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Credit Risk Management Strategies and Loan Performance of Banks in Kenya

Astone Okwatsa[1]*

[1] Department of Mathematics and Physics, Technical University of Mombasa, Kenya
*Corresponding author

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Abstract
Credit risk management is essential for maintaining loan portfolio quality and ensuring sustainable lending operations among banks in Kenya. This study synthesises existing literature on the relationship between credit risk management strategies and loan performance, focusing on Know Your Customer (KYC) procedures, creditworthiness assessment, and collateral and loan security. The study adopts a literature synthesis approach, reviewing relevant scholarly publications and examining their theoretical foundations, empirical findings, and research gaps. The review is guided by the Merton Model and Information Asymmetry Theory, which explain borrower default risk and the challenges arising from unequal access to information between lenders and borrowers. The synthesis indicates that effective KYC procedures strengthen borrower identification and information verification, creditworthiness assessment supports informed lending decisions, and collateral and loan security provide mechanisms for mitigating potential credit losses. The reviewed literature generally associates effective credit risk management practices with improved loan portfolio quality, reduced non-performing loans, and stronger banking performance. However, the effectiveness of these strategies depends on their implementation, the reliability of borrower information, and the integration of credit appraisal, loan monitoring, and recovery procedures. The review also identifies the need for further research examining the relationship between these strategies and direct loan performance indicators, including repayment rates, non-performing loan ratios, loan recovery rates, and default rates. The study concludes that comprehensive credit risk management is important for strengthening loan performance and promoting sustainable lending operations in Kenya.

1. INTRODUCTION

In recent years, commercial banks have continued to dominate Kenya's banking and financial sector, accounting for the largest proportion of financial assets among formal banking institutions. According to the Central Bank of Kenya (CBK), commercial banks play a pivotal role in financial intermediation by mobilising deposits, extending credit to households and businesses, facilitating payments, and supporting economic development. Although the structure of Kenya's financial sector has evolved with the growth of microfinance banks, savings and credit cooperative societies (SACCOs), and financial technology (fintech) institutions, commercial banks remain central to the country's financial system because of their asset base, extensive branch networks, customer reach, and broad range of financial services. Their contribution to economic activity, however, depends partly on their ability to allocate financial resources efficiently while maintaining the quality and recoverability of their loan portfolios. This makes effective credit risk management an essential component of sustainable banking operations and sound financial intermediation (Alshatti, 2020).

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The development of Kenya's modern banking system can be traced to the early twentieth century, when formal banking institutions were established during the colonial period. Since then, the sector has undergone substantial institutional and regulatory transformation, particularly following the enactment of the Banking Act and the strengthening of supervisory oversight by the Central Bank of Kenya. Within this evolving regulatory environment, commercial banks perform the fundamental function of mobilising savings and converting them into credit facilities that support investment, consumption, trade, and business expansion. Nevertheless, lending activities expose banks to credit risk arising from borrowers' inability or unwillingness to meet their contractual repayment obligations. Differences in ownership structures, strategic objectives, risk appetites, governance arrangements, and lending practices influence how individual banks identify, assess, monitor, and control these risks. Consequently, the effectiveness of credit risk management strategies has become an important consideration in determining the quality of bank loans and the overall sustainability of banking operations (Paudel, 2018).

Credit risk is widely recognised as one of the most significant risks confronting commercial banks because lending constitutes a major source of interest income while simultaneously exposing institutions to potential financial losses. When borrowers fail to honour their repayment obligations, banks may experience declining interest income, increased loan impairment provisions, reduced liquidity, and pressure on regulatory capital (Haro et al., 2026). These consequences can weaken profitability and constrain banks' capacity to extend further credit. In the Kenyan banking sector, credit risk management is therefore particularly important in ensuring that lending decisions balance the pursuit of returns with the need to preserve asset quality and financial stability. Evidence from banking studies indicates that financial performance is influenced by several risk-related factors, including credit risk, liquidity risk, and capital adequacy, underscoring the interconnected nature of risk management and banking performance (Aryal, 2023). Effective credit risk management requires bank managers to evaluate borrowers' repayment capacity, examine expected cash flows, assess collateral adequacy, and consider the risks associated with lending across different economic sectors. These assessments are necessary to ensure that credit allocation contributes to sustainable returns and the preservation of shareholder value (Alshatti, 2015).

Credit risk management strategies encompass the policies, procedures, analytical techniques, and monitoring mechanisms employed by banks to identify, assess, mitigate, and control the risks associated with lending. Such strategies may include rigorous credit appraisal, borrower creditworthiness assessment, credit scoring, collateralisation, credit diversification, loan covenant enforcement, continuous loan monitoring, and timely recovery of overdue facilities. Their effectiveness depends not only on the existence of formal policies but also on the quality of their implementation, the reliability of credit information, the competence of lending personnel, and the strength of internal controls. A comprehensive credit risk management framework enables banks to identify potentially problematic borrowers at an early stage, establish appropriate lending limits, and take corrective action before repayment difficulties escalate. Conversely, weak appraisal procedures, inadequate borrower assessment, poor loan monitoring, and ineffective recovery mechanisms may expose banks to excessive credit losses. Systematic credit risk management is consequently essential for reducing the incidence of non-performing loans (NPLs), protecting banking assets, and strengthening the quality of lending outcomes, particularly during periods of economic uncertainty and financial stress (Bhattarai, 2019).

Loan performance represents a critical dimension of banking operations because it reflects the extent to which credit facilities generate expected income and are repaid according to agreed contractual terms. It may be assessed using indicators such as loan repayment rates, the proportion of non-performing loans, loan recovery rates, default rates, and the quality of the overall loan portfolio. Strong loan performance supports income generation, reduces impairment losses, preserves liquidity, and enhances banks' capacity to sustain lending activities (Millan et al., 2023). Poor loan performance, on the other hand, increases provisioning requirements, constrains the availability of funds for productive lending, and may weaken institutional resilience. The relationship between credit risk management strategies and loan performance is therefore central to understanding how commercial banks can maintain sound lending portfolios while operating in an environment characterised by changing macroeconomic conditions, borrower vulnerabilities, and evolving regulatory requirements. The quality of credit management decisions is particularly important because the consequences of inadequate lending controls may extend beyond individual credit facilities to affect the financial position and operational sustainability of banking institutions.

The significance of credit risk management is further underscored by the need to assess banking sector stability through multiple financial indicators. The Central Bank of Kenya's Banking Sector Stability Index (BSSI) provides a composite perspective on the condition and resilience of the banking system by drawing on indicators associated with asset quality, liquidity, capital adequacy, operational efficiency, and profitability. Measures such as the non-performing loan ratio, liquidity ratio, capital adequacy indicators, and return on assets provide insights into the capacity of banks to absorb losses, meet obligations, and maintain sustainable operations. By examining these indicators against historical trends, the index supports the assessment of systemic vulnerabilities and the formulation of appropriate regulatory and supervisory responses (CBK, 2023). From a credit risk management perspective, asset quality is particularly important because deterioration in loan repayment performance can increase credit losses, raise provisioning requirements, and place additional pressure on capital adequacy and profitability. Accordingly, the relationship between credit risk management strategies and loan performance has implications not only for individual banks but also for the stability of the wider Kenyan banking system.

Maintaining sound and diversified loan portfolios remains a fundamental requirement for effective banking management. Banks must ensure that lending decisions are supported by reliable borrower information, appropriate risk assessment procedures, adequate collateral arrangements, and effective post-disbursement monitoring. Inadequately assessed or poorly monitored loans may deteriorate into non-performing facilities, requiring additional provisions and reducing the income generated from lending activities. These developments can weaken profitability, limit the resources available for new credit, and undermine institutional resilience. Previous research has identified the deterioration of loan portfolio quality as an important challenge for banking institutions, particularly when economic conditions adversely affect borrowers' cash flows and repayment capacity (Bhattarai, 2019). For commercial banks in Kenya, these concerns highlight the importance of evaluating whether existing credit risk management strategies adequately address borrower default risk, changing economic circumstances, and the operational challenges associated with loan recovery.

Recent developments in Kenya's banking sector have further highlighted the importance of credit risk management in sustaining loan performance. According to the Central Bank of Kenya, deterioration in asset quality has contributed to increased credit risk exposure, higher provisioning requirements, and pressure on banking sector profitability and capital buffers. The reported downward movement in the Banking Sector Stability Index between 2022 and early 2024 was associated with rising credit risk and an increase in distressed and restructured loans (CBK, 2023). Such developments demonstrate the potential consequences of weaknesses in credit assessment, loan monitoring, and recovery processes. An increase in non-performing loans requires banks to allocate additional resources to impairment provisions, thereby reducing net earnings and potentially constraining their capacity to absorb further losses. Similarly, growth in risk-weighted assets can increase capital requirements and place additional pressure on banks' capital adequacy positions. These conditions reinforce the need for credit risk management strategies that are responsive to changing borrower risk profiles and capable of identifying emerging repayment difficulties before they materially affect loan portfolio quality.

Furthermore, changes in credit growth and banking profitability provide additional context for examining the effectiveness of credit risk management strategies. During the period under consideration, credit growth in Kenya's banking sector decelerated amid tighter lending standards, increased risk aversion among banks, and subdued private sector demand for credit. Although stricter credit standards may help limit exposure to high-risk borrowers, excessive risk aversion can also restrict access to financing for creditworthy households and businesses. The resulting challenge is to establish a balance between prudent lending and the efficient provision of credit to productive economic activities. The reported weakening of commercial banks' net profits, together with marginal declines in return on equity (ROE) and return on assets (ROA), further illustrates the potential implications of rising credit risk and reduced lending activity for financial performance (CBK, 2023). These developments suggest that effective credit risk management should not be evaluated solely by its capacity to reduce loan defaults but also by its contribution to maintaining sound loan performance, sustainable credit growth, and an appropriate balance between risk and return.

Despite the importance of credit risk management, the effectiveness of individual strategies may vary depending on their design, implementation, and suitability to the prevailing lending environment. Credit appraisal procedures may be ineffective when borrower information is incomplete or unreliable, while collateral requirements may offer limited

protection when asset valuations are inaccurate or recovery processes are prolonged. Similarly, credit monitoring mechanisms may fail to identify emerging repayment difficulties when banks lack timely information or adequate analytical capacity. These limitations demonstrate that the adoption of credit risk management policies does not automatically translate into improved loan performance. Rather, the outcomes depend on how effectively banks integrate risk identification, borrower assessment, credit approval, loan administration, monitoring, and recovery into a coordinated management framework. It is therefore necessary to examine the contribution of these strategies to loan performance within the Kenyan commercial banking sector.

Against this background, the study on Credit Risk Management Strategies and Loan Performance of Banks in Kenya seeks to establish how credit risk management practices influence the quality and repayment performance of bank loans. By focusing on the strategies employed to assess borrower creditworthiness, mitigate lending risks, monitor outstanding facilities, and recover overdue loans, the study addresses an important aspect of banking management and financial stability. The study is premised on the understanding that effective credit risk management can strengthen loan portfolio quality, reduce non-performing loans, protect banking assets, and support sustainable lending operations. Its findings are expected to contribute to the understanding of the relationship between credit risk management strategies and loan performance while providing relevant insights for banking practitioners, policymakers, and other stakeholders concerned with improving credit administration and strengthening the resilience of Kenya's banking sector.

2. LITERATURE REVIEW

This chapter presents a comprehensive review of theoretical and empirical literature on credit risk management strategies and loan performance of banks in Kenya. It examines the conceptual foundations of credit risk management and its significance in ensuring effective lending practices, minimising loan defaults, improving repayment rates, and maintaining the quality of loan portfolios. The chapter focuses on three principal credit risk management strategies: Know Your Customer (KYC) procedures, creditworthiness assessment, and collateral and loan security. These strategies are examined in relation to their contribution to borrower evaluation, risk mitigation, loan recovery, and the overall performance of credit facilities.

The chapter further discusses the Merton Model and Information Asymmetry Theory, which provide theoretical explanations of borrower default risk and the informational challenges associated with lending. The empirical review evaluates existing studies on the relationship between credit risk management strategies and loan performance, highlighting their findings and implications for banking operations. Finally, the chapter critically examines the reviewed literature to identify methodological, theoretical, and empirical gaps that justify the present study on credit risk management strategies and loan performance of banks in Kenya.

2.1. Theoretical Framework

The theoretical framework establishes the conceptual foundation for explaining the relationship between credit risk management strategies and loan performance of banks in Kenya. Effective credit risk management requires financial institutions to identify potential credit risks, assess borrowers' repayment capacity, establish appropriate lending conditions, and implement mechanisms for monitoring and recovering outstanding loans. The effectiveness of these processes can influence the incidence of loan defaults, the accumulation of non-performing loans, and the overall quality of banking assets.

This study is anchored in two theoretical perspectives: the Merton Model developed by Robert C. Merton (1974) and Information Asymmetry Theory advanced by Akerlof (1970) and subsequently extended to credit markets by Stiglitz and Weiss (1981). The Merton Model explains default risk through the relationship between a borrower's asset value and debt obligations, while Information Asymmetry Theory explains the challenges arising from unequal access to information between borrowers and lenders. Together, these theories provide a foundation for understanding how credit risk management strategies can reduce uncertainty, improve lending decisions, and enhance loan performance.

Merton Model

The Merton Model was developed by Robert C. Merton (1974) in his seminal work, On the Pricing of Corporate Debt: The Risk Structure of Interest Rates. The model extended the Black–Scholes option pricing framework to the valuation of corporate liabilities by establishing a structural relationship between a firm's asset value, debt obligations, and probability of default. It provides a quantitative framework for understanding how changes in the financial position of a borrower can influence the likelihood of failure to meet contractual debt obligations.

The model assumes that the total market value of a firm's assets follows a stochastic process and that the firm finances its operations through equity and a single class of zero-coupon debt with a specified maturity. Under the original formulation, default occurs at maturity when the value of the firm's assets is insufficient to cover its outstanding debt obligations. Equity holders receive the residual value after debt repayment, while creditors face potential losses when the value of the firm's assets falls below the amount owed. Consequently, the probability of default is influenced by the value and volatility of the firm's assets, its debt structure, and the time remaining until maturity.

In credit risk management, the Merton Model provides a theoretical basis for estimating default probabilities, assessing credit spreads, and evaluating the risk associated with lending to corporate borrowers. Its structural approach has influenced the development of commercial credit risk assessment systems, including Moody's KMV, and has informed the broader development of risk-based credit assessment and capital allocation practices under the Basel regulatory framework, including the Internal Ratings-Based (IRB) approach.

The relevance of the Merton Model to the present study lies in its explanation of the relationship between borrowers' financial conditions and their ability to meet loan repayment obligations. Banks that undertake rigorous assessments of borrowers' assets, liabilities, cash flows, and financial vulnerability are better positioned to identify potential default risks before approving credit facilities. Such assessments can inform lending decisions, credit limits, loan pricing, and the subsequent monitoring of outstanding loans. Effective application of these principles can therefore contribute to improved loan performance by limiting exposure to borrowers whose financial circumstances indicate an elevated risk of default.

However, the direct application of the original Merton Model to all borrowers in Kenya may be constrained by the limited availability of observable market values for privately owned enterprises and small and medium-sized enterprises. In such circumstances, banks may need to rely on financial statements, cash-flow projections, credit histories, and other borrower-specific information when assessing credit risk. Nevertheless, the model remains relevant to this study because it provides a theoretical explanation of default risk and supports the importance of effective creditworthiness assessment as a strategy for improving loan performance.

Information Asymmetry Theory

Information Asymmetry Theory explains situations in which one party to a transaction possesses more relevant information than the other, potentially resulting in inefficient decisions and unfavourable outcomes. The theory was established by Akerlof (1970), who demonstrated how information imperfections and quality uncertainty can lead to adverse selection and market failure. In credit markets, borrowers generally possess more information about their financial circumstances, repayment intentions, investment opportunities, and exposure to risk than lenders can readily obtain. This imbalance creates uncertainty that may affect the quality of lending decisions and increase the likelihood of loan default.

Stiglitz and Weiss (1981) extended the application of information asymmetry to credit markets by demonstrating that lenders may not effectively eliminate credit risk simply by increasing interest rates. Higher interest rates can attract borrowers willing to undertake riskier projects while discouraging relatively safer borrowers. Furthermore, higher borrowing costs may increase the financial burden on borrowers and encourage riskier investment decisions. Consequently, lenders may resort to credit rationing rather than continuously increasing interest rates, since doing so may worsen the composition and quality of their loan portfolios.

Information asymmetry manifests primarily through adverse selection and moral hazard. Adverse selection occurs before loan approval when lenders cannot adequately distinguish between borrowers with different risk profiles. Moral hazard arises after a loan has been granted when borrowers undertake activities that increase default risk or fail to comply with the conditions under which credit was extended. Both problems can adversely affect loan performance when banks lack effective borrower screening, contractual safeguards, and monitoring mechanisms.

In credit risk management, Information Asymmetry Theory provides a theoretical justification for implementing KYC procedures, creditworthiness assessment, collateral requirements, and continuous loan monitoring. KYC procedures enable banks to verify borrower identities and establish reliable customer profiles. Creditworthiness assessment helps lenders evaluate repayment capacity, financial stability, and previous credit behaviour. Collateral requirements provide an additional source of recovery in the event of default and may influence borrower behaviour, while continuous monitoring enables banks to identify emerging repayment difficulties and deviations from contractual obligations.

The theory is particularly relevant to the Kenyan banking sector because the quality of lending decisions depends on the availability, accuracy, and effective use of borrower information. Where information is incomplete or unreliable, banks may approve credit facilities to borrowers whose repayment capacity is inadequate, resulting in increased default rates and deterioration in loan portfolio quality. Effective credit risk management strategies can reduce these information-related challenges by strengthening borrower screening, improving credit decisions, and facilitating timely intervention when repayment difficulties emerge. Information Asymmetry Theory therefore provides an important foundation for explaining how credit risk management strategies can contribute to improved loan performance among banks in Kenya.

2.2. Empirical Review of Literature

Know Your Customer (KYC) and Loan Performance

Know Your Customer procedures constitute an important component of credit risk management because they enable banks to identify and verify customers, establish reliable customer profiles, and obtain information relevant to lending decisions. Effective KYC practices support customer due diligence by reducing uncertainty regarding borrower identity, financial circumstances, and the legitimacy of customer transactions. In the context of lending, these procedures provide an important information base for assessing credit applications, identifying potential risks, and determining whether additional verification is necessary before credit is approved.

Willing (2025) emphasises that KYC enables banks to develop accurate customer profiles, identify high-risk clients, and prevent engagement with illicit counterparties. This perspective highlights the importance of customer identification and verification in strengthening the information available to credit officers. Reliable customer information can improve the preliminary assessment of borrowers and reduce the risks associated with incomplete documentation or misrepresentation during the loan application process.

Similarly, Aidoo (2025) highlights that effective KYC improves the quality of information available for credit risk assessment, enabling banks to make informed lending decisions and reduce exposure to potentially problematic borrowers. This suggests that comprehensive customer due diligence can contribute to improved loan performance by strengthening the reliability of information used during credit appraisal. When borrower information is accurate and adequately verified, banks are better positioned to identify inconsistencies and determine whether an applicant meets the institution's lending requirements.

Bankingly (2025) reports that financial institutions implementing comprehensive KYC practices experience lower incidences of loan default, thereby strengthening asset quality and profitability. This finding presents KYC not merely as a regulatory compliance requirement but also as a strategic component of credit risk management. By improving the reliability of customer information, KYC procedures may help banks identify potential risks before they develop into repayment problems.

Nevertheless, the effectiveness of KYC in improving loan performance depends on the extent to which the information obtained is incorporated into substantive credit assessment and monitoring processes. Verification of customer identity alone does not establish a borrower's capacity to repay a loan. KYC should therefore complement financial analysis, credit history assessment, collateral evaluation, and continuous loan monitoring. Collectively, the reviewed literature suggests that effective KYC procedures can strengthen borrower screening and support better lending decisions, although their contribution to loan performance depends on the quality of implementation and integration with other credit risk management strategies.

Creditworthiness and Credit Risk Management

Creditworthiness assessment is a fundamental component of credit risk management because it enables banks to evaluate the ability and willingness of borrowers to meet their contractual repayment obligations. The assessment generally involves examining borrowers' income, cash flows, financial statements, existing liabilities, repayment histories, and other indicators of financial stability. Effective creditworthiness assessment enables banks to distinguish between borrowers with different levels of credit risk and to structure lending arrangements in accordance with their repayment capacity.

Altaf and Shah (2025) find that banks that rigorously assess borrowers' financial positions, repayment histories, and collateral experience fewer defaults and higher repayment rates. Their findings emphasise the importance of comprehensive borrower evaluation in reducing exposure to credit losses. By considering several indicators of financial capacity and repayment behaviour, banks can identify potential weaknesses in borrowers' financial positions before extending credit and make lending decisions that reflect the associated risks.

Shah (2022) emphasises the use of credit scoring and financial ratio analysis as important tools for quantifying repayment capacity and assessing credit risk. Credit scoring provides a systematic approach to classifying borrowers according to selected risk indicators, while financial ratio analysis assists in evaluating liquidity, profitability, leverage, and other dimensions of financial performance. These techniques can strengthen the consistency and objectivity of lending decisions when supported by reliable information and appropriate analytical procedures.

Kauna (2021) demonstrates a statistically significant positive relationship between creditworthiness assessment and the financial performance of commercial banks, measured through indicators such as return on assets (ROA) and return on equity (ROE). This finding suggests that effective borrower assessment may contribute to stronger financial outcomes by reducing exposure to high-risk borrowers and limiting the costs associated with default. However, profitability indicators measure broader institutional outcomes and should be distinguished from direct measures of loan performance, such as repayment rates and non-performing loan ratios (Thion'go et al., 2024).

Chesoli (2021) further corroborates the importance of effective credit risk management, including continuous monitoring and portfolio diversification, in enhancing bank profitability and stability. These practices complement creditworthiness assessment by enabling banks to monitor changes in borrower risk profiles and manage concentrations of credit exposure. Initial borrower assessment is therefore most effective when integrated with continuous monitoring throughout the loan period.

The reviewed studies collectively indicate that creditworthiness assessment is an important strategy for improving lending decisions, reducing default risk, and supporting sound loan portfolio management. However, the effectiveness of these practices depends on the quality of borrower information, the suitability of assessment techniques, and the extent to which the resulting evaluations inform actual credit decisions. This underscores the importance of examining the relationship between creditworthiness assessment and loan performance within the Kenyan banking sector.

Collateral & Loan Security and Credit Risk Management

Collateral and loan security are important credit risk management mechanisms because they provide banks with an additional source of recovery when borrowers fail to meet their contractual obligations. Collateral may include property,

equipment, financial assets, and other acceptable forms of security. The effectiveness of collateral arrangements depends on appropriate valuation, valid documentation, enforceability of security interests, and the ability of banks to recover outstanding amounts when default occurs. Collateral can also influence borrower behaviour by increasing the potential consequences of failing to repay a loan.

Ngode (2021) reports that higher collateral requirements in Kenyan commercial banks are associated with lower non-performing loan (NPL) ratios. The study identifies a negative and statistically significant relationship between collateral levels and NPL ratios, suggesting that secured lending is associated with improved loan portfolio quality. This relationship may be explained by the potential of collateral to reduce lenders' expected losses and encourage borrowers to fulfil their repayment obligations. However, collateral requirements should be assessed alongside other lending practices because the relationship between collateral and loan performance may also reflect differences in borrower risk and loan characteristics.

Njenga (2021) observes that incorporating collateral policies into broader credit risk management frameworks strengthens credit controls, reduces the frequency and severity of defaults, and protects bank profitability. This perspective emphasises the importance of integrating collateral management with borrower assessment, loan approval procedures, and continuous monitoring. Effective collateral management requires banks to establish appropriate security requirements, verify ownership, undertake reliable valuations, maintain complete documentation, and ensure that recovery procedures are implemented when necessary.

Besanko (2021) supports the importance of collateral by emphasising its role in signalling borrower commitment and reducing moral hazard. By pledging assets, borrowers may have stronger incentives to comply with repayment obligations because default can result in the loss of the pledged assets. Collateral can therefore complement other credit risk management strategies by influencing borrower incentives and providing an additional mechanism for mitigating potential losses.

Muigai and Maina (2018) provide empirical evidence from multiple commercial banks indicating that effective credit risk management practices, including collateral enforcement, are positively associated with financial performance measures such as ROA and ROE. Their findings suggest that effective implementation of credit risk management practices can protect banking assets and support sustainable financial performance. Nevertheless, financial performance is influenced by several factors, and the reported association does not necessarily establish the independent effect of collateral on loan repayment outcomes.

Chesoli (2021) also demonstrates that robust credit risk management incorporating collateral and other risk mitigation mechanisms is associated with reduced NPL ratios and enhanced financial stability. This finding reinforces the argument that collateral is most effective when integrated into a comprehensive credit risk management framework rather than treated as a substitute for proper borrower evaluation and loan monitoring.

Overall, the reviewed literature indicates that collateral and loan security can contribute to improved loan performance by providing an additional source of recovery, strengthening borrower incentives, and reducing potential losses arising from default. However, collateral does not eliminate credit risk, and its effectiveness may be constrained by inaccurate valuations, declining asset values, legal disputes, and delays in enforcement. Consequently, banks need to integrate collateral management with sound credit appraisal, continuous monitoring, and effective recovery procedures to enhance loan performance.

2.3. Critique of Literature

The reviewed literature provides important insights into the relationship between credit risk management strategies and the performance of lending operations. Existing studies highlight the significance of KYC procedures, creditworthiness assessment, and collateral and loan security in improving borrower screening, strengthening credit decisions, and mitigating potential loan losses. In particular, studies by Ngode (2021), Muigai and Maina (2018), and Chesoli (2021) emphasise the contribution of collateral and broader credit risk management practices to asset quality, profitability, and

financial stability. Similarly, Altaf and Shah (2025), Shah (2022), and Kauna (2021) highlight the importance of assessing borrowers' financial capacity and repayment risk before extending credit.

Despite these contributions, several limitations emerge from the reviewed literature. First, much of the empirical evidence relies on quantitative associations between selected credit risk management practices and banking performance indicators. Although such evidence is useful for identifying relationships, it may not adequately establish causal effects or explain how particular strategies influence loan performance over time. For instance, studies such as Kauna (2021) and Njenga (2021) provide useful insights into the relationship between creditworthiness, collateral management, and bank performance, but research based on cross-sectional data or limited observation periods may not fully capture the long-term effects of credit management practices or the influence of changing economic conditions.

Second, the reviewed literature tends to place considerable emphasis on financial performance measures such as ROA and ROE, which do not directly capture all dimensions of loan performance. Although profitability is an important outcome of effective banking operations, it may be influenced by operating costs, interest margins, fee income, and other factors beyond loan repayment. Consequently, the use of profitability indicators alone may not provide a comprehensive assessment of the relationship between credit risk management strategies and loan performance. Direct indicators, including repayment rates, default rates, loan recovery rates, and NPL ratios, are necessary to establish a clearer understanding of the quality and performance of loan portfolios.

Third, the literature does not always adequately integrate qualitative and institutional factors that influence the effectiveness of credit risk management. Borrower behaviour, managerial judgement, staff competence, organisational culture, and governance structures may significantly affect the implementation of formal credit management procedures. For example, the availability of borrower information does not necessarily guarantee that it will be correctly interpreted, while the existence of collateral policies does not ensure effective valuation or recovery. The issues highlighted by Altaf and Shah (2025) and Shah (2022) concerning borrower assessment and credit risk analysis indicate the importance of considering the quality of implementation alongside the formal adoption of credit management practices.

Fourth, although the Merton Model and Information Asymmetry Theory provide useful theoretical foundations for understanding credit risk, their application in emerging-market contexts requires careful consideration. The Merton Model assumes observable and continuously valued firm assets, conditions that may not exist for many privately owned enterprises and small and medium-sized enterprises in Kenya. Similarly, Information Asymmetry Theory explains adverse selection and moral hazard but may not fully capture the institutional, behavioural, and operational factors that influence lending and repayment decisions in practice (Akerlof, 1970; Stiglitz & Weiss, 1981). These limitations suggest that the theories should be applied with due consideration of the characteristics of borrowers and the institutional environment in which banks operate.

Finally, the reviewed studies do not fully establish the relative contributions of KYC procedures, creditworthiness assessment, and collateral and loan security to loan performance when the three strategies are considered together. Although individual studies provide evidence concerning specific credit risk management practices, differences in research designs, performance indicators, and study contexts make it difficult to determine the comparative importance of these strategies. There is therefore a need for further research that examines the three strategies within a common analytical framework and relates them directly to loan performance indicators.

The present study addresses these gaps by examining credit risk management strategies and loan performance of banks in Kenya, with particular attention to KYC procedures, creditworthiness assessment, and collateral and loan security. By focusing on these strategies and their relationship with loan performance, the study seeks to contribute to a more comprehensive understanding of how banks can strengthen credit administration, minimise loan defaults, improve repayment outcomes, and maintain sound loan portfolios. The findings are expected to provide useful insights for banking practitioners and other stakeholders concerned with effective credit risk management and sustainable lending operations in Kenya.

3. METHODOLOGY

This study adopted a literature synthesis approach to examine the relationship between credit risk management strategies and loan performance of banks in Kenya. Relevant literature was reviewed from published journal articles, scholarly books, and institutional reports focusing on Know Your Customer (KYC) procedures, creditworthiness assessment, and collateral and loan security. The selected literature was analysed thematically to identify recurring findings, areas of agreement and divergence, and gaps in existing knowledge. The synthesis provided a basis for understanding how credit risk management strategies influence loan performance and for identifying areas requiring further research.

4. FINDINGS

4.1. Literature Synthesis and Observations

The reviewed literature establishes that credit risk management strategies are important determinants of loan performance because they influence borrower selection, lending decisions, default prevention, and loan recovery. The theoretical perspectives of the Merton Model (Merton, 1974) and Information Asymmetry Theory (Akerlof, 1970; Stiglitz & Weiss, 1981) provide complementary explanations for this relationship. While the Merton Model links default risk to borrowers' financial conditions and debt obligations, Information Asymmetry Theory explains how inadequate borrower information can result in adverse selection and moral hazard. Both perspectives support the need for effective credit risk management strategies to minimise lending risks and improve loan portfolio quality.

The empirical literature identifies Know Your Customer (KYC) procedures as an important foundation for effective credit risk management. Willing (2025), Aidoo (2025), and Bankingly (2025) emphasise the contribution of customer identification, verification, and due diligence to improved borrower profiling and risk assessment. An important observation is that KYC primarily strengthens the information available to lenders rather than directly guaranteeing repayment. Its effectiveness therefore depends on its integration with creditworthiness assessment and subsequent loan monitoring.

Creditworthiness assessment emerges as another critical strategy for improving lending outcomes. Altaf and Shah (2025) highlight the importance of evaluating borrowers' financial positions, repayment histories, and collateral, while Shah (2022) emphasises credit scoring and financial ratio analysis as tools for assessing repayment capacity. Kauna (2021) further reports a statistically significant positive relationship between creditworthiness assessment and commercial banks' financial performance. These findings suggest that rigorous borrower assessment can reduce exposure to high-risk borrowers. However, an important observation is that improved financial performance does not necessarily demonstrate improved loan repayment directly. This distinction highlights the need to examine loan performance using specific indicators, including repayment rates, default rates, loan recovery rates, and non-performing loan ratios.

The literature also demonstrates the importance of collateral and loan security in mitigating credit risk. Ngode (2021) reports a negative and statistically significant relationship between collateral levels and non-performing loan ratios, suggesting that secured lending may contribute to improved loan portfolio quality. Njenga (2021) emphasises the importance of integrating collateral policies into broader credit risk management frameworks, while Besanko (2021) explains how collateral can strengthen borrower commitment and reduce moral hazard. Similarly, Muigai and Maina (2018) and Chesoli (2021) associate effective credit risk management practices with improved financial performance, reduced non-performing loans, and greater financial stability. Nevertheless, collateral should not be regarded as a substitute for sound credit appraisal because its effectiveness depends on accurate valuation, legal enforceability, and efficient recovery procedures.

A further observation is that the three credit risk management strategies are complementary rather than independent in their practical application. KYC establishes reliable customer information, creditworthiness assessment evaluates repayment capacity, and collateral and loan security provide an additional mechanism for mitigating potential losses. Their combined effectiveness depends on the consistency with which banks implement these practices throughout the

lending process. Weaknesses in one area may undermine the effectiveness of the others. For example, accurate customer identification cannot compensate for inadequate assessment of repayment capacity, while adequate collateral may not prevent default or guarantee timely loan recovery.

The literature also reveals methodological and conceptual limitations. Several reviewed studies focus on financial performance indicators such as return on assets (ROA) and return on equity (ROE), which reflect broader institutional outcomes rather than loan performance alone (Kauna, 2021; Muigai & Maina, 2018). Consequently, the reported relationships between credit risk management and profitability should not automatically be interpreted as evidence of improved loan repayment. Furthermore, the reviewed literature provides insufficiently integrated evidence on the relative contributions of KYC, creditworthiness assessment, and collateral and loan security when these strategies are considered together. Differences in research designs, measurement approaches, and study contexts also limit direct comparison of findings.

The theoretical literature similarly requires contextual interpretation. Although the Merton Model provides a useful framework for understanding default probability, its assumptions regarding observable market values may limit its direct application to privately owned businesses and small and medium-sized enterprises. Information Asymmetry Theory provides a broader explanation of borrower information problems but does not, by itself, establish the magnitude of the effects of individual credit risk management strategies on loan performance (Akerlof, 1970; Merton, 1974; Stiglitz & Weiss, 1981). These observations reinforce the importance of examining the strategies within the practical and institutional conditions characterising the Kenyan banking sector.

Overall, the literature suggests that effective KYC procedures, creditworthiness assessment, and collateral and loan security can contribute to improved loan performance by strengthening borrower screening, reducing lending uncertainty, and enhancing recovery prospects. However, the extent of their contribution depends on implementation quality, the reliability of borrower information, and the integration of the strategies within a comprehensive credit risk management framework. The principal observation emerging from the synthesis is that **the existence of credit risk management policies does not necessarily guarantee satisfactory loan performance; their effectiveness depends on how consistently and appropriately they are implemented**. This provides the rationale for examining the relationship between these three strategies and loan performance of banks in Kenya, with particular attention to direct measures of repayment and loan portfolio quality.

4.2. Proposed Framework

Credit risk management strategies play a significant role in determining loan performance among banks in Kenya. The principal strategies include Know Your Customer (KYC) procedures, creditworthiness assessment, and collateral and loan security. These strategies are intended to strengthen lending decisions, minimise credit losses, and enhance loan portfolio quality. Loan performance can be evaluated using indicators such as loan repayment rates, non-performing loan (NPL) ratios, loan recovery rates, and loan default rates. Effective implementation of credit risk management strategies is therefore expected to improve repayment outcomes, reduce loan defaults, and promote sound loan portfolio management (Ngode, 2021; Altaf & Shah, 2025; Muigai & Maina, 2018).

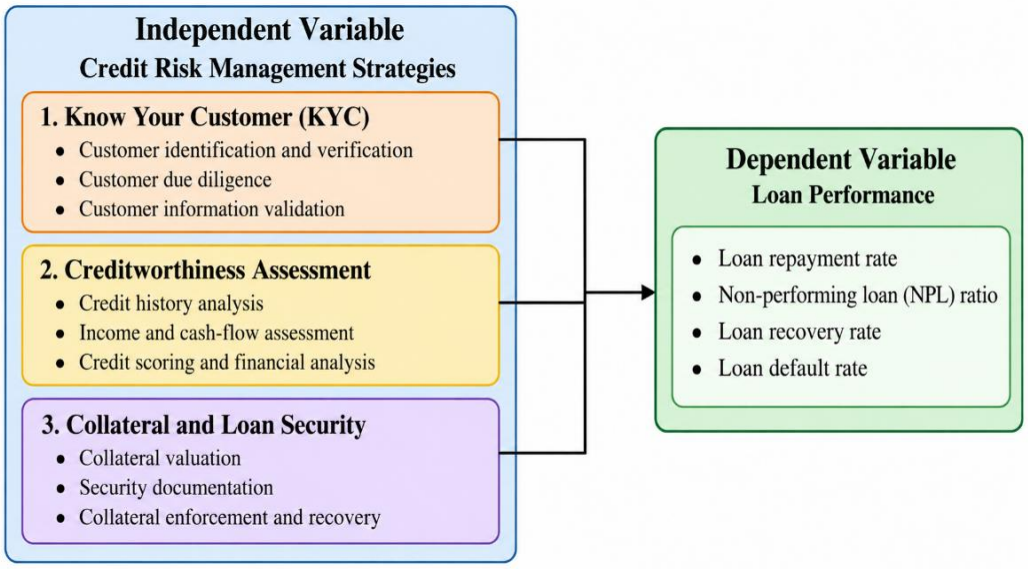


Figure 1: Proposed Conceptual Framework

Figure 1 illustrates how the three credit risk management strategies are expected to influence loan performance. First, KYC procedures involve customer identification and verification, due diligence, and validation of customer information. These practices help banks establish reliable borrower profiles and strengthen the information available for lending decisions (Willing, 2025; Aidoo, 2025). Second, creditworthiness assessment involves analysing borrowers' credit histories, income, cash flows, and financial positions to determine their capacity to repay loans. Effective assessment can improve borrower selection and reduce exposure to default risk (Shah, 2022; Altaf & Shah, 2025). Third, collateral and loan security involve collateral valuation, security documentation, and enforcement and recovery procedures. These measures provide additional protection against potential credit losses and may improve loan recovery outcomes (Ngode, 2021; Njenga, 2021).

The framework proposes that effective implementation of these strategies is associated with improved loan performance. This is reflected in higher loan repayment and recovery rates and lower NPL and loan default rates. The direction of the relationship is consistent with the arguments of Information Asymmetry Theory, which emphasises the importance of reducing information gaps between borrowers and lenders (Akerlof, 1970; Stiglitz & Weiss, 1981). However, the framework represents a proposed relationship derived from the literature rather than an empirically established causal effect. Its actual strength may depend on the effectiveness of implementation and the broader lending environment.

5. CONCLUSION AND RECOMMENDATIONS

The literature synthesis establishes that credit risk management strategies play an important role in determining loan performance among banks in Kenya. The reviewed literature identifies Know Your Customer (KYC) procedures, creditworthiness assessment, and collateral and loan security as complementary strategies for strengthening borrower screening, improving lending decisions, and mitigating potential credit losses. The Merton Model (Merton, 1974) and Information Asymmetry Theory (Akerlof, 1970; Stiglitz & Weiss, 1981) provide theoretical explanations for the importance of evaluating borrowers' financial conditions and reducing information asymmetry between lenders and borrowers. Empirical studies generally associate effective credit risk management practices with improved loan portfolio quality, reduced non-performing loans, and stronger financial performance (Ngode, 2021; Muigai & Maina, 2018; Chesoli, 2021).

However, the effectiveness of these strategies depends on their implementation, the reliability of borrower information, and the integration of credit assessment, loan monitoring, and recovery procedures. The literature also reveals the need to distinguish loan performance from overall bank profitability and to examine the individual and complementary

contributions of different credit risk management strategies. Consequently, effective credit risk management should be understood as a continuous process that extends from customer identification and credit appraisal to loan monitoring and recovery.

Based on these observations, banks in Kenya should strengthen KYC procedures to ensure accurate customer identification and reliable borrower information, thereby supporting informed lending decisions (Willing, 2025; Aidoo, 2025). They should also enhance creditworthiness assessment by systematically evaluating borrowers' credit histories, income, cash flows, existing liabilities, and repayment capacity before approving credit facilities (Altaf & Shah, 2025; Shah, 2022). Furthermore, banks should improve collateral valuation, security documentation, loan monitoring, and recovery procedures to minimise potential credit losses and strengthen loan portfolio quality (Ngode, 2021; Njenga, 2021). These strategies should be integrated within a comprehensive credit risk management framework rather than implemented independently.

Finally, further research should examine the relationship between credit risk management strategies and direct indicators of loan performance, including repayment rates, non-performing loan ratios, recovery rates, and default rates. Such research would provide a clearer understanding of the contribution of individual strategies to loan performance and generate evidence to inform credit management practices. Overall, the effective implementation of credit risk management strategies is essential for improving loan repayment outcomes, reducing default risk, and promoting sustainable lending operations among banks in Kenya.

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