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Title of proposal: Lending Circles: A Community-Centered Approach to Financial Security and Social Justice

The views and ideas expressed in this proposal are those of the authors. They do not necessarily reflect those of the Federal Reserve System or the Federal Reserve Banks that host events in the Racism and the Economy series.

Life in the Financial Shadows

> *"In the US, credit gives you the ability to build something that can help you build your future."*
>
> *— Boni, MAF client*

The financial system isn't working for millions of people across the country. For years, low-income, immigrant, and communities of color have struggled to access the most basic financial products and services, restricting their ability to realize their financial potential. Financial products are largely designed for people who earn higher wages and have steady cash flows, baselines that do not match the realities of many low-income households. Some checking accounts, for example, require a minimum deposit just to open an account or use at no cost. Low-income families already struggling to pay bills are charged a hefty fee to use such accounts because they cannot afford to keep their money sitting in an account. At best, they are secondary users of products designed for people who can afford to keep their cash idle, or at worst they are an afterthought, invisible to financial institutions.

The lack of access to safe and affordable products is detrimental to the financial lives of marginalized communities. Black and Latinx households are 4 times more likely to be unbanked than white households.[1] Immigrant communities also experience disproportionate invisibility in the financial mainstream, where only 63 percent have checking accounts compared to the 76 percent of households headed by someone born in the United States.[2] Having less access to banking services carries more costs: Black households are 2.7 times more likely to use pawn loans, while Latinx households are 3.1 times more likely to use payday loans than White households.[3]

Similarly, while 1 in 5 adults nationally are credit invisible, low-income and communities of color are nearly 10 times more likely to have no credit history compared to their White and higher-earning

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[1] Federal Deposit Insurance Corporation, "How America Banks: Households Use of Banking and Financial Services." 2019. https://www.economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf

[2] Anna Paulson, Audrey Singer, Robin Newberger, Jeremy Smith, "Financial Access for Immigrants: Lessons from Diverse Perspectives," Federal Reserve Bank of Chicago, The Brooking Institution. May 2006. https://www.brookings.edu/wp-content/uploads/2016/06/20060504_financialaccess.pdf

[3] Meghan Greene, Hannah Gdalmanm, Elaine Golden, Stephen Arves, Necati Celik, "The FinHealth Spent Report 2021." Financial Health Network. 2021. https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2021/04/19180204/FinHealth_Spend_Report_2021.pdf

counterparts.[4] Without basic tools like a credit score, families are barred from opportunities to reach their financial goals, like owning a home or saving for college. In some states, people are even denied renting apartments or are turned away from jobs that require a credit check.

Credit is like a passport into the financial mainstream; without it people are denied entry at every turn, which makes life that much harder and expensive for poor families. In 2020, Americans spent $303 billion on interest and fees for everyday financial services, most of which was paid by low-income households.[5] To put this into perspective: poor families pay over 10 percent of their annual income in interest and fees.[6] Even beyond these day-to-day costs, unbanked and underbanked households pay more when they turn to alternative financial services. More than 12 million Americans take out payday loans each year, costing another $9 billion in payday loan fees.[7] On average, a borrower will spend $520 in fees to repeatedly borrow $375, falling into a downward spiral and further into poverty.[8]

Living outside the mainstream costs even more in moments of crisis. During the COVID-19 pandemic, nearly 70 million Americans had to wait much longer for their stimulus checks to arrive in the mail because they didn't have a checking account.[9] The federal government did not realize they had wrong addresses or phone numbers for millions of people—harsh realities that are part of being poor, marginalized, always on the move, and with precarious connections to mainstream institutions.[10] The government, with all its capacity and reach, struggled reaching poor people living in the financial shadows, those who needed the most help, most urgently.

Yet, despite increasing disparities in access to programs and services, the organizations most committed to help financially invisible consumers continue to be neglected by the broader financial ecosystem themselves. More than half of nonprofits nationally suffer from frequent or chronic budget deficits, while 40 percent have fewer than three months of reserves to cushion an emergency shortfall.[11] Considering that nonprofits fill such critical needs for low-income, immigrant, and communities of color, funding for community-based organizations is also a core barrier to reach people with the greatest financial needs.

[4] Consumer Financial Protection Bureau, "Who are the credit invisibles?" 2016. https://files.consumerfinance.gov/f/documents/201612_cfpb_credit_invisible_policy_report.pdf

[5] Meghan Greene, Hannah Gdalmanm, Elaine Golden, Stephen Arves, Necati Celik, "The FinHealth Spent Report 2021." Financial Health Network. 2021. https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2021/04/19180204/FinHealth_Spend_Report_2021.pdf

[6] Office of Inspector General United States Postal Service, "Providing Non-Bank Financial Services for the Underserved." January 27, 2014. https://www.uspsoig.gov/sites/default/files/document-library-files/2015/rarc-wp-14-007_0.pdf

[7] The Pew Charitable Trusts Fact Sheet, "Payday Loan Facts and the CFPB's Impact." May 2016. https://www.pewtrusts.org/-/media/assets/2016/06/payday_loan_facts_and_the_cfpbs_impact.pdf

[8] Ibid.

[9] Aaron Klein, "70 million people can't afford to wait for their stimulus funds to come in a paper check." Brookings. March 31, 2020. https://www.brookings.edu/opinions/70-million-people-cant-afford-to-wait-months-for-their-stimulus-to-come-in-a-paper-check/

[10] Kalena Thomhave, "Poorest Americans Have the Most Difficulty Accessing Stimulus Checks." Spotlight on Poverty & Opportunity." June 24, 2020. https://spotlightonpoverty.org/spotlight-exclusives/poorest-americans-have-the-most-difficulty-accessing-stimulus-checks/

[11] Michael Etzel and Hilary Pennington, "Time to Reboot Grantmaking." Stanford Social Innovation Review." June 17, 2017. https://ssir.org/articles/entry/time_to_reboot_grantmaking#

Building Credit, Building Community

> *"For me, at some point, it stopped being about credit. These people just met each other an hour ago, and now we're helping each other with our financial goals. It builds community."*
>
> *— Alan, MAF client*

Rather than trying to coax people into products and services that weren't made for them, there's another option: a community-centered approach that builds on what is already good and working in people's lives.[12] This approach requires a radical reshaping of how financial institutions work with and for people. Rather than assuming that low credit scores or a lack of credit history imply that people can't pay—assumptions reflected in the exorbitant interest rates and fees burdened on poor people—a community-centered approach leans into people's strengths.[13] Implementing a community-centered approach is simple: meet people where they are and listen deeply to engage and build solutions together.

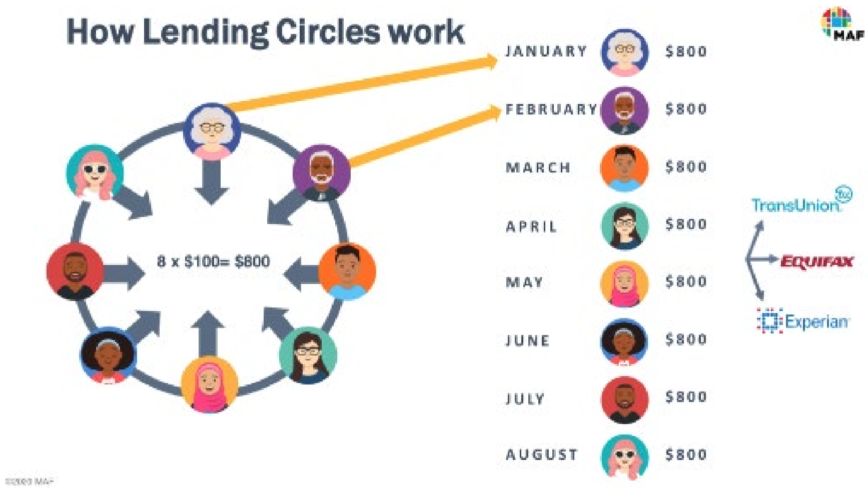
This community-centered approach is behind the innovative and pioneering financial practices that have helped people navigate through crisis after crisis. In 2008, when the global financial crisis brought our financial system to the edge of collapse, the recession shrunk more than 50 percent of available consumer credit, pushing low-income workers toward high-cost debt.[14] Yet, despite the unnerving crisis, people were saving and lending with one another through a time-honored tradition of mutual support and trust. Lending circles are rooted in this tradition.

Lending circles formalize a global tradition of social lending into an opportunity to step out of the financial shadows. Across the world, people have come together to borrow and lend to one another. Known as "*tandas*" and "*cundinas*" in Mexico, "*paluwagan*" in the Philippines, and "*susus*" in West Africa, communities are leveraging their social capital to meet their financial needs. In the same way, lending circles bring people together to form zero-interest, small-dollar loans based on pooled resources that rotate to members of the circle. The transformational impact of this practice hinges on three critical aspects: first, all participants sign a promissory note, making an informal activity visible. Second, lending circles providers like MAF step in to make the circle whole if a participant is unable to pay. This takes the risk and uncertainty off of participants, ensuring that the loan will be available when it's their turn. Finally, the lending circles provider reports payment activity to the major credit ratings agencies.

[12] Mission Asset Fund, "MAF's Vision for Showing Up & Doing More." May 13, 2021. https://www.missionassetfund.org/mafs-vision-for-showing-up-and-doing-more/

[13] Meghan Greene, Hannah Gdalmanm, Elaine Golden, Stephen Arves, Necati Celik, "The FinHealth Spent Report 2021." Financial Health Network. 2021. https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2021/04/19180204/FinHealth_Spend_Report_2021.pdf

[14] Jose Quinonez and Tara Robinson, "Credit Deserts: The absence of low-cost credit in low-income communities." Mission Asset Fund. February 2012. https://www.missionassetfund.org/wp-content/uploads/2021/03/Report_-Credit-Deserts-The-absence-of-low-cost-credit.pdf



Lending circles provides an added incentive for unbanked clients to open checking accounts, opening up access to many more financial services and resources. In practice, lending circle disbursements are deposited directly into their checking accounts, as payments are debited automatically on a monthly basis. Paired with proactive monthly alerts and communications from the lending circle provider, automatic payments reduce risks that payments are forgotten or lost in the mail.

But lending circles by themselves aren't enough. People need financial education that, like lending circles, is timely and relevant to their lives. Lending circles participants draw from a library of culturally relevant financial education modules, giving them an opportunity to build personalized learning plans that meet their needs and realities. By pairing safe financial products with financial education, participants report feeling more confident about their financial lives, and in turn more confident about achieving their goals.

Putting a community-centered approach into practice means staying agile. During the COVID-19 pandemic, financial upheaval and uncertainty made it hard for many households to continue making payments on loans they had taken out before the crisis. People needed options, not warnings and late fees. Offering no-fee loan modifications, such as payment holds, forbearance options, and repayment plans, created an important avenue of relief for low-income communities who have been particularly hard-hit by the pandemic. This flexibility allowed clients the time and space to use their loan to meet their goals, successfully participate in their lending circle, and still honor their commitments to their families, as well as to their fellow lending circle participants.

For nearly 15 years, we have seen first-hand how Lending Circles help low-income, immigrant, and communities of color establish and build credit, enabling them to step out of the financial shadows. Lending Circles supports people at every stage of their financial journeys: 4 out of 5 clients who join MAF's Lending Circles without a credit score establish one during the program, opening the door to larger loans and other mainstream financial services. Across all borrowers, clients increase their credit score by an average of 120 points, with nearly 80 percent completing their Lending Circle with prime or near-prime credit. Not only are they building credit, but clients are also saving money: compared to high-cost loans, clients save an average of $154 on fees and interest when they join a Lending Circle. In an external evaluation of MAF's Lending Circles, researchers found that participants reduced their debt by an average of $2,400, in comparison to an average increase of

$2,700 in debt among similar people who didn't participate in the program.[15] Through this community-centered financial practice, 99 percent of loans are repaid.

Scaling What Works

> *"Even though I can avoid a high-interest loan now, I was able to pay off my own car, no interest. I was able to do that with what I received [from the Lending Circle]. I loved that. My circle helped me pay off my car and boost my credit. And now Lending Circles are also helping me buy a home."*
>
> *— Joleen, MAF Client*

For nonprofit organizations to work at scale, we need considerable investments and intentionality. In particular, investing in technology and partnerships are key to bringing lending circles to scale. While rarely the first investment a nonprofit makes, technology needs to be an organizational strength, not a minimum-feasible solution. Investing in and building a robust technological infrastructure allows for agile product design, real-time evaluation, and meaningful tracking of client progress. We need to leverage best in class technology for poor people as well as the affluent. A strong technological infrastructure and tools can streamline client communications through automated payment reminders and a centralized system to route client inquiries.

Among immigrant and Latinx communities in particular, cell phones are playing a growing role in the way people connect and get information. As people are increasingly mobile, we need to ensure our tools are evolving to meet that reality. Investing in mobile applications that offer financial education and access to financial services can offer a pathway of access into communities in the financial shadows. Mobile finance apps with tools like financial actions plans, goal-setting tools, and real-time credit insights give people a "financial coach" they can put in their pocket. In this way, we meet people where they are, giving them flexible and accessible financial tools that can help them reach their goals at their own pace.

With these tools, lending circles can be scaled exponentially through a networked approach. Rather than opening new offices in cities across the country, consider partnering with local nonprofits who know their communities best. These trusted, locally rooted organizations are the experts in their respective communities, and they have the relationships to best support their clients' needs. Treat these growing partnerships as you would support lending circles participants, offering financial and technical support to complement their own strengths and build collective expertise.

Importantly, having multilingual program information and staff that speak clients' language is imperative. This is true both for program support as well as design: conducting in-language and in-culture surveys, focus groups, and individual interviews to inform product design and development are pivotal to ensuring that client voices remain front and center.

By using the best of finance and technology to meet people where they are, we can create meaningful change in a sustainable way. If we want to collectively scale impact, there is more that we can do to reach people in the financial shadows. We should:

- Expand nonprofit capacity with strategic technological investments to facilitate rich community-centered engagement with marginalized communities.

[15] Belinda Reyes, Elias Lopez, Sarah Phillips, Kurt Schroeder, "Building Credit for the Underbanked: Social Lending as a Tool for Credit Improvement." Cesar E. Chavez Institute, College of Ethnic Studies at San Francisco State University. June 2013. https://www.missionassetfund.org/wp-content/uploads/2021/03/Eval-short-web-FINAL.pdf

- Support a network of nonprofits working to improve the financial lives of low-income and immigrant communities with funds from fines and fees levied against bad actors in the financial marketplace.[16]
- Create a public option for basic, safe, and secured checking accounts to ensure that everyone is included and engaged in our modern digital financial system.[17]

A community-centered approach to financial security puts people at the center, building on their inherent strengths to create a truly inclusive financial system for everyone. Our vision for an equitable and just financial system is grounded in values, where everyone's innate strengths and individual journeys are recognized and respected. We envision a world where low-income and immigrant communities—the true experts in what works and what is needed in their lives—are offered products and services that meet them where they are and treat them with respect and dignity. In this world, low-income, immigrant, and communities of color have access to financial resources and tools they need to lay down roots, build their lives, meet their goals and reach their financial potential.

[16] Mission Asset Fund, "MAF Sponsors SB 455: CA Financial Empowerment Fund." March 6, 2019. https://www.missionassetfund.org/maf-sponsors-sb-455/

[17] Roosevelt Institute, "Fact Sheet: FedAccounts Would Provide Economic Relief and Inclusion in the Short and Long Term." April 2020. https://rooseveltinstitute.org/wp-content/uploads/2020/07/RI_FedAccounts_FactSheet_202004.pdf