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Shadow Finance and Small and Medium Scale Enterprises in Cross River State

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Abstract

The study investigated the impact of shadow finance on small and medium-scale enterprises in Cross River State. The specific objectives included examining the effects of Esusu, moneylenders, fintech loan apps, and cooperative societies on small- and medium-scale enterprises in Cross River State. A survey research design was employed, with data obtained from primary sources. The study population comprised 200 SMEs in Calabar, Ikom, and Ogoja, using a structured questionnaire. Data were analyzed using descriptive statistics and multiple regression analysis to determine the relationship between shadow finance indicators and SME development. Based on these results, shadow finance significantly improves SME access to capital and supports short-term business operations. Esusu and cooperative lending had a positive impact on sales growth. The study recommended that the Central Bank of Nigeria should enforce stricter regulation of digital lenders and promote lower-interest credit facilities through the Bank of Industry. SMEs should also adopt financial literacy and formal registration to qualify for institutional funding.

Keywords: Shadow finance, SME development, informal credit, Fintech lending, Esusu, money lenders, fintech loan Apps, Cooperative societies

Introduction

The role of shadow finance is even more pronounced due to the predominance of small-scale trading, agro-based businesses, and service-oriented enterprises that require short-term working capital. These enterprises often operate in unstable economic environments where immediate access to cash determines business continuity. Consequently, informal financial systems provide a critical lifeline by enabling SMEs to manage liquidity, stock inventory, and respond to market demands. Empirical studies have also demonstrated that informal financing mechanisms such as ROSCAs significantly enhance SME performance by improving access to quick, collateral-free credit. However, while shadow finance plays a crucial supportive role, it also presents significant structural limitations. Informal financial systems are often characterized by high implicit interest rates, limited capital capacity, weak legal enforcement mechanisms, and exposure to exploitation. Moreover, reliance on shadow finance may trap SMEs in cycles of short-term borrowing, limiting their ability to transition into formal credit systems or achieve sustainable expansion. In addition, lack of regulatory oversight exposes borrowers to financial risks such as fraud, default by group members, and inconsistent lending practices.

Discussions on SME financing in Nigeria further emphasize that although alternative financing channels such as shadow banking and fintech-driven informal credit systems have expanded financial inclusion, they still do not fully address the long-term financing needs of SMEs. Overall, the interaction between shadow finance and SMEs in Cross River State reflects a dual financial reality: on one hand, it provides essential survival funding for enterprises excluded from formal credit markets; on the other hand, it imposes structural constraints that may limit long-term growth and formalization. Understanding this relationship is therefore critical for policy formulation aimed at improving financial inclusion, strengthening SME resilience, and promoting sustainable economic development in Cross River State and Nigeria at large.

Small and Medium Scale Enterprises (SMEs) are widely recognized as the backbone of developing economies due to their contributions to employment creation, income generation, poverty reduction, and local industrial development. In Nigeria, SMEs account for a significant proportion of business activities and are central to economic diversification efforts, particularly in non-oil sectors such as agriculture, trade, transportation, and services. In Cross River State, SMEs play an especially important role in sustaining household incomes and stimulating grassroots economic activities, particularly in semi-urban and rural communities such as Calabar, Ikom, Ogoja, and Obudu. Despite their importance, SMEs in Nigeria continue to face persistent financial constraints that limit their growth and survival. One of the most critical challenges is inadequate access to formal financial services. Commercial banks and other regulated financial institutions often perceive SMEs as high-risk borrowers due to limited collateral, weak financial documentation, and inconsistent cash flow records. Consequently, many SMEs are either denied credit or subjected to unfavourable lending conditions such as high interest rates and strict repayment terms (Anokwuru & Wike, 2021; Olalekan & Adenle, 2021).

In response to these financial exclusion challenges, SMEs in Cross River State and across Nigeria have increasingly turned to shadow finance, which refers to informal and semi-formal financial systems operating outside the direct regulation of the Central Bank and formal banking institutions. Shadow finance includes cooperative societies, rotating savings and credit associations (ROSCAs), daily contribution systems ("ajo" or "esusu"), money lenders, trade credit arrangements, and emerging informal digital lending platforms. These systems are characterized by flexibility, trust-based relationships, minimal documentation requirements, and rapid disbursement of funds, making them attractive to SMEs that are excluded from formal credit markets. The growing reliance on shadow finance is strongly linked to structural inefficiencies within the formal financial system. Studies have shown that SMEs in developing countries, including Nigeria, often face financial exclusion due to stringent collateral demands, perceived credit risk, and high transaction costs imposed by banks. As a result, informal financing channels have become an essential alternative for business survival, particularly for micro and small enterprises operating in environments with weak financial infrastructure. Research further indicates that a large proportion of MSMEs in Nigeria depend on informal financial sources such as cooperative societies and ROSCAs, especially in rural and semi-urban areas where formal banking penetration is low.

Theoretical framework

This study draws primarily from financial intermediation theory

Financial Intermediation theory

The Financial Intermediation Theory is one of the most important frameworks in financial economics used to explain how financial resources are mobilized and allocated within an economy. The theory was originally propounded by Gurley and Shaw (1960), who argued that financial intermediaries emerge because direct interaction between savers and borrowers is inefficient due to high transaction costs, imperfect information, and uncertainty in financial markets. According to their proposition, financial institutions such as banks, microfinance institutions, and credit unions serve as essential conduits that mobilize surplus funds from savers and channel them to deficit units in the economy for productive investment purposes. This function is critical in promoting capital formation and stimulating economic development, particularly in developing economies where financial markets are often underdeveloped and fragmented (Ejinkonye *et al.,* 2024).

The theory was significantly strengthened by Diamond (1984) through his influential concept of delegated monitoring, which explains the monitoring role of financial intermediaries in credit markets. Diamond (1984) argued that individual savers lack both the expertise and incentives to monitor borrowers effectively after lending their funds, which leads to problems such as moral hazard and adverse selection. Financial intermediaries resolve this challenge by acting as delegated monitors, thereby reducing monitoring costs and improving credit discipline. By pooling deposits and diversifying loan portfolios, banks are able to spread risk and enhance the efficiency of financial intermediation. Recent literature continues to affirm that delegated monitoring remains a core mechanism through which financial institutions reduce information asymmetry and improve financial system stability (Akeju, 2022; Bojuwon *et al.,* 2023).

Further advancement of the theory was provided by Boyd and Prescott (1986), who emphasized the role of financial intermediaries in reducing information acquisition and screening costs. They posited that intermediaries are more efficient than individual lenders in collecting, processing, and interpreting information about borrowers. This informational advantage allows them to allocate credit more efficiently, reduce default risk, and improve investment outcomes. Modern empirical studies continue to support this view, showing that financial intermediaries significantly enhance financial deepening and economic growth by improving access to credit and reducing inefficiencies in capital allocation (Afolabi, 2022; Ejinkonye *et al.,* 2024). In contemporary financial literature, the Financial Intermediation Theory has been extended to include broader macroeconomic and developmental dimensions. For instance, studies have shown that financial intermediation contributes to financial inclusion, investment expansion, and improved economic resilience, particularly in developing countries like Nigeria (Bojuwon *et al.,* 2023; Akeju, 2022). However, despite its importance, the effectiveness of financial intermediaries in many developing economies is constrained by structural inefficiencies such as weak regulatory frameworks, limited outreach of formal banking services, and high cost of credit. These limitations often result in financial exclusion of micro, small, and medium enterprises (MSMEs), which are considered high-risk borrowers by commercial banks (Afolabi, 2022; Anthony-Orji *et al.,* 2022).

Literature Review

In the context of SMEs in Nigeria and specifically Cross River State, the Financial Intermediation Theory provides a strong explanation for the persistent financing gap experienced by small businesses. Although financial intermediaries are expected to facilitate efficient allocation of credit, many SMEs are excluded from formal financial systems due to lack of collateral, inadequate financial records, and perceived credit risk. As a result, banks often prefer lending to large, established firms with stable cash flows, thereby limiting SME access to formal credit markets (Bojuwon *et al.,* 2023; Ejinkonye *et al.,* 2024). This structural exclusion significantly constrains SME growth, innovation, and sustainability. Consequently, SMEs in Cross River State increasingly depend on shadow finance systems, which emerge as alternative financial intermediaries outside the formal banking structure. These include cooperative societies, rotating savings and credit associations (ROSCAs), informal thrift collectors, money lenders, and trade credit arrangements. From the perspective of Financial Intermediation Theory, these informal systems can be understood as substitute intermediation mechanisms that arise when formal financial institutions fail to adequately serve certain segments of the economy. Recent studies confirm that informal financial systems play a significant role in sustaining SME operations in Nigeria, especially in rural and semi-urban areas where access to formal banking services remains limited (Ubah et al., 2023; Bojuwon et al., 2023).

However, while shadow finance improves short-term liquidity and enhances business survival, it does not fully replicate the efficiency, stability, and scalability of formal financial intermediation. Informal systems are often characterized by limited capital base, absence of regulatory oversight, high implicit interest rates, and reliance on social trust rather than formal contracts. Empirical evidence suggests that although informal finance increases access to funds, it may also trap SMEs in cycles of short-term borrowing, thereby limiting long-term capital accumulation and formal sector integration (Afolabi, 2022; Ejinkonye et al., 2024). Financial Intermediation Theory remains highly relevant in explaining both formal financial systems and the emergence of shadow finance in developing economies. Recent empirical literature (2020–2024) further reinforces its applicability by demonstrating how financial intermediation influences SME financing behavior, financial inclusion, and economic development. In Cross River State, the theory provides a clear lens for understanding why SMEs rely heavily on shadow finance due to inefficiencies in formal credit markets, while also highlighting the policy need for improved financial inclusion and strengthened intermediation structures to support sustainable enterprise growth.

Empirical Literature

Ogar, *et al.,* (2023) conducted an empirical study titled Shadow Banking and Micro-, Small and Medium Scale Enterprises: A Municipal Assessment in Nigeria. The study examined the extent to which shadow banking activities influence the performance and sustainability of MSMEs in Nigeria using municipal-level data. The researchers employed quantitative techniques and discovered that shadow banking significantly improved enterprise financing, liquidity management, and operational continuity among SMEs. Their findings revealed that many SMEs depended heavily on informal financing channels because conventional banks were unable to satisfy their credit demands. The study further established that shadow finance enhanced business expansion, job creation, and productive activities among SMEs operating in financially excluded regions. The researchers concluded that shadow banking serves as an alternative financial intermediation mechanism capable of supporting entrepreneurship and local economic development in Nigeria. This study is particularly relevant to Cross River State where many SMEs experience difficulties obtaining formal bank loans because of poor collateral capacity and inadequate financial documentation.

Similarly, Mohammed, *et al.,* (2025) investigated the implications of alternative financing channels on the growth of Micro, Small, and Medium Enterprises in Nigeria. The study adopted a mixed-methods approach to compare the effectiveness of formal banking institutions with alternative financing systems. Findings from the study revealed that alternative financing channels such as cooperative societies, fintech lenders, microfinance institutions, and informal savings groups significantly enhanced SME growth and financial sustainability. The researchers observed that many SMEs preferred shadow financing systems because of their accessibility, flexibility, lower transaction costs, and faster loan processing mechanisms. The study further revealed that alternative financing improved business resilience, especially during periods of economic instability and inflationary pressure in Nigeria. The authors concluded that shadow finance has become indispensable for SMEs due to the persistent inefficiencies of the formal financial sector. This finding strongly aligns with the realities in Cross River State where many SMEs rely on informal and semi-formal financing arrangements to sustain daily business operations.

In another related study, Oyewale and Alabi (2024) examined financial inclusion as a tool for enhancing SME performance in Osun State, Nigeria. Although the study focused broadly on financial inclusion, its findings have direct relevance to shadow finance because many financial inclusion initiatives involve non-traditional financing mechanisms outside the conventional banking structure. Using survey research design and regression analysis, the researchers found that access to alternative financial services significantly influenced SME profitability, growth, and operational efficiency. The study showed that SMEs with access to mobile finance systems, cooperative funding, and digital lending platforms demonstrated higher survival rates and better market competitiveness than enterprises relying solely on commercial banks. The researchers concluded that inclusive financial systems and alternative financing structures contribute substantially to SME development in Nigeria. This empirical evidence suggests that expanding shadow financial systems in Cross River State could improve the performance and sustainability of SMEs across the state.

A study conducted by Ajemunigbohun and Ipigansi (2023) on risk financing techniques and SME performance in Nigeria also provides important empirical insight into alternative financing systems. The study assessed the influence of financial risk management and non-traditional financing techniques on SME performance using cross-sectional survey data from Lagos State. Findings from the study revealed that SMEs utilizing alternative financing arrangements experienced improved business stability, enhanced liquidity management, and greater resilience against economic uncertainties. The study further noted that flexible financing systems enabled SMEs to manage operational risks more effectively compared to enterprises dependent solely on formal bank credit. The researchers argued that alternative financing systems have become essential because many traditional financial institutions perceive SMEs as high-risk borrowers. The implication of this finding is that shadow finance can improve business continuity and organizational survival among SMEs in Cross River State where economic volatility and inadequate institutional support continue to affect enterprise growth.

Emerah and Oyedele (2023) investigated the determinants of venture capital financing among SMEs in Nigeria. The study established that venture capital and private equity financing significantly influenced SME growth and expansion. The researchers discovered that SMEs receiving venture capital support recorded higher productivity levels, stronger innovation capacity, and increased market competitiveness. The study also revealed that venture capital financing provided SMEs with managerial guidance and strategic support beyond mere financial assistance. However, the researchers noted that limited awareness and weak institutional frameworks constrained the accessibility of venture capital financing for many SMEs in Nigeria. Despite these limitations, the study concluded that alternative financing systems remain crucial for enterprise development in emerging economies. This finding is highly relevant to SMEs in Cross River State where limited access to conventional financing often compels businesses to depend on informal investors and alternative funding arrangements.

Aminu and Manko (2024) examined the impact of non-financial services provided by Deposit Money Banks on SME development in Nigeria. Although the study focused primarily on support services, the researchers found a strong relationship between access to advisory services, financial literacy support, alternative financing mechanisms, and SME growth. The study revealed that many SMEs benefitted more from flexible financing support systems and business advisory arrangements than from conventional loan facilities. The researchers concluded that financial innovation and non-conventional financing mechanisms significantly improve SME sustainability and growth potential. This finding supports the argument that shadow finance provides more adaptable and entrepreneur-friendly financing opportunities for SMEs compared to rigid formal banking systems.

Williams and Yusoff (2024) examined the role of Mushārakah financing in addressing financial challenges confronting SMEs in Lagos, Nigeria. The study found that many SMEs depended initially on personal savings, cooperative contributions, and informal financing before transitioning into Islamic partnership financing structures. The researchers argued that alternative financing arrangements such as Mushārakah reduce financial pressure on SMEs because they emphasize profit-sharing rather than excessive interest-based repayment systems. Findings further revealed that SMEs utilizing partnership-based financing demonstrated stronger financial sustainability and business continuity. The study concluded that alternative financial arrangements could significantly reduce the financial exclusion experienced by SMEs in Nigeria. The implication for Cross River State is that expanding awareness and accessibility of alternative financing systems could strengthen SME survival and enterprise development within the state.
Akomolafe and Ani (2023), in their study on the effect of shadow banking activities on the

Nigerian economy, acknowledged that although shadow banking contributes positively to financial intermediation and economic growth, inadequate regulation could create systemic financial risks and instability. The study recommended stronger regulatory frameworks to ensure that shadow financial activities contribute effectively to sustainable economic development without undermining financial stability. Empirical evidence also suggests that the poor performance of many SMEs in Nigeria is linked to broader macroeconomic challenges such as inflation, exchange rate volatility, weak infrastructure, and declining manufacturing activities. Community discussions and economic reviews indicate that high interest rates and restricted access to formal credit have further worsened financing challenges for SMEs across Nigeria. Consequently, many enterprises increasingly depend on informal financial arrangements, cooperative funding systems, and shadow financial intermediaries for business survival.

Conclusion

Informal financial systems are often characterized by high implicit interest rates, limited capital capacity, weak legal enforcement mechanisms, and exposure to exploitation. Shadow finance and SMEs reflects a dual financial reality and provides an essential survival funding for enterprises. Small and Medium Scale Enterprises (SMEs) are widely recognized as the backbone of developing economies due to their contributions to employment creation, income generation, poverty reduction, and local industrial development

Recommendations

The following recommendations were proffered thus:

1. Central Bank of Nigeria should enforce stricter regulation of digital lenders and promote lower interest credit facilities through Bank of Industry.

2. SMEs should also adopt financial literacy and formal registration to qualify for institutional funding

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