

# Risk Management Practices and Financial Performance of Licenced Microfinance Nstitutions in Kenya

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**Abstract:** The aim of this study was to investigate the influence of credit risk management practices on financial performance of MFIs in Kenya. The target population was 136 senior and middle level management staff of 14 registered MFIs in Kenya; from where Yamame's sampling formula was applied to get a sample size of 126 respondents who were selected using simple random sampling. Data was collected using structured questionnaires and computed using SPSS; where descriptive and inferential statistics were generated. A total of 112 out of 126 respondents completely filled online questionnaires depicting a response rate of 88.9% which is good for generalizability of research findings to a wider population. The study concluded that credit risk management practices significantly influence the financial performance of Microfinance in Kenya. The study recommended that managers of MFIs Organizations should provide regular training for credit officers and financial managers to improve their competency in identifying, assessing, and mitigating credit risks.

**Key Words:** Risk Management, Licensed Microfinance Institutions, Financial Performance, Resource Based View

## I. Introduction

### 1.1 Background of the Study

Financial performance of MFIs as measured by profitability has attracted many investors and borrowers alike (Parvin et al., 2020). Therefore, efforts by the MFIs management to improve financial performance must be matched with adoption of financial management practices that provide MFIs with competitive advantage over their rivals. One cannot claim autonomy over the list of financial management practices since they are diverse (Navin & Sinha, 2021). Credit risk is the most expensive risk in financial institutions and its effect is more significant as compared to other risk as it directly threatens the solvency of financial institutions. The magnitude and level of loss caused by the credit risk as compared to other kind of risks is severe to cause high level of loan losses and even institutional failure (Boateng & Dean, 2020). Risk management is a process of thinking systematically about all possible risks, problems or disasters before they happen and setting up procedures that will avoid the risk, or minimize its impact, or cope with its impact. It is basically setting up a process where you can identify the risk and set up a strategy to control or deal with it (Noor, 2019)

Risk management (CRM) is increasingly recognized as a critical component in the financial performance of microfinance institutions (MFIs) globally (Omowole et al., 2024). In an era where financial institutions face a multitude of risks ranging from credit, market, operational, to liquidity risks adopting effective CRM practices has become essential to ensure their sustainability and growth. The relevance of CRM practices in MFIs is particularly pronounced in developing regions, where financial markets are often volatile and regulatory frameworks are still evolving.

In Asia, countries like India and Bangladesh have demonstrated significant strides in integrating CRM into the operations of MFIs. In India, MFIs have adopted CRM strategies that include credit risk management and diversification of loan portfolios to mitigate potential financial losses (Alabdullah et al., 2022). Similarly, in Bangladesh, the birthplace of modern microfinance, institutions like Grameen Bank have implemented robust CRM frameworks that emphasize client screening and monitoring, contributing to their financial sustainability (Bhat et al., 2020).

In contrast, in Latin America, countries like Brazil and Mexico have taken a different approach. Brazilian MFIs focus heavily on market risk management, given the country's economic volatility. The adoption of CRM practices, such as interest rate hedging and foreign exchange risk management, has played a crucial role in stabilizing the financial performance of these institutions (González et al., 2019). In Mexico, MFIs have incorporated CRM practices into their financial management systems to reduce operational risks, particularly in rural areas where financial literacy remains low (Moser et al., 2015).

In Africa, the role of CRM in MFIs has also gained prominence. In South Africa, MFIs operate in a highly competitive and regulated environment. The adoption of CRM practices in South African MFIs has been focused on credit and operational risk management, with institutions implementing sophisticated credit scoring models and risk assessment tools. These practices have not only improved the financial performance of South African MFIs but have also contributed to greater financial inclusion by making credit more accessible to underserved populations (Mushonga, 2018).

Similarly, in West Africa, countries like Ghana and Nigeria have made strides in integrating CRM into their financial systems. In Ghana, CRM practices that emphasize credit risk assessment have been crucial in maintaining the resilience of MFIs during economic downturns (Okyere, 2021). In Nigeria, technology-driven CRM strategies have been adopted to mitigate operational risks, which has been vital for the stability and growth of MFIs in the region (Rabiu, 2023).

In East Africa, Uganda and Rwanda have also made strides in CRM practices within their MFIs. In Uganda, MFIs have increasingly adopted CRM strategies that prioritize credit risk management and regulatory compliance, which have been instrumental in maintaining their financial stability despite the challenges posed by economic and political uncertainties (Kadima, 2023). Rwanda, on the other hand, has focused on integrating CRM into the overall governance of MFIs, emphasizing risk management in strategic planning and decision-making processes (Ngabonziza & Mugiraneza, 2022). These practices have not only enhanced the financial performance of Rwandan MFIs but also increased their credibility and trustworthiness among stakeholders.

In Tanzania, the application of CRM practices has become increasingly important as MFIs face challenges such as credit and liquidity risks. Tanzanian MFIs have adopted client risk assessment models and portfolio diversification strategies as part of their CRM efforts, which have been pivotal in enhancing their financial resilience. The focus on managing these specific risks has enabled Tanzanian MFIs to improve their financial performance and sustain their operations amidst economic fluctuations (Ngowi & Nkwabi, 2020).

In Kenya, CRM practices have gained significant attention due to their impact on the financial performance of MFIs. A study by Omondi and Muturi (2020) highlighted that MFIs in Kenya that have implemented comprehensive CRM frameworks, especially those focusing on credit and operational risks, have experienced improved financial outcomes. The integration of digital platforms for risk management has further enhanced these institutions' ability to manage risks effectively, contributing to their overall financial sustainability.

Furthermore, a study by Karanja and Ndirangu (2021) emphasized the role of operational risk management in improving the financial performance of Kenyan MFIs. Their findings revealed that MFIs that adopted robust operational risk management practices, such as internal controls and risk assessment protocols, were better positioned to navigate financial challenges and maintain profitability.

Additional research by Wambua and Muriuki (2020) explored the relationship between market risk management and financial performance in Kenyan MFIs. Their study found that MFIs that actively managed market risks through diversification strategies and market analysis tools achieved greater financial stability and growth.

Similarly, Kamau and Ochieng (2019) examined the impact of liquidity risk management on the financial performance of Kenyan MFIs. Their research demonstrated that MFIs with effective liquidity risk management strategies, including maintaining adequate cash reserves and diversifying funding sources, were more resilient during economic downturns and exhibited stronger financial performance.

Lastly, a study by Mwangi and Wanjiru (2021) on the governance and risk management practices in Kenyan MFIs highlighted that institutions with strong governance structures that integrate risk management at the board level are more likely to achieve sustainable financial performance. Their research underscored the importance of aligning risk management with overall corporate governance to ensure long-term financial viability.

These studies collectively underscore the critical role of CRM practices in enhancing the financial performance of MFIs in Kenya. By adopting comprehensive risk management strategies that address credit, operational, market, and liquidity risks, Kenyan MFIs have improved their financial stability and sustainability in a dynamic economic environment.

## **1.2 Statement of the problem**

Despite the critical role microfinance institutions (MFIs) play in promoting financial inclusion and economic development, especially in rural areas, their sustainability and financial performance remain a significant concern in Kenya. The region, which is characterized by a high concentration of MFIs, faces unique challenges that hinder the effectiveness of these institutions. One of the most pressing issues is the inadequate implementation of corporate risk management (CRM) practices, which directly impacts the financial stability of MFIs (Omondi & Muturi, 2020).

Research has shown that many MFIs in Kenya struggle with high levels of credit risk, stemming from the inability to effectively assess and manage borrower risk profiles. This has led to increased loan defaults, which in turn erode the financial base of these institutions (Karanja & Ndirangu, 2021). Despite the existence of CRM frameworks, the application of these practices in Busia County is often inconsistent and lacks the rigor required to mitigate such risks effectively. As a result, many MFIs in the region face liquidity challenges, which further compromise their ability to sustain operations and serve their clientele.

Additionally, credit risks in Kenya's MFIs are exacerbated by the limited adoption of technological innovations and inadequate staff training on risk management practices. Studies have indicated that many MFIs in the region are still reliant on manual processes for risk assessment and management, which are prone to human error and inefficiencies (Wambua & Muriuki, 2020). This lack of modernization not only hampers the efficiency of risk management but also increases the operational costs, thereby affecting the overall financial performance of these institutions.

Moreover, market risks, including competition and regulatory changes, pose significant threats to the financial performance of MFIs in Kenya. The region has seen a proliferation of financial service providers, including commercial banks and mobile money platforms, which have encroached on the traditional customer base of MFIs. Without robust market risk management strategies, many MFIs find it challenging to maintain their market share and profitability (Mwangi & Wanjiru, 2021). The cumulative effect of these challenges is a declining financial performance, which threatens the long-term sustainability of MFIs in Kenya and their ability to fulfil their mission of providing financial services to underserved populations.

### 1.3 Objective of the study

The general purpose of the study was to investigate the impact of Risk Management Practices and Financial Performance of Licensed Microfinance Institutions in Kenya.

### 1.4 Research Hypothesis

Risk management practices have no statistically significant relationship on financial performance of Licensed microfinance institutions in Kenya.

## II. Literature review

### 2.1 Theoretical literature

#### 2.1.1 Risk Management Theory

The Risk Management Theory posits that organizations can mitigate risks and improve performance through structured risk management processes (Hubbard, 2020). This theory is rooted in the premise that risks are inherent in all organizational operations, and their effective management is critical for achieving financial and operational stability. It emphasizes a systematic approach to identifying, assessing, prioritizing, and addressing risks to minimize potential negative impacts and maximize opportunities.

In the context of microfinance institutions (MFIs), the Risk Management Theory provides a framework for understanding the relationship between risk management practices and financial performance. MFIs operate in environments characterized by high levels of uncertainty, including credit defaults, market volatility, and liquidity challenges. By adopting structured risk management processes, MFIs can anticipate and mitigate risks, thereby enhancing their financial sustainability (Shad et al., 2019).

The theory underpins the study's focus on credit, operational, market, and liquidity risk management practices as critical components influencing the financial performance of MFIs. For instance, effective credit risk management ensures that MFIs maintain quality loan portfolios by assessing borrowers' creditworthiness and implementing robust repayment monitoring mechanisms. Similarly, operational risk management minimizes disruptions caused by internal inefficiencies or fraud, while market risk management addresses fluctuations in economic conditions that could impact lending activities (DuHadway et al., 2019).

Furthermore, liquidity risk management ensures that MFIs maintain sufficient cash flow to meet their financial obligations and operational requirements. The systematic application of these practices, as advocated by the Risk Management Theory, fosters organizational resilience, reduces financial losses, and supports long-term growth (Ahmed et al., 2018)s. In essence, the theory aligns with the study's objectives by highlighting how structured risk management processes directly enhance the financial performance of MFIs, thereby contributing to their sustainability and overall impact.

#### 2.1.2 Resource-Based View (RBV) Theory

The Resource-Based View (RBV) Theory emphasizes that an organization's resources and capabilities are fundamental for achieving competitive advantage and superior performance (Alvarez & Barney, 2017). These resources, which must be valuable, rare, inimitable, and non-substitutable (VRIN), form the basis of an organization's strategic positioning and long-term success. The RBV Theory underscores the role of internal capabilities in driving financial and operational performance (Mansourinia & Badsar, 2023).

In the context of microfinance institutions (MFIs), the implementation of effective risk management practices can be viewed as a critical organizational resource. Risk management capabilities, including expertise in credit evaluation, advanced technological tools, and robust internal control systems, provide MFIs with a competitive edge. These resources enable MFIs to navigate the complex financial environment, manage uncertainties, and enhance their financial performance (Mansourinia & Badsar, 2023).

The RBV Theory also highlights the importance of leveraging intangible resources, such as organizational culture, employee expertise, and leadership commitment to risk management. By embedding a culture of risk awareness and equipping staff with the necessary skills, MFIs can strengthen their resilience and adaptability.

Moreover, this theory aligns with the study's objective of analysing how credit risk management strategies contribute to the competitive positioning of MFIs. Effective risk management practices not only mitigate potential losses but also enhance stakeholder confidence, attract investments, and improve client retention. Thus, the RBV Theory provides a robust framework for understanding how MFIs' internal resources and capabilities drive their financial sustainability and long-term success (Gichuhi, 2022).

### 2.3 Conceptual Framework

#### Independent variable

##### Risk Management

- Market Risk
- Financial Risk

#### Dependent variable

##### Financial Performance

- Profitability

Figure 2.1: conceptual Framework

**III. Research Methodology**

This study adopted quantitative research design on the impact of credit risk management practices on the financial performance of microfinance institutions (MFIs). The target population was 126 senior and middle level management staff of 14 registered MFIs in Kenya; from where Yamame’s sampling formula was applied to get a sample size of 112 respondents who were selected using simple random sampling. Data was collected using structured questionnaires and computed using SPSS; where descriptive and inferential statistics were generated.

**IV. Results and discussion**

**4.1 Descriptive statistics: Risk Management Practices and Financial Performance of Licensed Microfinance Institutions in Kenya.**

Table 1

Statement	Mean	Std dev
Effective risk management practices are critical to the financial sustainability of microfinance institutions.	3.57	1.317
The adoption of risk mitigation strategies has enhanced our organization's competitive advantage.	3.69	1.246
Integrating risk management into strategic planning improves financial outcomes.	3.45	1.176
Regulatory compliance driven by risk management efforts positively impacts financial performance	3.62	1.132
Risk management practices have positively influenced our return on assets (ROA)	3.58	1.183
Overall mean	3.428	1.124

Source: Field Data

The data presented in Table 1 offers insights into the relationship between Risk Management Practices and Financial Performance of Licensed Microfinance Institutions in Kenya. The analysis reveals a general agreement among respondents on the significance of these practices, though the varying levels of agreement highlight areas of divergence.

Firstly, the statement that effective risk management practices are critical to financial sustainability recorded a mean score of 3.57 and a standard deviation of 1.318. This indicates that respondents moderately agree with the importance of risk management in ensuring sustainability, though the relatively high variability in responses suggests differing levels of experience or understanding among the participants.

Similarly, the adoption of risk mitigation strategies enhancing competitive advantage garnered a mean score of 3.29, with a standard deviation of 1.245. While the moderate mean reflects a general recognition of the benefits of these strategies, the variability points to potential differences in how MSMEs implement or perceive their effectiveness in achieving a competitive edge. The integration of risk management into strategic planning emerged as a particularly significant factor, with the highest mean score of 3.59 and a standard deviation of 1.179. This finding underscores the critical role of embedding risk management into broader strategic objectives to drive financial outcomes. It reflects a consensus that strategic planning processes benefit from incorporating risk considerations, leading to enhanced organizational performance.

Regulatory compliance, driven by risk management efforts, was also viewed favorably, with a mean score of 3.37 and a standard deviation of 1.136. This demonstrates that respondents appreciate the positive impact of compliance on financial performance, likely due to the reduced risks of penalties and improved stakeholder confidence. The lower variability here suggests a more consistent understanding of the link between compliance and financial success. Lastly, risk management practices’ influence on return on assets (ROA) achieved a mean score of 3.32, with a standard deviation of 1.182. Respondents moderately agreed that such practices contribute to improved ROA, though variability again indicates differing levels of perceived impact.

The overall mean score of 3.428 and standard deviation of 1.01 summarize the collective responses, suggesting general agreement on the significance of risk management for financial performance while highlighting room for improvement and consistency in practice across the sector. These findings align with existing literature. For instance, studies by Kaplan and Mikes (2014) highlight the importance of integrating risk management into strategic planning, emphasizing its role in driving improved financial outcomes. Similarly, Ernst & Young (2018) found that regulatory compliance not only mitigates risks but also enhances financial performance and organizational reputation.

Table 4.2 Inferential statistics

Model Summary							
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics		
					R Square Change	F Change	Sig. F Change
1	.815 <sup>a</sup>	.664	.661	.941	.664	89.921	.000
a. Predictors: (Constant), Credit risk management practices							

ANOVA <sup>a</sup>						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	79.662	1	79.662	89.921	.000 <sup>b</sup>
	Residual	80.618	91	.886		
	Total	160.280	92			
<b>a. Dependent Variable: Financial Management.</b>						
<b>b. Predictors: (Constant), Credit risk management practices</b>						

The regression model indicates a strong positive relationship ( $R=0.705$ ) between credit risk management practices and financial management, with 66.4% ( $R^2=0.664$ ) of the variability in financial management explained by the model. The adjusted  $R^2$  (66.4%) confirms the model's robustness. The F-statistic of 89.921 and the associated p-value of .000 demonstrate that the model is highly significant, suggesting that credit risk management practices are a critical predictor of financial management outcomes. The ANOVA table supports these findings, with significant variability explained by the model and a small residual error (Mean Square Residual=0.886). Overall, the results highlight the importance of credit risk management practices in driving financial management performance. Prior studies, such as Nyamu (2019), focused on commercial banks, this analysis may extend the understanding of credit risk management to non-bank financial institutions, highlighting its broader applicability. Unlike Muriuki and Waweru (2017), who found moderate correlations, this study's  $R=0.705$  suggests that the impact of credit risk management on financial management could vary significantly across sectors or regions.

## V. Conclusion

The findings of this study underscore the critical role of credit risk management practices in enhancing financial management performance. With a strong positive correlation ( $R=0.815$ ) and nearly half of the variability in financial management ( $R^2=66.4\%$ ) explained by the model, it is evident that effective credit risk management significantly contributes to financial stability and efficiency. The model's statistical significance ( $p=0.000$ ) highlights the robustness of this relationship, reinforcing the importance of prioritizing credit risk mitigation strategies. These results are consistent with previous studies, which have consistently shown that organizations implementing sound credit policies experience improved financial outcomes. This study adds to the growing body of evidence by emphasizing the universal applicability of credit risk management practices across financial sectors and regions.

Ultimately, the research provides actionable insights for financial managers, policymakers, and stakeholders, emphasizing that robust credit risk management is not merely a regulatory requirement but a strategic imperative for achieving sustainable financial performance.

## VI. Recommendations

Based on the findings of the study, the following recommendations are proposed:

- i. **Enhance Risk Management Policies** - Financial institutions should develop and implement robust credit risk management policies, including comprehensive credit evaluation processes, continuous monitoring of credit exposures, and timely risk mitigation measures. These practices will help to strengthen financial performance, as evidenced by the strong relationship between credit risk management and financial management.
- ii. **Invest in Risk Management Training** - Organizations should provide regular training for credit officers and financial managers to improve their competency in identifying, assessing, and mitigating credit risks. Skilled personnel are better equipped to apply advanced credit management techniques, ensuring effective risk control and enhanced financial outcomes.
- iii. **Leverage Technology in Risk Management** - Institutions should adopt modern technological tools, such as predictive analytics and credit scoring systems, to enhance the accuracy and efficiency of credit risk assessments. Technology-driven approaches can reduce residual risks and improve decision-making, further bolstering financial management performance.
- iv. **Develop Comprehensive Risk Diversification Strategies** - To mitigate the adverse effects of credit defaults, financial institutions should diversify their credit portfolios across various sectors, geographic locations, and customer demographics. This reduces exposure to concentrated risks and stabilizes financial performance.
- v. **Strengthen Regulatory Compliance** - Financial institutions should ensure full compliance with regulatory frameworks governing credit risk management. Adhering to established standards and best practices not only minimizes risk exposure but also enhances stakeholder confidence and organizational sustainability.
- vi. **Encourage Continuous Research and Benchmarking** - Financial institutions should regularly benchmark their credit risk management practices against industry leaders and conduct research to identify emerging trends and challenges. Continuous improvement ensures the alignment of practices with evolving market dynamics and enhances overall financial performance.

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