

Title

**THE ROLE OF CREDIT RISK MANAGEMENT ON THE FINANCIAL
PERFORMANCE OF MICROFINANCE INSTITUTIONS IN LILONGWE: A CASE
STUDY OF SELECTED MICROFINANCE INSTITUTIONS IN MALAWI**

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ABSTRACT

This comprehensive study thoroughly examined the critical role that effective credit risk management plays in shaping and enhancing the financial performance of Microfinance Institutions (MFIs) operating in Lilongwe, Malawi. In a country where high unemployment rates and widespread poverty make small businesses and entrepreneurship the primary pathway to economic stability and household survival, MFIs serve as essential lifelines by delivering accessible savings, credit, insurance, and other vital financial services to low-income individuals and micro-enterprises that are often excluded from traditional banking systems. Credit risk emerges as one of the most pressing and persistent challenges facing these institutions, directly causing reduced profitability through mounting non-performing loans, increased provisioning requirements that strain capital reserves, elevated operating expenses linked to aggressive debt collection, diminished asset quality, and weakened overall capital adequacy that threatens long-term institutional sustainability. By deeply analysing how robust credit risk management practices can mitigate these negative impacts, the research provides actionable insights that enable MFIs such as Eldridge Finance Limited, NEEF, FINCA, and SACCOs to adopt proactive strategies, strengthen their financial positions, and continue supporting poverty reduction and economic growth across Malawi.

The study adopted a well-balanced mixed-methods research design that combined quantitative surveys with in-depth qualitative interviews to capture both measurable statistical relationships and rich contextual experiences from key personnel including managers, risk officers, and loan officers across the seven registered MFIs in

Lilongwe. Data were meticulously collected through structured questionnaires administered to 60 respondents, achieving an impressive 71.1% response rate with 42 fully completed returns, supplemented by open-ended responses and expert insights that revealed real-world practices. Key findings demonstrated overwhelmingly strong positive perceptions: 95.3% of respondents strongly agreed or agreed that effective credit risk management is crucial for superior financial performance, while 85.7% confirmed a significant direct relationship between sound credit risk practices and improved profitability, return on assets, and portfolio stability. Practical techniques such as thorough pre-loan credit assessments (92.9% agreement), regular policy reviews and updates (83.4%), use of CRM software (61.9%), collateral valuation, KYC due diligence, credit scoring models, group lending with peer monitoring, IFRS 9-compliant impairment provisioning, and continuous portfolio stress testing were identified as highly effective in reducing non-performing loans, minimising loan loss provisions, and enhancing capital adequacy. Major challenges highlighted included inadequate collateral valuation (78.6%), external economic pressures like runaway inflation and currency depreciation (76.2%), high loan default rates linked to seasonal agricultural cash flows and limited borrower financial literacy (73.5%), poor technology infrastructure (71.5%), and difficulties in remote client follow-up. Qualitative narratives from institutions such as NEEF, Eldridge Finance, SACCOs, and FINCA richly illustrated successful strategies ranging from rigorous business plan evaluations and dynamic risk monitoring to personalised restructuring, financial literacy training, and early-warning systems that collectively strengthen repayment discipline and portfolio resilience.

The study firmly concludes that superior credit risk management is not merely a defensive tool but a powerful strategic driver that directly boosts financial performance, investor confidence, regulatory compliance, and the ability of MFIs to safely expand lending to SMEs and low-income clients. It urgently recommends immediate adoption of integrated frameworks that combine advanced credit scoring, regular policy updates, staff training, digital tools, and collaborative partnerships with the Reserve Bank of Malawi and credit bureaus. By implementing these enhanced practices, MFIs can dramatically reduce defaults, improve profitability, maintain healthy capital positions, and continue playing their vital role in Malawi's fight against poverty and economic instability. The research contributes valuable empirical evidence and a practical conceptual framework complete with six tested hypotheses that future scholars and practitioners can build upon for even broader impact across the region.

KEYWORDS: Credit risk management, financial performance, microfinance institutions, non-performing loans, loan loss provisions, collateral valuation, IFRS 9, Lilongwe, Malawi, portfolio quality, poverty reduction

INTRODUCTION

In the present economic reality of Malawi, where persistently high unemployment rates combine with widespread poverty to leave millions of citizens struggling for survival, small businesses and entrepreneurship have become the most realistic and accessible pathway for ordinary people to achieve financial independence, household stability, and meaningful economic progress. Microfinance institutions stand at the

forefront of this effort, delivering essential financial services including micro-loans, savings products, and insurance to low-income entrepreneurs and small businesses that traditional commercial banks often overlook or reject due to perceived high risk and lack of collateral. Yet these very institutions face a formidable and ongoing threat in the form of credit risk, which arises when borrowers fail to repay loans on time or at all, leading to cascading negative consequences such as sharply reduced profitability, forced increases in loan-loss provisioning that erode capital reserves, higher administrative and collection costs, deteriorating asset quality across entire loan portfolios, and critically weakened capital adequacy ratios that can jeopardise the very survival and regulatory standing of the MFIs themselves. This study was therefore deliberately designed to provide a detailed, evidence-based understanding of how well-managed credit risk practices can transform these challenges into opportunities, enabling selected MFIs in Lilongwe to achieve stronger, more sustainable, and more resilient financial performance while continuing to serve the most vulnerable segments of Malawian society.

BACKGROUND OF THE STUDY

Microfinance institutions have truly transformed the global landscape of financial inclusion by pioneering innovative ways for low-income individuals, women entrepreneurs, rural farmers, and urban micro-business owners to access previously unavailable financial tools such as group loans, flexible savings accounts, micro-insurance, and business development training. Across developing nations including Malawi, these institutions have proven instrumental in breaking cycles of poverty, empowering marginalised

communities, and stimulating grassroots economic activity where conventional banks cannot or will not reach. In the specific Malawian context, MFIs operate under the regulatory oversight of the Reserve Bank of Malawi and have grown into a vibrant sector that serves thousands of clients daily through both urban hubs like Lilongwe and remote rural areas. Institutions such as Eldridge Finance Limited, the National Empowerment Fund (NEEF), FINCA, and various Savings and Credit Cooperatives (SACCOs) exemplify this success by offering tailored products that help clients start vegetable stalls, expand tailoring businesses, purchase farm inputs, or launch small retail shops. However, the same economic pressures that make microfinance necessary — escalating inflation, food shortages, currency depreciation, and unpredictable seasonal cash flows in agriculture — also amplify credit risk exposure, making effective risk management not just desirable but absolutely essential for the continued health and expansion of the entire sector.

PROBLEM STATEMENT

Recent alarming reports, including The Africa Report article by *Gregory Gondwe* published on 22 February 2023, have highlighted a rapidly worsening situation in which an increasing proportion of Malawians are finding it extremely difficult to service their microfinance debts amid the country's severe and ongoing economic downturn. Small businesses have been particularly devastated by runaway inflation, persistent food shortages, and a sharply depreciating Malawian Kwacha that together inflate input costs while shrinking customer spending power. A poignant real-life example is *Sarah Mwanza*, a determined small business owner in Lilongwe who

borrowed 200,000 Malawian Kwacha to launch her vegetable stand only to find herself now owing more than 500,000 Kwacha due to compounding interest and collection pressures. *Dr Wilson Banda*, Governor of the Reserve Bank of Malawi, has publicly expressed deep concern, noting that non-performing loans across the broader banking sector have surged to 6.1%, well above the critical 5% threshold that signals systemic risk to financial stability. In just one recent month, the central bank received 127 formal complaints about predatory lending practices ranging from exorbitant interest rates and hidden fees to aggressive and sometimes intimidating collection tactics. One documented case involved a farmer who unknowingly took three simultaneous loans from different MFIs, each unaware of the others, resulting in an unmanageable debt spiral. These interconnected problems — high default rates, multiple borrowing, weak credit information systems, inadequate collateral valuation, and limited borrower financial literacy — threaten not only individual MFIs but the entire microfinance ecosystem's ability to support economic recovery and poverty alleviation in Malawi. This study therefore sets out to rigorously investigate and provide practical solutions for these pressing issues by focusing specifically on credit risk management practices and their direct influence on the financial health of Lilongwe-based MFIs.

RESEARCH OBJECTIVES

The main objective of this research was to determine the overall role and measurable impact of credit risk management practices on the financial performance of microfinance institutions operating in Lilongwe. In support of this central goal, the study pursued several carefully defined

specific objectives: first, to examine in depth the precise nature and strength of the relationship that exists between effective credit risk management strategies and the key indicators of financial performance such as profitability, return on assets, capital adequacy, and portfolio quality among MFIs in Lilongwe; second, to identify and comprehensively describe the most effective and proven credit risk management practices currently being used or recommended that can reliably improve financial performance, including tools like credit scoring models, collateral valuation techniques, regular policy reviews, KYC processes, and IFRS 9-compliant provisioning; and third, to thoroughly investigate and analyse the wide range of internal and external challenges that MFIs encounter when attempting to implement and sustain these effective credit risk management practices in the challenging Malawian economic environment.

RESEARCH QUESTIONS

- What is the actual strength and direction of the relationship between well-implemented credit risk management practices and the overall financial performance of microfinance institutions in Lilongwe?
- Which specific credit risk management practices have proven most effective at improving key performance metrics such as reduced non-performing loans, lower provisioning costs, and enhanced capital adequacy within these institutions?
- What are the most significant and recurring challenges — both internal and external — that microfinance institutions in Lilongwe face when

trying to put effective credit risk management systems into practice, and how can these barriers be realistically overcome?

LITERATURE REVIEW

A thorough and detailed review of existing scholarly and empirical literature clearly establishes that credit risk remains one of the most influential factors determining the success or failure of financial institutions worldwide, particularly microfinance providers serving high-risk, low-collateral client bases. Risk in general is understood as the possibility of loss, injury, or other adverse outcomes arising from uncertainty (*Koller, 2013; Jorion, 2007*), while credit risk specifically refers to the potential financial loss when a borrower defaults on obligations (*Saunders & Allen, 2010; Merton, 1974*). Microfinance institutions are defined as specialised entities that deliver accessible financial services to the unbanked poor (*Yunus, 2003*), and credit risk management encompasses the systematic processes of identification, assessment, mitigation, monitoring, and control of these risks (*Bessis, 2015*). Empirical studies from Europe, North America, Australia, Greece, Sweden, and Pakistan consistently demonstrate negative relationships between high credit risk exposure and bank profitability, with non-performing loans and poor capital adequacy directly eroding returns on equity. In developing-country contexts, additional barriers such as absent or incomplete credit bureaus, weak collateral systems, and information asymmetry exacerbate these issues, yet targeted practices like robust KYC, credit scoring, group lending, and regular stress testing have been shown to produce measurable improvements in loan performance and institutional stability. This study bridges

important gaps by focusing specifically on the Lilongwe microfinance setting and by testing six practical hypotheses linking credit risk management components to financial outcomes.

RESEARCH METHODOLOGY

The research employed a robust mixed-methods design that integrated quantitative statistical analysis with rich qualitative insights to ensure both breadth and depth of understanding. The study was conducted exclusively in Lilongwe, targeting all seven registered MFIs operating in the city as the full population, given the manageable size. A total of 60 questionnaires were distributed to key personnel (managers, risk officers, financial officers, and loan officers), yielding 42 completed responses for a strong 71.1% response rate. Instruments included a detailed Likert-scale questionnaire for measuring perceptions and practices plus a semi-structured interview guide for capturing nuanced experiences. A small pilot with five institutions confirmed instrument reliability before full rollout. Data analysis combined descriptive statistics, inferential testing of hypotheses, and thematic coding of open-ended responses using SPSS and manual pattern identification, all while strictly observing ethical standards of informed consent, confidentiality, and voluntary participation.

RESULTS AND DISCUSSION

The findings painted a clear and overwhelmingly positive picture of the value of credit risk management. An impressive 95.3% of respondents agreed or strongly agreed that effective practices are crucial for financial success, while 85.7% confirmed a direct and significant positive relationship

with performance indicators and 95.2% noted improved financial stability. Core effective practices that received exceptionally high endorsement included thorough credit assessments during loan approval (92.9%), regular policy reviews (83.4%), and adoption of CRM software (61.9%), alongside training, collateral checks, and IFRS 9 provisioning. Challenges ranked highest were inadequate collateral valuation (78.6%), external inflation pressures (76.2%), and high default rates tied to seasonal cash flows and borrower skill gaps (73.5%). Qualitative responses richly illustrated real practices: NEEF uses detailed business plan evaluations and ongoing monitoring; Eldridge Finance emphasises strict KYC and compliance screening; SACCOs apply credit-scoring models integrated with bureau data; and FINCA follows three-stage IFRS 9 impairment with risk-based pricing and stress testing. Respondents described addressing defaults through reminders, restructuring, guarantor engagement, and legal recovery, while noting that strong CRM has reduced losses, boosted Sharpe ratios, improved investor confidence, strengthened compliance, and enabled safer SME lending.

CONCLUSION

This research has convincingly demonstrated that well-executed credit risk management is a powerful and indispensable driver of superior financial performance among microfinance institutions in Lilongwe. By reducing defaults, optimising provisioning, enhancing portfolio quality, and building stakeholder trust, these practices allow MFIs to operate more profitably, sustainably, and impactfully in support of Malawi's development goals. The study therefore calls for urgent, coordinated

action to embed the identified best practices across the sector.

RECOMMENDATIONS

Microfinance institutions should immediately strengthen credit assessment procedures, adopt digital CRM and scoring tools, conduct regular policy updates and staff training, improve collateral valuation systems, and partner with regulators and credit bureaus for better information sharing. Policymakers are urged to support financial literacy programmes for borrowers, enforce responsible lending guidelines, and invest in national credit infrastructure. Development partners can fund pilot implementations of integrated risk frameworks, while institutions themselves should prioritise continuous portfolio stress testing and proactive default management strategies to safeguard both their financial health and their mission of inclusive growth.

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