Chit funds

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What is a chit fund?

- A chit fund is a type of saving scheme where a specified number of subscribers contribute payments in instalment over a defined period.
- Each subscriber is entitled to a prize amount determined by lot, auction or tender depending on the nature of the chit fund.
- Typically the prize amount is the entire pool of contribution minus a discount which is redistributed to subscribers as a dividend.

How does it work?

- For example, consider an auction-type chit fund with 50 subscribers contributing Rs 100 every month. The monthly pool is Rs 5,000 and this is auctioned out every month. The winning bid, say Rs 1000, would be the discount and be distributed among the subscribers. The winning bidder would then receive Rs 4,000 (Rs 5,000 – 1,000) while the rest of subscribers would receive Rs 20 (1000/50). Winners cannot enter the auction again and will be liable for the monthly subscription as the process is repeated for the duration of the scheme. The company managing the chit fund (foreman) would retain a commission from the prize amount every month. Collectively, the subscribers to a chit fund are referred to as a chit group and a chit fund company may run many such groups.

What are the laws governing chit funds?

- Classifying them as contracts, the Supreme Court has read chit funds as being part of the **Concurrent List of the Indian Constitution;** hence both the centre and state can frame legislation regarding chit funds.

- States like Tamil Nadu, Andhra Pradesh and Kerala had enacted legislation (e.g The Kerala Chitties Act, 1975 and The Tamil Nadu Chit Funds Act, 1961) for regulating chit funds.

Chit Funds Act, 1982:

- In 1982, the Ministry of Finance enacted the Chit Funds Act to regulate the sector. The 1982 Act regulates chit funds and prohibits a fund from being created without the prior sanction of the state government.Under the Act, the central government can choose to notify the Act in different states on different dates; if the Act is notified in a state, then the state act would be repealed. States are responsible for notifying rules and have the power to exempt certain chit funds from the provisions of the Act.

Contemporary relevance

- A scam involving the Saradha group allegedly conning customers under the guise of a chit fund has raised serious questions for the industry.
- With a reported 10,000 chit funds in the country handling over Rs 30,000 crore annually, chit fund proponents maintain that these funds are an important financial tool.
- The scam has also sparked responses from both the centre and states: the Finance Ministry, Ministry of Corporate Affairs and SEBI have all promised to act and the West Bengal Assembly has passed The West Bengal Protection of Interest of Depositors in Financial Establishments Bill, 2013, with Odisha and Haryana considering similar legislation

What is the role of RBI and SEBI?

- The Reserve Bank of India (***RBI***) is the regulator for banks and other non-banking financial companies (NBFCs) ***but does not regulate the chit fund business***.

- While chit funds accept deposits, the term ‘deposit’ as defined under the Reserve Bank of India Act, 1934 does not include subscriptions to chits.
- However, the RBI can provide guidance to state governments on regulatory aspects like creating rules or exempting certain chit funds.
- As the regulator of the securities market, SEBI regulates collective investment schemes. But the ***SEBI Act, 1992 specifically excludes chit funds*** from their definition of collective investment schemes.
- In the recent case with Saradha Group, the SEBI investigation discovered that Sarada was, in effect, operating a collective investment scheme without SEBI’s approval.

Even after many chit funds scam why do people invest?

1. **Who are investors in these funds→ Poor not middle class**
    - These companies work in a network of multi-level marketing systems.
    - One agent has 10 sub-agents under him and again these 10 sub-agents have 100 sub-agents reporting to him.
    - They make a pyramid of such agents.
    - All these agents are poor people who have some social standing in their community.
    - These agents collect money for chit fund companies.
    - ***So when these companies dupe poor people, then the person who had some social standing in the community is called a thief.***
    - Poor people do not invest in chit fund companies, but they put their hard-earned money into the hands of the man whom they believe in their community.

    - They know him and they only trust that man, not the company.
    - Take the example of the Pearl Agrotech Corporation Limited chit fund company, which had 70 lakh agents.
    - If you see all the chit fund companies in India, you will get 2 crores, such agents.
2. **Minimum 3% more returns compared to other investment avenues**
3. **Hardly 6% of the Indian population discuss these scams**

The Chit Funds (Amendment) Bill, 2019

Key provisions:

- **Names for a chit fund:** The Act specifies various names which may be used to refer to a chit fund. These include chit, chit fund, and Kuri. The Bill additionally inserts 'fraternity fund' and 'rotating savings and credit institution' to this list.
- **Substitution of terms:** The Act defines certain terms in relation to chit funds. It defines:

(a) 'chit amount' as the sum of subscriptions payable by all the subscribers of a chit;

(b) 'dividend' as the share of the subscriber in the amount kept apart for running the chit;

(c) 'prize amount' as the difference between chit amount and the amount kept apart for running the chit.

The Bill changes the names of these terms to 'gross chit amount', 'share of discount' and 'net chit amount' respectively.

- **Presence of subscribers through video-conferencing:** The Act specifies that a chit will be drawn in the presence of at least two subscribers. The Bill seeks to allow these subscribers to join via video-conferencing.

- **Foreman's commission:** Under the Act, the 'foreman' is responsible for managing the chit fund. He is entitled to a maximum commission of 5% of the chit amount. The Bill seeks to increase the commission to 7%. Further, the Bill allows the foreman a right to lien against the credit balance from subscribers.
- **The aggregate amount of chits:**
  - Under the Act, chits may be conducted by firms, associations or individuals.
  - The Act specifies the maximum amount of chit funds which may be collected. These limits are:

(i) one lakh rupees for chits conducted by individuals, and for every individual in a firm or association with less than four partners

(ii) six lakh rupees for firms with four or more partners.

- The Bill increases these limits to three lakh rupees and 18 lakh rupees, respectively.
  Application of the Act: Currently, the Act does not apply to:

(i) any chit started before it was enacted

(ii) any chit (or multiple chits being managed by the same foreman) where the amount is less than Rs 100.

- The Bill removes the limit of Rs 100 and allows the state governments to specify the base amount over which the provisions of the Act will apply.

Ponzi Scheme

- It is an ***investment fraud*** that pays existing investors with funds collected from new investors. Ponzi scheme organizers often promise high returns with little or no risk.

- It leads victims to believe that profits are coming from product sales or other means, and they remain unaware that other investors are the source of funds.