the loan portfolio and their long-term viability. This ensured constant financial stability and sustainability of the DTMFIs thus providing finances to unprivileged individuals and MSEs, whereas promoting economic growth.

Credit Rationing Theory (CRT)

Joseph Stiglitz and Andrew Weiss hypothesized this theory in 1981 in their initial research “Credit Rationing in Markets with Imperfect Information”. The theory stated that lenders cannot accurately distinguish between low-risk and high-risk borrowers as a result of asymmetric information, which results to credit rationing in financial markets. Lenders may choose to reduce the credit extended to some borrowers or purely decline to grant them loans rather than change interest rates to balance risk. Higher interest rates may either cause borrowers to undertake too much ethical risk or promote more risky borrowers (adverse selection), which rises default rates and worsen asset quality.

Credit Rationing Theory (CRT) is directly applicable to credit risk management techniques and asset quality in Deposit- Taking Microfinance organizations (DTMFIs). High Non-Performing Loan (NPL) levels jeopardize financial sustainability so, microfinance organizations have to carefully screen borrowers and restrict loan allocation to reduce default risks. Credit rationing guarantees that only creditworthy applicants get money, therefore helping to preserve the quality of lending portfolios. Deposit-taking microfinance institutions (DTMFIs) can improve their financial stability by using efficient risk assessment models, lending rules and loan monitoring systems, therefore supporting financial inclusion and economic development even as they support financial stability.

Modern Portfolio Theory (MPT)

Harry Markowitz first put out the Modern Portfolio Theory (MPT) in 1952 in his work Portfolio Selection. The theory transformed financial decision-making through the diversification idea to maximize risk and return. Markowitz maintained that the performance of a whole portfolio should be the main emphasis of investors rather than the individual asset returns. By balancing assets with different risk-return profiles, investors can optimize returns while reducing the overall risk of their portfolio. This concept, referred to as the efficient frontier, assists investors in selecting portfolios with the highest expected return under a specific level of risk.

The theory was relevant in the handling of credit risk and the quality of asset in Kenyan DTMFIs. DTMFIs need to become more careful when lending out varied groups of borrowers to avoid any too many loans in a single geographical location resulting in greater default on loans. The DTMFIs may stabilize their resources through adopting diversification, stress testing, and sectoral risk testing. This will enable them achieve their loan portfolios as lucrative and sustainable.

Agency Theory

The agency theory was hypothesized by Jensen and Meckling in 1976 in their initial study, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure". The theory defined the principal-agent affiliation, whereby one party, the principal, delegates responsibilities to the other, the agent, who is expected to act in the principal's best interest. However, conflicts of interest and information asymmetry may cause agents to put their own goals ahead of the principal's, which creates agency costs. This theory was majorly adopted in financial sector in establishing managerial decision-making, risk-taking behavior, and financial success.

The Agency Theory is inherently linked to the credit risk management and assets quality in DTMFIs. Since interests of the institution may not always take precedence over those of the borrowers and the managers, effective governance, assessment of borrowers, and mitigation of risks are the key to prevent loan defaults and financial losses. DTMFIs are able to; improve the management of credit risks, minimize NPLs, and protect their financial condition by aligning the managerial incentives with the goals of asset quality management.

Empirical Review

Wambua (2020) researched the impact of the credit risk identification on the quality of assets of DTMFIs in Kenya. By applying descriptive survey design, the study collected source data of credit managers at the selected microfinance institutions. The results showed that poor practices in risk identification caused the increase of non-performing loan (NPL) ratios, diminishing the quality of the asset. Nevertheless, the study had conceptual weaknesses, in that it only identified the risk and ignored the other elements of management of credit risks. The literature based research methodology relied on the secondary data, whereas the present study relied on questionnaires to collect primary information on industry practitioners.

Kamau (2023) examined the efficiency of the methods of credit assessment to the borrowers to reduce asset impairment in the MFIs in Kenya. The research utilized a mixed-method approach in order to get the information of credit risk managers and evaluated the financial success of the sampled commercial banks. The findings of the research indicated that high credit risk evaluation, like debt-to-income analysis, CRB reports, and the study on the borrower history, contributed to the increase in the quality of the assets. However, the study did not examine how exogenous economic variables like inflation and changes in the interest rates impacted the quality of the assets. The gap was filled in the current research given that external economic elements were included in the assessment of credit risk management strategies.

Kariuki (2022) examined the effectiveness of credit risk monitoring systems in avoiding deterioration on the assets in Kenyan MFIs. The information provided by risk analysts was collected through a mixed approach and the company financial records of institutions. The findings revealed that default rates decreased because of frequent examination of financial stability of borrowers and patterns of loan repayments. However, the study did not put into consideration external economic factors since variation in the interest rates on quality of assets and inflation would have an impact on the research. The research under consideration avoided this limitation by introducing macroeconomic factors into the analysis of the methods of credit risk monitoring.

Mutua (2022) studied the effect of credit risk control systems on asset quality Kenyan DTMFIs. The research adopted experimental technique to assess numerous loan approval systems, debt restructuring methods, and risk-based lending criteria in selected banks. These research findings found that financial institutions with regular credit risk control strategies adjustment in accordance with market environments had lower NPL levels. Nonetheless, the research was confined to a small number of urban-based MFIs, thereby creating a contextual gap. The current research tackled this gap by intensifying the sample to have both urban and rural DTMFIs for a more representative analysis.

RESEARCH METHODOLOGY

A descriptive research design was selected in this research as it gives an opportunity to investigate the phenomenon as it is but also determine the relations between the variables. The subsequent multiple regression model was utilized for the research analysis;

$$Y_{it} = \beta_0 + \beta_1 CRI_{it} + \beta_2 CRA_{it} + \beta_3 CRM_{it} + \beta_4 CRC_{it} + \varepsilon_{it}$$

Where:

Y=Asset quality

B0=Constant

CRI=Credit risk Identification Practices

CRA=Credit risk assessment Practices

CRM= Credit Risk Monitoring Practices

CRC=Credit Risk Control Practices

E=Error term

β_1 - β_4 =Regression Coefficients

This study targeted 14 deposit-taking DTMFIs in Kenya. The unit of observation was the DTMFIs, while the units of analysis included Operations Managers, Credit Managers, and Risk Management Officers from each institution (Blumberg, Cooper, & Schindler, 2023). The census method was adopted as the primary data collection approach.

The research adopted a systematic analysis by utilizing of both primary and secondary data. The research embraced a standardized questionnaire with a set of questions to gather data from participants. Closed-and open-ended questions were also employed in gathering of standardized data that aligned with the research objectives.

Normality Test

Jarque Berra test was employed. It is founded on the skewness and kurtosis of converted multivariate data on the assurance of independence. Table 1 was used to show the normality tests.

Table 1 Shapiro-Wilk Test for Normality

Variable	Statistic	df	Sig.
Credit Risk Identification	0.972	33	0.421
Credit Risk Assessment	0.968	33	0.353
Credit Risk Monitoring	0.975	33	0.498
Credit Risk Control	0.964	33	0.297

Research Data (2025)

As it can be inferred in Table 1 above, all research variables p-values are larger than 0.05. By the decision rule, a p-value of greater than 0.05 implies that there is no need to reject the null hypothesis of normality and the variable is said to be normally distributed. These findings validate that the data are normally distributed thus confirming the validity of regression conclusions.

Multicollinearity Test

In the current research both VIF and tolerance was computed in the independent variables.

Table 2 Variance Inflation Factors and Tolerance Values

Variable	Tolerance	VIF
Credit Risk Identification	0.721	1.386
Credit Risk Assessment	0.684	1.462
Credit Risk Monitoring	0.745	1.342
Credit Risk Control	0.692	1.445

Research Data (2025)

Table 2 above indicates that, the entire tolerance values are above 0.2 and all the VIFs are less than 5. This proves that the independent variables were not multicollinear. As the results verify, each of the variables has distinct explanatory power that does not over-correlate with the regression model. This observation is in line with that of Cuthbertson (2010), which observed multicollinearity to appear frequently in high R-squared values and trivial predictors, which is not the case here.

Regression Analysis

Table 3, 4 and 5 show the model fitness, ANOVA and regression coefficient test results.

Table 3 Fitness of the Model

Model	R	R ²	Adjusted R ²	Std. Error of the Estimate
1	0.841	0.707	0.689	0.2634

Research Data (2025)

According to Table 3, the model recorded an R² of 0.707 implying that the four credit risk management practices accounted 70.7 percent of the variance in asset quality. The adjusted R² of 0.689 is also another evidence of the model being robust in the consideration of the number

of predictors. The correlation coefficient ($R = 0.841$) is indicative that the predictors and asset quality have a high level of association. The Standard error (0.2634) is relatively small indicating that the predictive accuracy of the model was good and it can be considered as a reliable basis for analysis.

Table 4 ANOVA

	Sum of Squares	Df	Mean Square	F	Sig.
Regression	41.892	4	10.473	151.327	0.000
Residual	17.356	250	0.069		
Total	59.248	254			

Source: Research Data (2025)

Table 4 indicates the ANOVA findings that verify the fact that the regression model is significant ($F = 151.327$, $p < 0.01$). This means that there is a significant impact of the independent variables (credit risk identification, credit risk assessment, credit risk monitoring, and credit risk control practices) on asset quality. The regression sum of squares (41.892) is significantly higher than the residual sum (17.356) so the model accounts most of the difference in the dependent variable.

Table 5 Regression Results (Dependent variable: Asset Quality)

Variable	Coefficient	Std. Error	t-Statistic	Sig.
Constant	0.512	0.144	3.556	0.001
Credit Risk Identification	0.284	0.072	3.944	0.000
Credit Risk Assessment	0.316	0.079	4.000	0.000
Credit Risk Monitoring	0.227	0.068	3.338	0.001
Credit Risk Control	-0.193	0.061	-3.164	0.002

Source: Research Data (2025)

Table 5 indicates that credit risk identification and assessment as well as monitoring are positively and significantly impacting asset quality whereas credit risk control is found to affect the quality of assets negatively, albeit, significantly. The constant term (0.512) is also statistically significant, showing the baseline level of asset quality when the predictors are held constant. The regression equation generated from these coefficients is as follows:

$$\text{Asset Quality} = 0.512 + 0.284(\text{CRI}) + 0.316(\text{CRA}) + 0.227(\text{CRM}) - 0.193(\text{CRC}) + \varepsilon$$

Where:

CRI	=	Credit Risk Identification
CRA	=	Credit Risk Assessment
CRM	=	Credit Risk Monitoring
CRC	=	Credit Risk Control

ε = Error term

This equation affirms that credit risk identification, credit risk assessment and monitoring practices are having a positive impact on asset quality, whereas excessive dependence on credit

risk control practices is related to less asset quality. Equilibrium of these practices then defines overall stability of DTMFIs.

Conclusions

The first goal determined how practices of credit risk identification affected the quality of assets. The results of the research showed an outstanding positive effect which indicated that those institutions that invested in market risk detection, operational risk evaluation, and systematic screening of borrowers had better performances in the asset. This reflected the fact that detection of risk early reduced the NPL rates and enhanced financial stability.

The second goal focused on the practice of credit risk assessment. The study findings revealed a high positive relationship, which means that repayment outcomes were significantly improved with the help of data-driven assessments, risk profiling, and systematic appraisals. Effective evaluation systems also helped these banks to provide loans more proportionate to the borrowing capacity of the borrowers hence reducing the rate of default and enhancing the quality of overall assets.

The third objective studied the impact of credit risk monitoring activities on the quality of assets. These findings of the research revealed an impressive positive effect, which argued that the use of early-warning tools, borrower follow-ups, and round-the-clock surveillance was associated with reduced loan impairments. The results depicted how aggressive monitoring allowed financial institutions to deal with risks before they escalate into greater proportions which would encourage sustainability of the asset base in the long term.

The fourth goal determined the impact of credit risk control practices on the quality of assets. Although serious enforcement and recovery mechanisms were widely used, the study findings indicated a significant negative impact, which indicated that they were often reactive and not proactive measures to impaired loans taken in the past. Unnecessarily strict controls harmed the relationships of borrowers and did not make the portfolio any healthier. These studies have underscored the necessity of DTMFIs to ensure good quality of assets in the long run through the implementation of a combination of enforcement and preventive and adaptive measures.

Policy Implications and Recommendations of the Study

The conclusions of the research play a significant role in the regulation and practice of microfinance industry. There is a need to embrace the practice of financial risk identification whereby DTMIs should embrace the early screening processes, operational risk identification, and market risk identification due to the positive and impressive influence of credit risk identification practices. Guidelines that guide rigorous risk identification models should be prioritized by the policymakers such as the CMA and the CBK. The institutional stability can be ensured by mitigating adverse selection by integrating credit reference bureau data and investing in the borrower information systems.

The research also found that the quality of the assets could be influenced by the credit risk assessment procedures with a strong emphasis on financial risk assessment and borrower

appraisal. Regulators need to advocate the use of all MFIs to the use of standardized credit scoring models and stress testing instruments. Capacity building can also be encouraged so that the staff have the technical expertise to conduct comprehensive credit appraisals. In a policy standpoint, these measures will not only warn institutions against rising default rates but will also promote financial inclusion since they will ensure responsible lending.

Additionally, the study found out that credit risk monitoring enhanced the quality of the assets and this emphasized the need to observe them regularly and take preventive measures. DTMFIs ought to invest in digital monitoring systems that have the ability to give early warning in the occurrence of probable defaults in real time. CBK can provide this at the regulating level, by enforcing regular reporting on the performance of the loans and mandating periodic portfolio stress tests. It is a great challenge to academic scholars and researchers to design context-specific monitoring models which are flexible to the realities of the microfinance business in Kenya.

It is interesting that the study found that asset quality deteriorated under the functions of credit risk control processes, but they were significant in statistical terms. According to this research result, overly strict enforcement measures such as aggressive collateral recovery or strict enforcement of repayment can in effect cause deterioration of the stability of the portfolio. Therefore, policymakers must reject simply reactive measures and promote the adoption of borrower-focused policies, such as the flexibility of the repayment plan, the possibility of restructuring, and financial literacy programs. This shows that it is important that microfinance managers balance the preventive and corrective actions.

In conclusion, the study recommends that DTMFIs adopt a holistic and balanced credit risk management model combining robust identification, intensive evaluation and proactive surveillance and responsive and supportive controls. The policymakers, regulators, and practitioners ought to collaborate to create systems that enhance financial stability and yet cushion borrowers. These actions may help in ensuring overall stability of the microfinance industry and promote it to foster inclusive economic growth in Kenya.

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