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Title

AN ASSESSMENT OF THE CAUSES OF LOAN DEFAULT AMONG SMALL AND MEDIUM ENTERPRISES (SMES) IN LILONGWE: A CASE STUDY OF TSOKA MARKET, AREA 3, AND THE NATIONAL ECONOMIC EMPOWERMENT FUND (NEEF)

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ABSRACT

This study examined the causes of loan default among small and medium enterprises (SMEs) a case study of Tsoka Area 3 Market and National Economic Empowerment Fund (NEEF) in Lilongwe. A quantitative research approach was employed, with data collected through structured questionnaires administered to 48 respondents, including SME owners and NEEF officials.

The study identified key economic, financial, and managerial factors influencing loan repayment. Findings revealed that high interest rates, inflation, market volatility, low sales, and short repayment periods significantly constrained SMEs' ability to repay loans. Additionally, financial mismanagement practices such as poor record-keeping, inadequate budgeting, weak cash-flow management, and the mixing of personal and business finances further contributed to loan default. Loan diversion, driven by business emergencies and inadequate lender monitoring, also negatively affected repayment performance.

The study concludes that strengthening financial management skills, reviewing loan conditions, and enhancing lender oversight are essential to improving loan repayment and reducing default rates among SMEs.

Keywords: International Monetary Fund (IMF), Small and Medium Enterprises (SMEs), Reserve Bank of Malawi (RBM), National Economic Empowerment Fund (NEEF)

INTRODUCTION

Small and Medium Enterprises (SMEs) are widely recognized as engines of economic growth, employment creation, and poverty reduction in both developed and developing economies. In Malawi, SMEs contribute significantly to income generation, entrepreneurship development, and economic diversification. *The Government of Malawi, through the Micro, Small and Medium Enterprises Policy (2011),* reaffirmed its commitment to strengthening the SME sector as a strategy for achieving sustainable development.

SMEs are generally defined as enterprises employing fewer than twenty employees *(Ward, 2009).* Despite their economic importance, SMEs face numerous constraints, particularly limited access to finance. Financial institutions, including banks and microfinance institutions, play a crucial role in addressing this constraint by providing credit facilities.

Microfinance institutions are entities that provide financial services to low-income individuals and small enterprises that lack access to traditional banking services *(Rooman, 2008).* In Malawi, the National Economic Empowerment Fund (NEEF) is one of the key institutions providing loans to SMEs and individuals to promote economic empowerment. This study focuses on SMEs financed by NEEF at Area 3 in Lilongwe.

While access to credit supports business expansion, innovation, and working capital management, loan default remains a persistent challenge. High default rates undermine financial institutions' sustainability and limit further credit provision. Understanding the determinants of loan default among SMEs is therefore essential for strengthening both SME growth and financial sector stability.

BACKGROUND OF THE STUDY

SMEs play a central role in Malawi's economy by providing employment opportunities, especially for youth and women. They operate in various sectors including retail, agriculture, hospitality, manufacturing, and services. In

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many cases, SMEs serve as the primary source of livelihood for households.

Despite their importance, SMEs encounter structural and operational challenges such as inadequate capital, weak managerial skills, limited market access, and exposure to economic shocks. One of the most critical challenges is loan repayment failure, commonly referred to as loan default.

Loan default occurs when a borrower fails to meet agreed repayment obligations within the specified period. Persistent loan defaults lead to increased non-performing loans (NPLs), reduced profitability for financial institutions, stricter lending conditions, and reduced access to finance for other entrepreneurs.

Macroeconomic factors such as inflation, high interest rates, and exchange rate volatility further increase repayment difficulties. At the micro level, poor financial management, inadequate record-keeping, and diversion of funds exacerbate the problem.

Understanding these factors in the context of Tsoka Market in Lilongwe provides valuable localized insight into SME financial behavior.

Profile of Tsoka Market

Tsoka Market is a well-established commercial centre located in Lilongwe, approximately 700 meters from the Game Complex. The market hosts diverse small and medium enterprises including restaurants, guest houses, liquor stores, clothing shops, furniture traders, vegetable vendors, and general merchandise retailers.

Its proximity to Area 3, where several financial institutions operate, makes it a suitable location for studying SME loan repayment patterns. The concentration of varied business types provides an opportunity to examine differences in financial management practices and repayment behaviour across sectors.

The dynamic nature of business operations in Tsoka Market allows this study to analyze the interaction between economic conditions, business performance, financial management, and loan default.

PROBLEM STATEMENT

Although financial institutions in Malawi continue to provide loans to SMEs to promote economic growth, loan default remains high. Many SMEs fail to repay loans within agreed terms despite institutional efforts such as credit assessment, monitoring, and repayment scheduling.

High default rates reduce financial institutions' lending capacity, increase operational risk, and discourage future investment in the SME sector. At the same time, defaulting SMEs experience restricted access to future credit, reputational damage, and potential business collapse.

There is limited empirical evidence specifically examining the determinants of loan default among SMEs in Tsoka Market. This gap necessitates a focused investigation into economic, business, managerial, and behavioral factors influencing loan repayment performance.

RESEARCH OBJECTIVES

Main Objective

To investigate the determinants of loan default among SMEs in Tsoka Market, Lilongwe.

Specific Objectives

- To assess the prevalence of loan default among SMEs in Lilongwe.
- To identify economic and business-related factors contributing to loan default.

- To examine the influence of financial management practices on loan repayment performance.
- To analyze the implications of loan default for SMEs and financial institutions.
- To assess the extent to which loan diversion contributes to loan default.

RESEARCH QUESTIONS

- What is the prevalence of loan default among SMEs in Lilongwe?
- What economic and business-related factors contribute to loan default?
- How do financial management practices influence repayment performance?
- What are the implications of loan default on SMEs and financial institutions?
- To what extent does loan diversion contribute to default?

SIGNIFICANCE OF THE STUDY

This study contributes to knowledge and policy in several ways.

To financial institutions, the findings will improve credit risk assessment, monitoring mechanisms, and loan structuring.

To government policymakers, the study provides evidence for strengthening SME financing policies and reducing non-performing loans.

To SMEs, the research highlights best financial management practices that enhance sustainability and repayment capacity.

To scholars, the study adds empirical evidence on SME loan default in Malawi.

LITERATURE REVIEW

Empirical Review

Loan Default Prevalence

Studies show SMEs exhibit higher default rates than large firms due to limited capital buffers and irregular cash flows *(World Bank, 2022).* In Malawi, rising inflation and economic instability have increased non-performing loans *(RBM, 2023).*

Limited financial literacy and weak accounting practices further constrain repayment capacity.

Economic and Business Determinants

High interest rates increase debt burden and reduce profitability *(IMF, 2022).* Inflation raises operational costs, reducing disposable income for repayment.

Business-level factors include low sales, competition, delayed customer payments, and seasonal income fluctuations.

Financial Management Practices

Effective budgeting, bookkeeping, and cash flow management improve repayment performance. SMEs separating personal and business finances demonstrate better financial discipline.

Poor planning and liquidity mismanagement increase default risk. Financial literacy training combined with monitoring improves repayment outcomes.

Loan Diversion

Loan diversion refers to using borrowed funds for non-business purposes. Studies link diversion to increased default risk, particularly when monitoring is weak.

Implications of Loan Default

For SMEs, default reduces access to future credit and threatens business survival. For lenders, it increases non- performing loans and reduces

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profitability.

THEORETICAL FRAMEWORK

Credit Risk Theory

Explains probability of borrower default due to financial instability.

Information Asymmetry Theory

Borrowers possess more information than lenders, increasing adverse selection and default risk.

Financial Management Theory

Emphasizes budgeting and cash flow control in enhancing repayment capacity.

Moral Hazard Theory

Explains borrower misbehaviours after loan disbursement, including diversion.

Liquidity Theory

Highlights importance of cash flow timing in meeting obligations.

CONCEPTUAL FRAMEWORK

Loan default (dependent variable) is influenced by:

- Economic factors
- Business-related factors
- Financial management practices
- Loan diversion

Moderating variables include financial literacy, loan terms, and lender monitoring.

RESEARCH METHODOLOGY

Research Method and Design

Research methodology refers to the systematic approach guiding data collection, analysis, and interpretation *(Hassan, 2022).* Broadly, research methods can be categorized into quantitative, qualitative, and mixed methods. Quantitative research emphasizes numerical data analysis to describe trends and relationships, whereas qualitative research examines social processes and perceptions. Mixed methods combine both approaches to gain deeper insights.

This study employed a quantitative approach to examine the prevalence, determinants, and impacts of loan default among SMEs. A descriptive research design was applied to capture current conditions and trends concerning loan repayment behavior. The descriptive design is appropriate because it allows the researcher to systematically describe the phenomena under study while evaluating relationships among variables, such as economic factors, financial management practices, and loan diversion.

Research Setting

The study was conducted at NEEF Area 3 Office and Tsoka Market, Lilongwe. Tsoka Market was selected due to its high concentration of SMEs spanning multiple sectors, including retail, hospitality, and services. Its proximity to financial institutions, particularly NEEF, made it ideal for analyzing interactions between lenders and SMEs regarding loan management and repayment performance. The setting ensured convenience, relevance, and accessibility for the data collection process.

Study Population

The target population comprises all SME owners and operators in Tsoka Market, Area 3, as well as loan officers at NEEF who oversee SME financing. According to Barnabee, the target population is defined as the group from which data is collected and

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conclusions are drawn.

In this study, the population included approximately 250 SME owners, covering vendors, retailers, restaurants, and small-scale service providers. These individuals provided relevant data on loan management practices, repayment behaviours, and factors contributing to default.

Sampling Method

Sampling refers to the process of selecting a subset of the population to represent the whole *(Assignment, 2022).* This study employed a combination of probability and non-probability sampling techniques:

- Simple Random Sampling was used to select SME owners to ensure every individual had an equal chance of participation, minimizing selection bias.
- Purposive Sampling, a non-probability technique, was used to identify key informants such as loan officers and experienced SME owners who could provide in-depth information on loan processes and repayment challenges.

The combination of these methods ensured representation while also including knowledgeable participants critical to addressing the research objectives.

Sample Size

The sample size refers to the number of respondents participating in the study *(Work, 2008).* Based on a target population of 250, a sample of 50 respondents was selected, representing 20% of the population. This proportion is consistent with recommendations for survey research *(Gay, Mills, & Airasian, 2012*) and is sufficient to provide reliable and generalizable findings within the context of the study.

Research Instrument

The study utilized a structured questionnaire as the primary data collection instrument. Questionnaires were designed to capture information on loan default prevalence, economic and business-related determinants, financial management practices, and loan diversion. The questionnaire ensured uniformity in data collection and facilitated quantitative analysis.

Data Collection Procedure:

Both primary and secondary data were used. Primary data were obtained directly from respondents using the structured questionnaire. Secondary data were collected through reviewing books, journals, policy documents, and prior studies relevant to SME loan repayment and financial management *(Kothari, 2006).* This dual approach enriched the study's depth and validity.

Pilot Study

A pilot study was conducted with seven participants to test the clarity, reliability, and validity of the research instrument *(Tracy Payne, 2021).* The pilot helped identify ambiguous questions, refine wording, and ensure respondents understood all items. Adjustments made following the pilot enhanced the reliability of the data collection instrument and reduced potential biases during the main study.

Data Analysis

Data analysis involved the systematic examination of collected information to derive meaningful insights *(Hassan, 2022).*

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Quantitative data were processed and analyzed using Microsoft Excel, employing descriptive statistics such as frequencies, percentages, and tabular presentations. Graphs and charts were used to visually illustrate patterns in loan default prevalence, contributing factors, and financial management practices. The analysis was aligned with the research objectives, allowing conclusions to be drawn regarding the determinants and implications of loan default.

ETHICAL CONSIDERATIONS

Confidentiality

Respondent identities were anonymized, and all data were used strictly for academic purposes. Sensitive information was handled with care to maintain privacy.

Prevention of Harm

The research was conducted to avoid social, psychological, or physical harm to participants. Participation was voluntary, and respondents could withdraw at any time without penalty.

Accurate Reporting

Findings were reported truthfully and without distortion. Data analysis and presentation were conducted objectively to maintain research integrity.

RESEARCH FINDINGS

Demographic Characteristics of Respondents

The study revealed that men (59%) dominate SME ownership in Tsoka Market, while women constitute 37% of operators. Regarding education, the majority of respondents have relatively low formal qualifications: 20% had a Junior Certificate, 29% an MSCE, 30% a diploma, and 17% a degree. This is consistent with literature indicating that lower education levels may hinder financial management capabilities among SME operators. Age distribution showed that 41% of respondents were between 18–30 years, suggesting that SMEs in the area are largely driven by young entrepreneurs. SMEs operate across diverse sectors, with retail (30%) and services (24%) predominating, followed by agriculture, manufacturing, wholesale, and other industries. Most SMEs (28%) had been in operation for one to three years, indicating a mix of established and newer businesses. The study also explored respondents' experience with loans. Most SME owners (58%) had obtained loans, highlighting reliance on external financing. NEEF respondents represented a range of roles in loan management, including loan officers, credit officers, branch managers, and recovery officers, with the majority possessing significant experience, ensuring credible insights into loan default issues.

Implications of Loan Default on SMEs and Financial Institutions

Loan defaults were found to negatively affect financial institutions by reducing profitability, increasing operational and recovery costs, and limiting lending capacity to other clients. Higher default rates prompted tighter lending requirements, increased staff workload, constrained cash flow and liquidity, and necessitated stricter monitoring of borrowers. Furthermore, defaults harmed institutional reputation and contributed to increased non-performing loan ratios. These findings corroborate literature emphasizing that non-performing loans pose a substantial risk to institutional stability and revenue generation.

Economic and Business-Related Factors Contributing to Loan Default

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SMEs identified several key factors contributing to loan default. High interest rates were seen as a significant barrier to timely repayment, as were market fluctuations and low sales volumes, which reduce cash inflows. Short repayment periods, inflation, and inadequate understanding of loan terms further exacerbated repayment challenges. These findings align with studies highlighting the vulnerability of SMEs to macroeconomic and market conditions and the importance of clear loan terms for repayment performance.

Financial Management Practices and Loan Repayment

Financial management practices significantly influenced repayment performance. While some SMEs maintained accurate financial records, prepared budgets, separated personal and business finances, and received financial management training, a sizable proportion did not. Poor financial planning and cash flow problems were commonly reported, increasing the risk of loan default. These results underscore the critical role of effective financial management and literacy in enabling SMEs to meet their financial obligations.

Loan Default Prevalence and Consequences

Loan defaults among SMEs were found to restrict access to future loans, prompt lenders to increase lending conditions, and result in penalties or extra charges. Defaults also led to reductions in loan amounts and heightened monitoring by financial institutions, limiting SMEs' growth potential.

Loan Diversion as a Cause of Default

Loan diversion emerged as a significant contributor to repayment challenges. SMEs reported using loan funds for purposes other than intended due to emergencies or inadequate monitoring by lenders. Such practices hindered their ability to honor repayment commitments, demonstrating that productive and monitored use of loans is essential for reducing default risk.

SUMMARY OF RESEARCH FINDINGS

The study explored five main objectives: analyzing the implications of loan defaults on SMEs and financial institutions, identifying key economic and business-related contributors to default, examining the influence of financial management practices on repayment, assessing the prevalence of loan default, and evaluating the role of loan diversion in repayment challenges.

Regarding the implications for financial institutions, respondents indicated that loan defaults reduce institutional profitability, increase operational and recovery costs, and limit the capacity to provide loans to other clients. Defaults were also associated with stricter lending conditions, increased workloads for credit and recovery officers, decreased cash flow and liquidity, intensified monitoring requirements, reputational damage, and a rise in non-performing loan ratios. Collectively, these findings underscore the significant strain loan defaults place on lending institutions.

Economic and business-related factors were identified as major contributors to SME loan default. High interest rates, market fluctuations, low sales volumes, short repayment periods, inflation, and inadequate comprehension of loan terms were all cited as challenges that impede timely repayment. These factors illustrate the vulnerability of SMEs to both macroeconomic pressures and internal business constraints.

The study further highlighted the role of financial management practices in repayment performance. Accurate financial record-keeping, budgeting and spending control,

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separation of personal and business finances, sound financial planning, effective cash flow management, and access to financial management training were shown to improve repayment outcomes. Conversely, deficiencies in these areas exacerbate repayment difficulties.

The prevalence of loan default among SMEs was evident in responses indicating that defaults limit access to future credit, prompt lenders to impose stricter conditions, incur penalties, reduce loan amounts, and trigger heightened monitoring. These findings demonstrate the cyclical impact of default on SME financial stability and access to financing.

Loan diversion was also found to be a significant contributor to repayment challenges. Respondents acknowledged that misappropriation of loans, whether due to using funds for unintended purposes, business emergencies, or inadequate lender monitoring, reduces repayment capacity and undermines the intended use of borrowed funds.

CONCLUSION OF THE STUDY

The study concludes that loan defaults among SMEs in Lilongwe result from a combination of economic pressures, financial management deficiencies, and loan diversion. High interest rates, volatile markets, low sales, short repayment terms, and inflation hinder repayment capacity, while poor financial practices—including weak record-keeping, inadequate budgeting, mixed personal and business finances, poor cash flow management, and lack of training—further exacerbate the problem. Loan diversion, often stemming from emergencies or insufficient oversight, further impairs repayment.

Loan defaults also adversely affect financial institutions by reducing profitability, increasing operational costs, limiting lending capacity, imposing stricter lending requirements, increasing staff workloads, and negatively impacting cash flow, liquidity, reputation, and non-performing loan ratios. The findings suggest that improved financial literacy, prudent use of loans, and effective monitoring can help mitigate defaults, strengthen repayment performance, and promote institutional stability and SME growth.

RECOMMENDATIONS

Based on the findings, the study recommends several interventions to reduce loan defaults and improve repayment outcomes:

- SME Financial Management Training: Development agencies and financial institutions should provide comprehensive training in accounting, budgeting, cash flow management, and the separation of personal and business finances to enhance repayment capacity and financial literacy.
- Enhanced Loan Repayment Tracking: Financial institutions, including NEEF, should monitor the utilization and repayment patterns of SME loans, identifying early warning signs to prevent misappropriation and default.
- Tailored Loan Terms and Support: Repayment schedules and loan terms should align with SME business cycles and cash flow patterns, providing flexibility that enhances the likelihood of timely repayment.
- Awareness of Loan Terms: Borrowers should be fully informed of loan conditions to prevent misunderstandings and unintentional defaults.
- Encouraging Proper Loan Utilization: SMEs should use loans for their intended purposes, supported by institutional guidance and oversight to reduce diversion and improve

productive use of funds.

AREAS FOR FURTHER STUDY

The study identifies several areas for future research: investigating methods to reduce SME loan defaults through behavioral, financial, and institutional interventions; exploring the role of online financial tools and monitoring systems in improving repayment; assessing the impact of loan defaults on SME growth in Malawi; and further evaluating the effect of loan diversion on repayment performance.

In conclusion, addressing loan default among SMEs requires a multifaceted approach combining improved financial management practices, prudent borrowing, effective oversight, and targeted institutional support to promote repayment, institutional stability, and SME growth.

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