Formal RoSCAs in Argentina

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June 1999

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Abstract

Informal Rotating Savings and Credit Associations (RoSCAs) are often held up as models for NGOs interested in microfinance. Unlike informal RoSCAs, formal RoSCAs in Argentina do not use social capital to screen members and to enforce repayment. They rely instead on reduced transaction costs, regulation, the legal system, and individual risk evaluations. Net savers earn lower rates with formal RoSCAs than with bank accounts, but net borrowers pay lower rates. Formal RoSCAs increase access to small loans and savings services for the unbanked in Argentina, but NGOs probably cannot do much to promote them.

Author's notes

A later version of this paper appears in *Development in Practice*, Vol. 10, No. 2, pp. 229-232. This work was supported by the Division of Asset Building and Community Development of the Ford Foundation. Mark Schreiner is a Post-doctoral Fellow in the Center for Social Development, George Warren Brown School of Social Work, Washington University in St. Louis. His work focuses on ways to improve access to small loans and to saving services for poor people in low-income countries and in the United States. He thanks Raúl Hemmings of Fiat Crédito and Bernardo Blanc, Jorge Malagrino, and Susana Morano of PlanCoop in Buenos Aires.

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Rotating Savings and Credit Associations

Members of Rotating Savings and Credit Associations (RoSCAs) make payments into a pot that is given to each member in turn by some rule. Members yet to get the pot are net savers; Members who got the pot in the past are net borrowers. RoSCAs are everywhere, almost all are informal, and they are even more popular for women than for men (Ardener and Burman, 1995; Bouman, 1995). RoSCAs can act as informal insurance (Calomiris and Rajaraman, 1998), and they can help members to raise big sums sooner than if they saved by themselves (Besley et al., 1993; van den Brink and Chavas, 1997).

Informal RoSCAs tap into sunk investments in social capital to screen members and enforce contracts. They epitomize four of the virtues of informal finance (Schreiner and Nagarajan, 1998):

- Slashed transaction costs;
- Supply of both saving services and loans;
- Substitution of confidence in personal characters for collateral; and
- Socially or self-enforced contracts.

Von Pischke (1992) praises RoSCAs as models for NGOs and other aid agencies that aim to improve access to small loans and saving services for the poor. In practice, however, informal RoSCAs have severe weaknesses. Like other informal financial intermediaries (Christensen, 1993), informal RoSCAs cannot make big, long-term loans; take big, long-term deposits; intermediate between strangers; or diversify risk well. The informal nature of RoSCAs keeps them beyond the influence of intervention.

In Argentina, some commercial banks and car dealers organize RoSCAs that cannot rely on social capital since their members are strangers (Ignacio Aguirre, 1994). Formal RoSCAs have also been reported in Korea (Campbell and Ahn, 1962) and México (Mansell-Carstens, 1995). What can NGOs learn about the supply of small loans and saving services from formal RoSCAs in Argentina? This note tells how formal RoSCAs cope without social capital, describes their strengths, and suggests lessons for NGOs. Formal RoSCAs mitigate some of the weaknesses of informal RoSCAs, but they do not allow much scope for a role for NGOs.

How formal RoSCAs work

As in most parts of the world, most RoSCAs in Argentina are informal. Members know each other well and see each other every day. For example, most informal RoSCAs in Argentina are made up of workers in offices. Knowledge and trust from repeated contact build the social capital that enables RoSCAs to exclude bad risks from the group and to enforce social sanctions on defaulters.

Unlike in most parts of the world, Argentina also has some formal RoSCAs run by car dealers and banks. The members do not know each other and never meet. In the absence of social capital among the members of the group, the government of Argentina regulates formal RoSCAs to protect the deposits of net savers.

With 20 to 100 members, formal RoSCAs are much bigger than informal RoSCAs. The size of informal RoSCAs is constrained by the fact that social capital weakens as size increases. Few informal RoSCAs last longer than a year, but formal RoSCAs in Argentina can last ten to eighty-four months. The length of informal RoSCAs is constrained by the fact that, without constant maintenance, social capital weakens as time passes.

The most common formal RoSCA lasts thirty months since it has sixty members and awards two pots per month. The monthly payment is $133, so the typical pot is $4,000. Informal RoSCAs have smaller pots since they have fewer members and shorter cycles and since members bear default risk. Formal RoSCAs can have bigger pots since the bank bears default risk and since the bank has the net worth and diversification to accept more risk. The size of the typical monthly payment suggests that while members of formal RoSCAs in Argentina do not have access to bank loans, they are not among the poorest of the poor. As in informal RoSCAs, formal RoSCAs do not charge explicit interest on loans. Unlike informal RoSCAs, the typical formal RoSCA charges $600 in fees and insurance and pays some interest to net savers.

Members make payments at a bank branch during the first week of each month. The bank deducts its fee and sends the rest to a firm specialized in the management of formal RoSCAs. On the tenth day of the month, the manager draws one winner by lot. The second winner is based on a bidding process that is not described here to save space. At the end of the month, the manager sends money for two pots back to the bank. Car dealers award new cars instead of cash.

Before they can collect the pot, winners must make a standard loan application and offer guarantees to the satisfaction of the bank. Since the bank bears default risk, it has the right to reject any application. A winner whose application is rejected must wait to be picked again at a point when the net loan is small enough for the bank to accept the risk. The funds from the unused pot are carried over to the next month.

At the end of the cycle, members who were never approved for a loan collect their accumulated savings. The interest from the 20-day float between collection and assignment each month is shared according to the average net deposit of each member.

Why formal RoSCAs work

Formal RoSCAs work for car dealers since the car serves as collateral against the debt to the RoSCA. Argentina has effective pledge registries for cars, and repossession is simple and quick. Furthermore, for all but the first few pots, the loan-to-value ratio is low; members with big equity stakes have strong incentives to repay as promised. Thus the expected costs of default are low.

Formal RoSCAs work for banks since the bank can refuse to give the pot to winners judged as bad risks. The savings aspect also reduces risk since members, before they get the pot, show the bank that they can make the same monthly payments as they will need to make after they get the pot. Furthermore, a bank runs many RoSCAs at once, and this diversifies its risk. Losses can be predicted from experience.

Government regulation helps formal RoSCAs to work for members. Regulation reduces risk for net savers since the RoSCA must, by law, return the deposits of all those who have yet to get the pot by the end of the cycle. In informal RoSCAs, one or two defaults can prompt all net borrowers to stop repayment since they fear all others will default, and this leaves net savers in the lurch. Formal RoSCAs are immune to this domino effect since they are regulated, since the bank has a cash reserve from non-RoSCA business, and since members do not know each other. Regulation also requires RoSCAs to fix the number of members and the length of the cycle. This prevents pyramid schemes in which pots to old members (who may then default) are funded by growth in the number of new members.

Finally, formal RoSCAs do use social capital since most Argentines already have been exposed to RoSCAs. A bank that started a formal RoSCA in a high-income country would first have to teach people how the system works.

Weaknesses and strengths

Formal RoSCAs in Argentina have four weaknesses as agents for development. First, they are not good choices for people who just want to save. Net savers earn an implicit monthly interest rate of about -0.70 percent; a comparable passbook account would earn about -0.46 percent. Second, deposits are frozen until a member wins the pot or the cycle ends. Third, formal RoSCAs do not reach the poorest. The number and size of payments require a steady income, and winners may still have to post collateral. Fourth, formal RoSCAs exploit the fact that their members cannot get formal loans elsewhere. Fees are high, and most banks earn a higher rate of profit on RoSCAs than on their other services.

Formal RoSCAs have three developmental strengths for net savers:

- The obligation to save allows members to choose to discipline themselves and/or provides a socially accepted excuse to deny requests to share spare cash.
- The chance to build a reputation through regular deposits can, with time, allow uncollateralized loans.
- Regulation assures that deposits are safe; unlike in informal RoSCAs, the manager cannot abscond with the funds.

Formal RoSCAs have two developmental strengths for net borrowers:

- The size of the group and the length of the cycle—and thus the size and length of loans—are less constrained than with informal RoSCAs.
- Net borrowers pay an implicit interest rate of about 1 percent per month; comparable bank loans would cost about 2 percent.

Finally, formal RoSCAs impose lower transaction costs on members than informal RoSCAs since social capital requires maintenance. For example, most people would rather not dun or shun their neighbours or co-workers who default in a RoSCA since they will still have to work with them in the future. Most punishments hurt both sides. Furthermore, informal RoSCAs require all members to meet in a set place at a set time. People may prefer to drop by a bank branch at a time convenient to them. In addition, informal RoSCAs may expect winners to throw a party or to buy food and drinks for the other members. This can be fun, and it builds trust, but the cost to maintain such informal networks can increase with development.

Lessons for microfinance NGOs

Can NGOs promote development through formal RoSCAs? The lessons from Argentina are not encouraging for four reasons. First, people—especially poor people—demand saving services as well as loans. Deposit-takers must be regulated; if not, then the poor risk the loss what little savings they have. Few NGOs are subject to prudential regulation and supervision, and most regulators are already too overtaxed to want to bother with NGOs. Second, formal RoSCAs require that the legal framework substitute for social capital. Many low-income countries do not yet have this infrastructure, and NGOs can do little to speed its construction. Third, the manager of a formal RoSCA must know how to judge the risk of individual borrowers. Those NGOs that can do this probably already make small loans without the need to use RoSCAs. Fourth, most NGOs are too small to diversify risk and lack the branch network needed to reduce transaction costs for users. Formal RoSCAs can increase access to small loans and saving services. Unfortunately, their development does not seem to leave much scope for a role for NGOs.

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