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Public Policy Consideration of Workplace-Based Rotating Savings and Credit Associations (ROSCAs) Use by Immigrants for Asset Building

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ABSTRACT

When immigrants need to save a large lump sum to purchase of home or for entrepreneurial efforts, many turn a “susu” or “partner” to build assets and secure middle-class status rather than mainstream financial services. This financial practice of pooling savings and credit based on an individual’s social connections is known as rotating savings and credit associations (ROSCAs). In these underground organized associations; participants agree to make regular contributions to an unregulated fund that participants then distribute, in whole or in part, to each contributor in rotation. Policymakers view ROSCAs as an informal or alternative financial service operating under the radar of regulations, even though one-third of the adult U.S. population are users (FDIC, 2014; OIG, USPS, 2014). Policymakers and the financial industry categorize consumers using informal or alternative financial services such as ROSCAs as “underbanked or unbanked” rather than “fully-banked.” This policy position reinforces the established poverty pathology around poor people and saving, while casting ROSCA users negatively. In contrast, ROSCA users view themselves as “fully-banked” by mixing and matching informal, alternative, and mainstream financial services; view the informal and alternatives sectors more formal and positive than acknowledged; and achieve greater success saving and accumulating wealth with ROSCAs

Keywords

ROSCA, Rotating Savings and Credit Associations, pooled savings, community savings funds, informal financial services, alternative financial services, asset building, informal financial practice, informal kin savings networks, financial inclusion

1 INTRODUCTION

Missing from the asset-building and financial services literature is Rotating Savings and Credit Associations (ROSCAs) (Ardener, 1994), an informal financial practice of pooled savings and credit based on an individual’s social connections. Predominately research on ROSCAs focuses on their origin and continued existence in many areas of the developing world; while little reference exists in the financial services literature related to ROSCAs as a substitute banking and savings tool. There is minimal U.S. recognition of the hidden use of pooled savings, even though it is estimated that 6% of Americans over the age of sixteen use an alternative or informal method of savings (Demirguc-Kunt & Klapper, 2012), and almost one-third of the adult U.S. population use some form of informal or alternative financial services FDIC, 2014; OIG, USPS, 2014).

In response, this research explores how workplace-based ROSCAs are similar and different from traditional ROSCAs; how participants interact with other components of the consumer financial services industry; and whether participants use ROSCAs to build assets. If new and established groups consciously choose to save using ROSCAs connected to their immigrant group or their workplace; even with clear disadvantages; found would be evidence that familiarity, trust, social connections and peer pressure are important saving motivators and factors that influence their financial services choices that receive little public policy support and acknowledgement.

The seminal work of Bonnett (1981) argues that “these associations are used by immigrants as a generational adaptive mechanism to cope with the urban complexities of New York ...and their use is important among first-generation immigrants but less so among the second generation.” Unlike Bonnett who researched the organizers and participants of various kin and community-based ROSCAs in Brooklyn; this work explores workplace-based ROSCAs organizers and participants; and explores deeper Bonnett’s belief that, “there is an overlap in the use between rotating credit associations and the larger banking and credit systems.” In so doing, this research builds on the work of Bonnett who explored the overlap from both the view of workplace-based ROSCA participants and how they are viewed and defined by the banking and financial services policy makers.

Workplace-based ROSCAs are a departure from the more traditional immigrant community and kinship-based models. There are two differences between the work-based ROSCA model the immigrant community and kinship-based model. First, the

common denominator in the workplace-based model is the place of employment rather than an ethnicity, church, or community kin network. Second, it is most common that the payments of the “throw” or “hand” are made in work-based ROSCAs on the payday of the workplace; possibly creating less financial risk than in immigrant community and kinship-based ROSCA models. The appearance of lower financial risk may lead some to participate in the workplace-based model who may not tolerate the higher financial risk of immigrant and community-based models. This difference may motivate a different and possibly a larger pool of participants to engage in the workplace-based model.

This research focuses on the overlooked and misunderstood existence and connections between participants’ use of three types of financial services to save and secure needed credit: formal “mainstream” (regulated savings and commercial banks); alternative “fringe” (check cashing, pawn brokers and loan sharks); and informal ROSCAs and lending circles. Since policy makers and the financial industry categorize ROSCA participants’ saving patterns using rigid definitions of “formal, informal or alternative” and their banking patterns as either “fully-banked (consumers using only formal “main street” regulated financial services), underbanked (consumers using a mixture of formal, alternative and informal financial services), or unbanked (consumers using only alternative and/or informal financial services)” using an outside established view, overlooked is an alternative reality that the informal and alternative sectors are more formal than acknowledged and viewed more positively than expected. Also missed may be a new pathology that ROSCA participants view themselves as “fully banked” even though they use alternative and/or informal financial services, while policy makers view ROSCA participants as underbanked because they use alternative and/or financial services in addition to formal financial services.

2 LITERATURE REVIEW

This literature review presents what we know about U.S. ROSCAs and other informal saving models. It highlights that the lion’s share of research focused on the international context and reveals a dearth on U.S. ROSCAs.

Limited Research on U.S. use of Alternative Informal Savings Models – ROSCA

Asset-building policy strategies have focused on finding solutions within the formal financial sector, with little consideration of policy solutions that may exist within the informal financial sector. Even though literature details the existence of varied forms of informal financial cooperative coined “ROSCA” that places emphasis on its function to mobilize saving, such pooled savings tools are mostly omitted from U.S. asset-building discussions. The research that exists on the extensive tradition of using ROSCAs in developing countries acknowledges that they are an essential aspect of how people work together to financially strengthen both their communities and themselves. Conversely, a dearth exists on their use in the U.S and participants’ historical comfort and familiarity with pooled savings groups and kin networks.

Recent research on informal finance continues to mostly focus on examining different aspects of ROSCAs operations in developing countries. This literature includes the effect that ROSCAs have on the time that it takes an individual to obtain financing (Callier, 1991; Besley, Coate & Loury, 1994); ROSCAs role in solving intertemporal allocation problems and in facilitating the acquisition of durable goods (Besley & Loury, 1994, Levenson and Besley, 1998); the relative merits of different mechanisms for distributing ROSCA funds (Besley & Loury, 1994; Kovsted and Lyk-Jensen, 1999); the potential for risk sharing in ROSCAs (Besley, 1995a; Calomiris and Rajaraman, 1998); and the way the ROSCA allocation compares to that produced by banks or informal credit markets (Besley and Loury, 1994; Van den Brink & Chavas, 1997). Further, most of the ROSCA literature can also be segmented into studies that emphasize either broad conceptual matters or those that examine ROSCAs on an individual country level (Besley and Levenson, 1996 for Taiwan; Handa and Kirton, 1999 for Jamaica; Kimuyu, 1999 in East Africa; and Dekle and Hamada, 2000 for Japan). In addition, little research explores ROSCAs’ ability to enforce its terms of membership, except Chiteji, 2002.

Anthropologists’ primary scholarly interest and fascination with the traditions of informal financial cooperatives operating in many areas of the non-western world including Asia, Africa and the West Indies are established (Notteboom, (1948); Geertz (1962); Ardener (1964); Bouman (1979); though less work is devoted to understanding their economic performance and influence on savings and wealth accumulation in the United Kingdom, Canada and the United States (Kurtz, 1973; Bonnett, 1976). In early sociological literature, these associations are equated with voluntary associations and mutual aid societies that exist in many instances among Jews, African-Americans, Japanese and other immigrants in urban society in the industrialized modern worlds.

Prior to the 1960s ROSCAs were referred to as ‘Rotating Credit Associations or RCA’ (Geertz, 1962, p. 242; Notteboom, 1948, pp.423-30), and emphasized loans and credit rather than savings (Adams and Gbate, 1992; Ardener, 1964). However, in public policy circles Fannie Mae and Freddie Mac refer to ROSCAs as pooled savings or community savings funds (Fannie Mae, 2002 & 2009). Specifically, lending underwriting guidelines of Fannie Mae refer to ROSCAs as “pooled savings (community saving funds)” initially in guidelines released June 30, 2002 that states that “some communities establish pooled savings arrangements (which may be called community saving funds) to give individuals who customarily use cash for their expenses and do not keep their savings in depository institutions as disciplined way of accumulating fund” (Fannie Mae, X, 603.20, 2002). These underwriting guidelines establishes that “funds from a community savings account or any other type of pooled savings may be

used for a down payment if the borrower can provide documentation to evidence his or her regular participation in contributing to the savings fund ... The borrower's obligation to continue making ongoing contributions under the pooled savings arrangement should be considered as part of his or her total debt when calculating the debt-to-income ratio"(Fannie Mae, B3-4, 2002 & 2009). Fannie Mae appears to also establish in regulations consideration of ROSCA participation as a borrower using "nontraditional credit history or alternative credit"; which allows a lender to use written references from creditors and the borrower's bank statements to document a nontraditional credit history (Fannie Mae, X, 804, 2002). However, an update to the 2012 regulation related to nontraditional mortgage credit reporting regulation states that their use is unacceptable when a borrower has no credit history, and it cannot be used to artificially create a credit history (Fannie Mae, B3-5. 2012).

This notion of a banking connection is discussed by Chiteji (2002, p.394) who views "ROSCAs as being required to solve an optimization problem for the entrepreneur"... and "a potential solution to this intertemporal allocation problem because it provides a means for entrepreneurs to put their separate funds into one pot ... and to mobilize sufficient funds to allow one member to purchase the indivisible good at every date that the ROSCA meets as a result." Further, suggested is that the monitoring cost of the formal banking sector contribute to the existence of ROSCAs; resulting in the greater a bank sector's monitoring costs, the more entrepreneurs there are who are excluded and left to seek out ROSCA financing. If the banking sectors monitoring costs can be reduced, one would expect ROSCA activities to decline as a result (Chiteji, 2002, p. 406).

There are two studies that focus on US ROSCAs; Bonnett (1981) seminal study that analyzed Rotating Credit Associations (RCAs) used by West Indian immigrants and Light's (1972) study of RCAs use by Chinese, Japanese and Black ethnic enterprise efforts in the U.S. most relevant to my proposed workplace-based ROSCA study. Bonnett (1981) provides the groundwork that reveals the importance of RCAs in the U.S as self-help institutions that serve as "structural shields" enabling the immigrants to cope with the complexity of urban life (Bonnett, 1981, p. xiii) and a means of saving for a major event or purchase or small-scale capital formation. This study of U.S. ROSCAs describes them as functional and instrumental institutions serving socio-economic functions among Black immigrant communities and their efforts to institutionalize these associations into their informal banking system. Light's (1972) research provides a valuable historical analysis of RCAs existence in the U.S. and relevance as "practical economic traditions that are a part of functioning culture."

Pool Savings and ROSCAs Assumptions, Purpose & Basic Operating Model

Three pooled savings assumptions are found in the literature. The first assumption is the general belief (at least from the anthropological literature) that ROSCAs are informal finance mechanisms that are predominantly used by the poor. Ardener (pg. 2, 1995) argues that "where incomes are very low, where there is no formal social security network, where ill health stalks and a variety of calamities hover, a system of low-cost ROSCAs helps to meet the challenges for all ...". Kurtz (1973) views poverty as a positive "correlate" of ROSCA participation. Calomiris and Rajaraman (1998) find that evidence on participation by the poor is widespread. Others find that ROSCAs are a response to deprivation and focusing on the whole context – socio-political, cultural and economic as well as the structural features of the associations (Wu, 1974; Kurtz 1973). Levenson and Besley (1996b) and Handa and Kirton (1999) challenge this assumption by offering empirical evidence that ROSCAs may not necessarily be meant for the poor. They show that ROSCA participation increases with income, i.e., richer individuals are more likely to participate in ROSCAs. Levenson and Besley (1996b) allude to this problem of endogeneity, but do not address this specifically due to the lack of good instruments. Handa and Kirton (1999) treat income as exogenous to participation.

The second reoccurring assumption is that people who participate in ROSCAs are credit constrained. The literature explains that even though ROSCAs serve both an economic and a social function; their primary purpose is economic - to pool funds from multiple participants in order to achieve certain financial goals; while their secondary purpose is social – with their meetings also providing important opportunities for feasting and networking (Hevener, 2006). Even though ROSCAs differ by region, a basic model can be extracted from the apparent diversity of ethnic customs (Light, 1972, pp. 21-22) that they "assist in small scale capital formation" (Ardener, 1964, p.217). Moreover, the lack of collateral is often given as a reason for why people choose an informal finance mechanism (such as the ROSCA) over a formal financial institution. Some scholars explain how "a group of individuals without access to credit markets could improve their welfare by forming a ROSCA" (Besley, Coate & Loury, 1992, p. 1). However, with this upward relationship between expenditure and ROSCA participation, there could be an indication that ROSCAs participants may not be credit constrained.

There is limited reference in the literature that outside the U.S. some participants may not be credit constrained. While this was unspecified in the theoretical work of Besley, Coate and Loury (1992), Handa and Kirton's work (1999) suggests that wealthier individuals may be members of ROSCAs, claiming that they "... observe individuals who are unlikely to be credit constrained in the formal capital market" (Handa and Kirton 1999, pg.180). In addition, Varadharjan's Inonesia study found that those who participate in ROSCAs are less likely to be credit constrained. Several of the hypotheses that Besley, Coate & Loury (1993) conjectured have been tested in a series of follow-up papers. However, thus far, the assumption of credit constrained as it related to US ROSCAs has not been researched, even though such a review is important to understanding how workplace-based ROSCAs work. On the U.S. landscape, Bonnett (1981) comments that "they help some West Indian immigrants validate their middle-class

aspirations through initial down payments on homes and purchases of businesses.” Hence, our understanding why individuals participate in U.S ROSCAs and whether it is because they are credit constrained is unclear. Left unanswered is why they might participate in more than one ROSCA, and even move from one to another. This void in the literature regarding the underlying fundamental assumptions of U.S. ROSCAs serve as a springboard for my research that will add to our understanding in this area.

The limited literature on U.S. ROSCA supports that they are used by credit constrained and poor individuals. U.S. ROSCAs are referred to as “the poor man’s bank” (Bonnett, 1981, p.76), and the argument maintains that, “Black borrowers were relatively disadvantaged in the capital market simply by virtue of their impoverishment and the marginal status of their business (Light, 1972, p.19). However, this dissertation explores whether ROSCAs are used by middle and upper income immigrants and not just by the poor. The third and final assumption is that women are more likely to participate in ROSCAs than men (Ardener, 1964; Ardener & Burman, 1995).

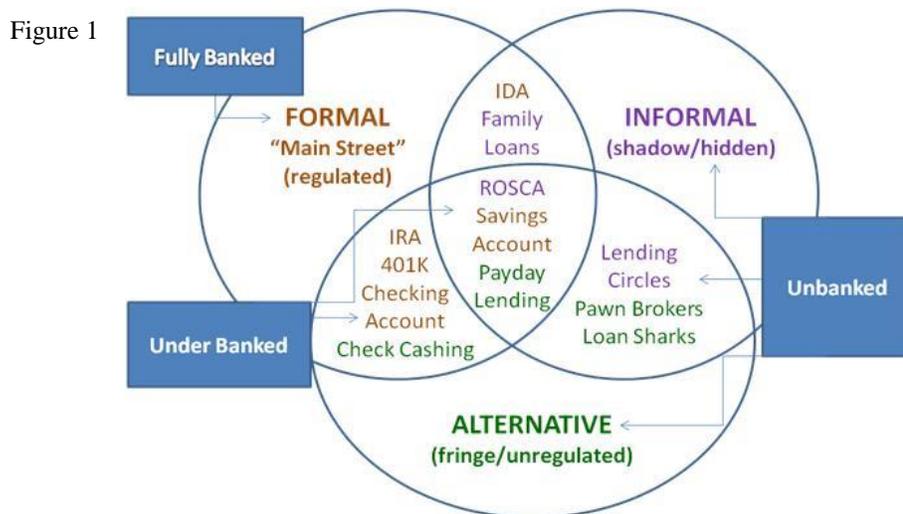
3 SUMMARY

ROSCAs and Unbanked and Underbanked Practices in U.S.

How are ROSCAs viewed by the banking and financial services makers is connected to terminology used to define and categorize their use and preferences regarding financial services. Here in lies a major policy issue that few are looking at; financial inclusion vs. exclusion that is linked to definitions of banked and unbanked, that treats ROSCAs as part of the informal or alternative sectors, and categorizes its users as “underbanked.” Established in the literature are the high and ever growing numbers of immigrants classified as “unbanked” or “underbanked” that by current definition are without any established retail banking relationship and dependent on check cashing centers for their needs or the U.S. Postal Services to issue affordable money orders. Estimated nationwide, there are seventeen million unbanked people; an increase from ten million in 2002; and forty-three million that are underbanked. Use of this definition for underbanked results in an estimated 6% of Americans over the age of sixteen that use an alternative or informal (community-based) method of savings (Demirguc-Kunt & Klapper, 2012) falling into this category of unbanked.

They are viewed as low- and moderate-income people that are victims of “financial exclusion” by policy makers convinced that banking the unbanked is the solution (Servon, 2013). According to the FDIC’s third National Survey of unbanked and underbanked households in the U.S. – household are categorized as “unbanked” (not having an account at an insured institution); “underbanked” (having a bank account but also use alternative financial services (AFS) outside of the banking system); or “fully banked” (having a checking or a savings account but do not meet the definition of underbanked). According to this 2013 survey of U.S. households 7.7 percent (1 in 13) were “unbanked”; while 20.0 percent (24.8 million) were “underbanked” (FDIC, 2014); and one in four households reported obtaining either transactional products or credit from non-bank providers in the prior 12 months. When applying the FDIC definitions to my diagram (included as Figure 1) of formal, informal and alternative financial sectors, only households that choose financial tools associated with the formal “Main Street” sector exclusively are considered “banked and financially included”. The almost one-third of the households that are considered “unbanked, or underbanked, and financially are excluded” when choosing to use alternative financial services such as ROSCAs.

When these households were asked to self-define their banking choices, they disagree with the FDIC’s categorization. ROSCA users consider themselves financially included and fully-banked. Figure 1 below illustrates the difficulties of banking and financial services policy makers to categorize the formal, informal and alternative financial sectors into three separate and distinct banking patterns classification - “fully banked, underbanked, or unbanked.”



This research suggests an increased focus on overlap between the three financial services sectors in order to better understand the utilization of workplace-based ROSCAs operating within the informal sector as effective methods of savings, asset-building, and as alternative financial services.

This research revealed a hidden, yet important overlap and intersections between the three sectors leading to expanded understanding of the role of ROSCAs and the hidden informal sector and stimulates ongoing conversation around financial inclusion and exclusion. At the center of these conversations is the preference in the U.S. for income or asset-based policy responses linked to an established underlying pathology of poverty and poor people.

Five themes emerged related to workplace ROSCA users, uses, benefits, differences, and participants. Seven findings derived from the themes. First, workplace ROSCAs are more widely used and established than indicated in the literature. Second, immigrants brought both workplace and traditional ROSCAs to the United States after their successful use in their country of origin. Third, workplace ROSCA users are diverse and have established credit. This finding contradicts the three established assumptions in the literature (that the poor, women, and the credit constrained are the predominant ROSCA users). Fourth, workplace and traditional ROSCAs are used for similar purposes, predominately asset building. Fifth, workplace ROSCA users want their short-term savings to be out of reach and shielded from both temptations and kinship networks. Sixth, participants perceived workplace ROSCAs as tools for financial security that are slightly less risky and dependent on trust than traditional ROSCAs. Seventh, workplace ROSCA users view themselves as fully banked, while policy makers classify them as underbanked.

This research provides insight into existence of workplace ROSCAs; their expanding use to save and build assets by more than just immigrants and the working poor; and the existence of an alternative reality with ROSCA users as “fully-banked” while using alternative and informal financial tools that leads to policymakers revisiting the existing consumer banking classifications. This research recommends policy recognition of this established alternative savings and asset-building tool that may exist in response to a market failure to provide a vehicle designed to deal with money in the way that growing numbers of people desire – out of easy reach and away from increasing fees.

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