Lending Circles

Provide Capital and Establish Credit History

In some cultures and nations, the banking and financial system is untrustworthy and less reliable than in advanced economies, like the United States. In response, some societies have developed alternative financial vehicles to save and get credit. Some call it Rotating Savings and Credit Associations (ROSCAs), and others call it Lending Circles. Many immigrant groups in the United States brought this practice with them and use it as an alternative to mainstream financial transactions.

The Lending Circles system was discussed in the *New York Times* (October 14, 2014) in *Lending Circles, a Roundabout Way to a Higher Credit Score.* The article explains how the alternative financial product can provide "a chunk of cash and a chance to build a credit score."
http://www.nytimes.com/2014/10/11/your-money/raising-a-credit-score-from-zero-to-789-in-26-months.html?_r=0

In the United States, savings and the ability to borrow are essential to ensure household financial stability, to make major purchases and to secure capital for establishing or expanding an existing business. However, when new immigrants arrive in the U.S., it takes time to establish credit and other financial transactions history. Initially, many work at entry-level jobs where their meager earnings barely cover basic family expenses. Many support their households in the U.S. and continue to provide support to their immediate and extended family members in their homelands.

During the initial period of resettlement, some immigrants may avoid opening bank accounts at all, perhaps not understanding the need, while others would only establish basic checking accounts. Immigrants are one of the main groups that lack banking transactions, according to the Federal Deposit Insurance Corporation (FDIC).
https://www.fdic.gov/householdsurvey/2013report.pdf

Mainstream financial transactions, among other things, establish banking relationships that are necessary for building up credit history. The credit history, current income and available collateral are the main determinants of a bank's decision to offer loans to a borrower. As some immigrants initially find it difficult to obtain small amount of loans to establish business or make financially significant purchases, they turn to the lending circles practices their ethnic group brought with them to the U.S. The purpose is to pool funds in order to achieve a financial goal that can only be obtained through a larger sum of money.

Lending Circles operate when people of the same ethnic group, co-workers, or families come together and make regular contributions in a defined cycle to a trusted person to hold the funds, which are disbursed as a lump sum to one member of the group every cycle. For example, if a group of 10 people decides to contribute $1,000 cash every month to the fund ($10,000 combined total for the month), the monthly payout of $10,000 goes to one member, and the cycle lasts for 10 months. For that person that gets the first payout of $10,000, that sum is an interest-free loan, and the rest of the contributors would become lenders and borrowers at some point before the cycle ends. The lending circles operate through an honor system based on trust, and the transactions are not regulated, so there are no official recorded transactions by a regulated entity.

Despite members making payments on time just like a bank loan to the fund, the activities are not recorded and cannot be used as a way to build a credit score. When transactions involve debt and payments are not recorded officially, then credit rating agencies will not be able to make a credit score.

The Federal Reserve Bank of Philadelphia's Community Affairs Department issued a discussion paper entitled *Alternative Financial Vehicles: Rotating Savings and Credit Associations (ROSCAs).* It discussed the benefits for ROSCA participants and incurred costs. It discussed the differences in the capital costs between ROSCAs and mainstream financial institutions.

Alternative Financial Vehicles states that people who form ROSCAs are personally acquainted with each other and are generally part of the same community. The social capital built on this relationship assesses participant's economic status and ensures his commitment to meeting his financial obligations. In this context, social capital is a determining factor of a person's creditworthiness. This capital built on this social network also serves as the organizer's credibility, as long as they view the organizer to be trustworthy.

There is a social bond between the organizer who establishes the fund and the participants who will make future contributions. The social capital prevents financial risks associated with ROSCAs. It forces members to save and make monthly payments in order to maintain their social status.

One of the economic benefits of the ROSCAs is the short period during which participants can make purchases (with the cumulative payout) compared to the time an individual would need to accumulate the same amount of personal savings. For example, a participant can request to get the lump sum ahead of the cycle to make a purchase of an appliance, which they could not do had they waited the time it would take to individually save the amount needed. Other benefits include lower transaction costs, since no interest or other fees are charged, as they would have been with mainstream lending institutions.

Alternative Financial Vehicles also points out how ROSCAs have greater accessibility and the flexibility to obtain loans when emergencies happen. This allows members to obtain small loans, which mainstream lending institutions may be reluctant to offer due to lack of credit history. Despite these economic benefits and credit enhancement opportunities, lending circles are still much more popular among refugee and immigrant groups but not in native-born American households (due to the lack of social capital).
http://www.phil.frb.org/community-development/publications/discussion-papers/discussionpaper-ROSCAs.pdf

Despite its success and frequent use by immigrant groups to use the lending circles or ROSACs as a way to access capital, the practice itself did not help them establish or improve credit history to access capital from mainstream financial institutions. To influence credit history requires more documentation than many ROSCAs use.

The creation of Mission Asset Fund (MAF), a not-for-profit organization in San Francisco, in 2007 with a $1 million grant from the Levi Strauss Foundation, has now demonstrated that the practice of lending circles can assist participants build up credit history. The organization started recording all lending circles transactions of contributions and payouts and the people that contribute to the funds. These recorded transactions are then reported to the credit bureaus. Since MAF was founded in 2007, it has helped 2,935 individuals build credit history and facilitated 3,862 zero-interest loans.

MAF has established a national network of 32 partners in 12 states, with 17 of those in 2014. In order to have a large scale impact, MAF worked to help the state of California pass legislation, SB 896 that will enable more non-profits in that state to facilitate credit-building loans.
http://missionassetfund.org/2014-annual-report/

Nashville has a diverse and growing foreign-born population. Some of the foreign-born operate various lending circles that force them to save and secure capital for big purchases. Nashville has also well-established immigrant and ethnic organizations that serve multiple and diverse populations. Some of them offer home buying services that address financial literacy sessions intended to increase building credit history or improved credit ratings. There is potential to organize ethnic nonprofit organizations to learn more about this opportunity to help non-formal transactions build up credit history, possibly through collaboration of organizations such as United Way of Metropolitan Nashville and the Mayor's Office of Financial Empowerment.