October 10, 2014

To,
Hon'ble Dr. M. Veerappa Moily, Chairman
& Hon'ble Members,
Standing Committee on Finance of Parliament,
New Delhi.

Hon'ble Sirs,

Memorandum from Chit Fund Industry

Subject: Efficacy of Regulation of Collective Investment Schemes, Chit Funds, etc

This is with reference to the publication released in the Media inviting views/suggestion from stakeholders, organizations etc on the referred subject.

Before we make our submission, we would like to invite your attention to our memorandum submitted last year, to the Finance standing Committee of Parliament that was followed by our deposition before the August committee, which would explain our involvement or rather anxiety over this subject. A copy of the said memorandum is enclosed herewith for your ready reference.

There is no denying the fact that the incidence that triggered the hornet's nest is so colossal and tragic that if not prevented from recurring, it would pave way for more such and even more voluminous scams than the likes of what we witnessed in 'Saradha' and other such companies. Ours being the sole Association representing this indigenous financial intermediary, Chit Fund, has the huge responsibility to give our best in assisting you in eradicating the unscrupulous elements from duping the public.

However, what we need to understand is that CIS & Chit Fund, that even this referred publication inviting views tries to connect, are entirely different, and the difference being something as between the North & South Poles. Simply put, Chits Funds are regulated by 'The Chit Funds Act, 1982 and Collective Investments, at least till recently when the SEBI Bill was passed, were in no one's domain and thus had their heyday.

<u>Chit Funds:</u> <u>Legal definition</u>

Section 2 (b) of THE CHIT FUNDS ACT 1982 is reproduced below:
"Chit" means a transaction whether called chit, chit fund, chitty, kuri or by any other name by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical installments over a definite period and that each subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount;

Explanation – A transaction is not a chit within the meaning of this clause, if in such transaction,-

i. *Some alone, but not all, of the subscribers get the prize amount without any liability to pay future subscription; or*
ii. *all the subscribers get the chit amount by turns with a liability to pay future subscriptions;*

To rewind, not very long ago, it was hailed as the champion of financial inclusion. Bill and Melinda Gates Foundation praised its potential to change the lives of the poor. According to research conducted in the states of Andhra Pradesh, Tamil Nadu, Karnataka, Kerala, and Delhi by the Institute for Financial Management and Research (IFMR) in 2010, nearly half the members of chit funds were below the poverty line. Almost every one of us, whether you call it chit, chitty, kuri, bisi, kitty, committee, ROSCA, had at one point or other might have used it. Many a poor household has built its modest dwellings or set up a small business through chit-fund borrowings.

<u>While the companies under probe</u> were running, what is called, an unregistered collective investment scheme (CIS). These are typically Ponzi schemes where new deposits are used to pay high returns to investors, luring others into investing in these schemes. When the rate of deposits slows down or the promoters bolt with the collection, the music stops and many depositors are left with their savings gone.

Some basic features of Chit Funds that distinguishes it from MLM/Ponzi companies are as follows.

1. Reserve Bank of India is the Principal Regulator for Chit funds, and has an advisory role, as provided u/s 73 of The Chit Fund Act, 1982 (Act No. 40 of 1982).

2. Chit Funds are defined under Sec. 45 I(c) of the RBI Act. RBI Notification No.DNBC.39/DG(H)-77 dated 20th June 1977 categorizes it as Miscellaneous Non-Banking company (MNBC)

3. Since the subject is in the concurrent list (Entry 7 of List III) of the Constitution, administration of the Rules is with the respective State Governments. The company should be registered with the Registrar of Chit Fund of the State of their operation.

4. Chit fund company means a company managing, conducting or supervising, as foremen, agent or in any other capacity, chits as defined in Section 2 (b) of 'The Chit Funds Act, 1982'
5. Any company carrying on the operation of 'Chit Fund' should have the words 'Chit', 'Chitty' or 'Kuri' as part of their company name.

6. Chit Fund companies are **not allowed** to accept deposits from the Public, Trade in Stock, Equity or other cash management.

7. Chit Funds, as of now, are not allowed to carry on other businesses without the permission of the Registrar/State Governments.

The fact however remains, whatever the term, the dangers that lurk in the vast financial services industry that operates on the fringes of regulation or in the grey regulatory zones are real and needs to be addressed, but not at the cost of Chit Funds.

Also, though undoubtedly the efficacy of the Regulation need to be checked time and again and loopholes, if any, have to be plugged, but even more important than the regulation is to attack the roots of this frequent eruption and nip the evil in the bud. Certain steps in this regard, we humbly suggest are

- The inability of the financial sector regulatory mechanism in India to identify and clamp down on such unscrupulous promoters and schemes before they become monsters leads to the periodic recurrence of such unfortunate episodes. The overt political patronage actually lends credibility to such schemes, as in the case of Saradha. Regulatory overlap creates opportunities for arbitrage and creates grey areas where devious firms can flourish. To explain, chit funds are regulated by state governments, CIS is monitored by SEBI and the rest of the NBFC sector is looked after by the RBI, even though all these different kinds of firms compete for the same pool of consumer savings.

- Second, the exclusion of a large segment of the population from access to formal finance throws them into the waiting arms of ponzi schemers. In fact, a large number of Saradha investors were those who could not open a bank account, because they did not have address proofs that are acceptable to banks. They were in fact, grateful to Saradha because it accepted their deposits!

- Third, financial literacy in India is very poor and people are not able to discern genuine financial instruments from bogus ones. Knowledge is a good antidote to greed, and in the absence of the former, people are driven solely by the latter.

Before we embark on the subject of efficacy of Regulation, it would be better to refresh ourselves with the intricacies of this unique indigenous financial intermediary. Briefly,

What is a chit fund?

Chit fund is a traditional financial system which has been prevalent even before the evolution of Banking. Though the system exists in other parts of the world by the name **Rotating Savings and Credit Association (ROSCA)**, India is the only country where its operations are governed by legislations. Chit funds are classified as Miscellaneous Non-Banking Financial Institutions, under the Reserve Bank of India Act, 1934 and are now governed by a Central Act, namely, The Chit Fund Act, 1982 which is administered by the respective State Governments. This system, with numerous in built advantages, viz., tax free dividend, easy accessibility, user friendly services etc; and free of latent cost and periodic interest hikes, or pre closure charges, is the most preferred option, for those, who plan to save small amounts. Chit fund is a saving cum borrowing instrument, which is unique when compared to other financial products.

How do they work?

A chit scheme generally has a predetermined value and duration. Each scheme admits a particular number of members (generally equal to the duration of the scheme), who contribute a certain sum of money every month (or everyday) to the 'pot'. The 'pot' is then auctioned out every month. The highest bidder (also known as the "prized subscriber") wins the 'pot' for that month. The bid amount is also called the 'discount' and the prized subscriber wins the sum of money equal to the chit value *less* the discount and the fixed fee to the foreman. The discount money is then distributed among all the members as 'dividend' and in the subsequent month; the required contribution is brought down by the amount of dividend.

Why people use Chit Funds?

Chit Funds address gaps left by the traditional banking sector. They mobilize huge amounts of small savings, and in return allow members to have access in the form of loans to lump sum amount of money that they would often not be able to get from traditional banks. Easy accessibility and flexibility are important aspects of this form of financing. Compared to banks, Chit Funds require less documentation, are more flexible about collateral, and allow to determine own interest rate (within the constraints of a given chit scheme). Furthermore, there is no need to determine upfront whether funds are used for saving or borrowing. This is a salient feature of chit funds as it not only puts in place a disciplined saving mechanism, but it also allows access to cash when needed. In addition, as Chit Funds use the funds of the participants, unlike banks, there is much less capital requirements for the institution. Though the banking sector has come up with No-Frill account, Mobile Banking, Banking Correspondent Model etc, these do not help the un-served population to get funds for their income generation activity. As regards MFIs, multiple lending, high cost of borrowing etc has affected their agenda; mainly because they are focused on redistribution of wealth while what is required is inclusion in the Creation of wealth. Debt distribution to the poor as done by MFIs by itself does not grow economies! Chit Funds on the contrary as against air dropping the finance, make sure that the entire cycle from distribution to collection is complete effectively, that too without any Government subsidy, thereby playing the crucial role in Financial Inclusion.

The primary uses of Chit Funds include:-

- To address consumption needs, such as, marriage, education, property purchase and so on.
- To pay off costlier loans from outside sources like loan from money lenders.
- To address working capital, business expansion or start-up capital needs of small businesses, besides providing bridge loans.
- For an emergency or simply as savings for future needs.

Characteristic of the Chit Fund Participants

A survey by Institute of Financial Management and Research, Chennai, reveal that approximately 80 percent of the participants in the registered chit fund industry are male and the average age is 40 to 45 years. It is also important to mention that more than 80 percent of the chit fund participants have more than high school level of education. In terms of the occupational characteristics, approximately 40 percent of the participants are self-employed, 23 percent of the participants are salaried class in the private sector, 13 percent salaried class in the government sector and 10 percent are housewives.

Volume of Chit Funds

Capitalizing on the social networking and community participation, this institution has survived over several years even after the influx of several other organized financial institutions and the increased complexity of financial markets. Under this model, money is circulated to the entire cross section of our society; be it housewives, salaried class businessmen, government servants, club members under different names namely: Kitties, Bisies, Kuries, Chit funds etc. It is estimated that the value of Chit turnover in States like Kerala, Tamil Nadu, and Andhra etc. are almost 10,000/- crore each per annum. Though no authentic figures are available, the size of the unregistered chit fund industry is speculated to be almost 100 times that of the registered ones. As the growth of this unregistered sector is not in the national interest, there is an urgent need to ascertain the exact volume and take remedial measure to contain the same**.**

The presence of more than 30,000 registered chit operators generating employment opportunities for several lacs of people either directly or indirectly especially in rural areas, without taking any subsidy from the government, speaks volumes for its strength in our national economy.

Role of Chit Funds in the economy and National Financial Inclusion Program

Chit funds operate on the unique **principle of intrinsic evaluation**. It is a faith on the subscriber's ability to repay and not the collaterals or its value, thus easing the credit flow to lower/middle income group, small entrepreneurs etc which are often wedged between the exorbitant cost of the moneylenders and the stringent procedures of the bank. The chit is not seen as an investment but a plan to get lump-sum finance for meeting the expenses such as marriage, education, and housing etc. at a future date. This industry accounts for a lion's share of credit to the rural masses and provides direct and indirect employment to millions giving impetus to GDP growth. **Dr. Babatosh Dutta Committee, Dr. A.C. Shah**

committee have lauded chit funds for the role in our economy. In the findings **of James Raj Committee** based on whose report the 1982 Act was enacted, Chapter 6 Para 13 "…. The rationale of chit funds is that they bring the borrowing class directly in contact with the lending class…" in other words, in the case of chit funds, the savers as well as the borrowers are put together and they are allowed to save or borrow for a pre determined term, the rates of interest being fixed on the principle of demand and supply of funds in the same group. The Chit Funds are of a self-liquidating nature and par-take the character of mutual benefit schemes.**"** That is to say, institutions like Chit Funds, in its own way, absolve the Government of their responsibility in reducing the interest rates, stabilizing the fiscal balance, reduction in the GDP etc.

The maiden survey conducted on the working of Chit Funds by M/s Institute of Financial Management and Research, Chennai under the Aegis of the Gates Foundation is an eye opener unraveling the inherent potential of this industry and suggesting ways and means to enhance its services to the deserving lot, in context of the current economic policies. The potential of this Industry to cater to the Lower and Middle Income households is quite substantial, which is possible only with the legislative and Administrative support.

Further, an NSSO study on unincorporated non-agricultural enterprises during July 2010 – June 2011 categorizes the various sectors in terms of their contribution to GDP. The corporate sector is pegged at 15%, Agriculture 17%, Government 23% while the Non-corporate contributes a whopping 45%. It further states that despite generating a value addition of Rs.6.28 lac crore per annum, less than 4% of this sector's financial needs are served by banks! As it further rightly emphasizes that it is in the national interest to nurture this sector, one question that arise is, what better tool than Chit Funds. The working paper series of the IFMR research titled ***"Chit Funds – A Boon to Small Enterprises"*** throws more light in this context.

Efficacy of the Chit Fund Regulation: The Chit Fund Act, 1982

Background for Regulation

While traditionally chit funds primarily serve as a saving mechanism, commercially they act more like a financial intermediary bringing together borrowers and savers, aiming to channelize the liquidity from agents with surplus towards deficit spenders. At the time when banks were getting nationalized and the entire financial system was being restructured as per new regulations, the Government, being aware of the popularity of the chit funds primarily among the lower income households, brought this alternative informal financial institution under the network of the formal credit market. Regulation in the Chit Fund industry was brought about by the Government of India to address mainly the problem of misuse of informal Chit Funds by unscrupulous promoters and to have a level playing field for the Industry throughout.

Introduction to Chit Fund Act

The first enactment on chit funds was by Government of Travancore (Kerala) in the year 1932, which was later followed by Madras Chit Fund Act 1961, Kerala Chitties Act 1975 etc. The Banking Commission while examining in depth the activities of the non-banking financial intermediaries in early 1970s had, inter alia, recommended that it is essential to have uniform chit legislation applicable to the whole of the country. The Reserve Bank of India (RBI), at the instance of the Government, accordingly drafted a Model Bill for the Chit Fund. RBI also sent the draft Bill to the Study Group under the Chairmanship of Shri James S. Raj. On the recommendation of this Group, a special Act was formulated by our Parliament under the name of **'The Chit Fund Act, 1982'**. The Central Act has been notified in all the States except the State of Jammu and Kashmir. **It is imperative to bring to light that, even now, in many States either Rules have not been formulated or is not implemented.**

This Act, it is relevant to note, contains many restrictions like a minimum Capital requirement (Section 8), prohibition of transacting business other than Chit Business (Section 12), a ceiling on the aggregate chit amount which is 10 times of the net-owned funds (Section 13), Utilization of funds (Section 14), security to be given for full value of chit (Section 20), a self-contained machinery for settlement of disputes etc and a number of penal provision for various defaults, etc. That is to say, there are enough investor protection measures, built into the Act, in the interest of the subscribing public.

However, many provisions of the Act are so stringent that even the Deposit taking companies, as illustrated in the chart below, do not have such restrictions. This causes undue hardship and heavy financial burden on the chit promoter as the RBI Act prohibits him to take any deposit from the company shareholder or the public even to honor his commitment to the chit holders.

Object of the RBI Act	**Relevant Sections**	
	RBI Act, 1934	**Chit Funds Act, 1982**
Registration	45 1A	Sec. 4 & 14 etc.,
Minimum capital requirements	*45 1A*	*Sec. 8(1)*
Prudential norms	45 1B	Sec. 13
Reserve Fund	45 1C	Sec. 8(3)
Security deposit	NIL	20(1)(a)

Few of the other restrictive, stringent provisions and our suggestions for amendment are as follows.

<u>Sec 2 (b) & 11 (1) - Insertion of the word 'Fraternity Fund'</u>

In Sec 2(b) Chit is defined as ***Chit, Chit Fund, Chitty or Kuri*** and Sec 11 (1) prescribes that no person can carry on this business without any of the above four words in their name.

Suggestion: It is suggested to insert the word 'Fraternity Fund' in the definition and Sec 11, to give a new nomenclature and partly to project the modernization of the Industry. This is with a view to make the definition of chit wider, meaningful and to make it convenient to

the general public so as to distinguish its working from the 'Prize Chits' which is banned under a separate legislation.

<u>SECTION 5</u> Prohibition of invitation for subscription except under certain conditions
No person shall issue or cause to be issued any notice, circular, prospectus, proposal or other document inviting the public to subscribe for tickets in any chit unless such notice, circular, prospectus, proposal or document contains a statement that the previous sanction required under section 4 has been obtained and the particulars of such sanction.

Suggestion: Since the application for obtaining the Previous sanction must be made along with Security Deposit equivalent to the chit value, it is suggested to the requirement of deposit should be deferred to the time of commencement of chit in order to avoid any financial burden on the chit promoter, as he has to pay out of pocket till the time of first auction.

<u>SECTION 12</u> Prohibition of transacting business other than chit business by a company
(1) Except with the general or special permission of the State Government, no company carrying on chit business shall conduct any other business.
(2) Where at the commencement of this Act, any company is carrying on any business in addition to chit business, it shall wind up such other business before the expiry of a period of three years from such commencement.
…………………………
Suggestion: Though the contents of Section 12 provide for transacting other business with the permission of the State Government, it is suggested that, the word 'Prohibition' in the heading may be replaced with the word 'Permission' as it is misleading.

<u>Sec 16 - Mandatory requirement of presence of two subscribers in each Auction.</u>
This Section provides for 2 subscribers presence for the conduct of the Chit auction. Meaning thereby a needy subscriber cannot get the chit confirmed unless there are two more subscribers physically present, failing which it has to be re-auctioned in the presence of a person deputed by the Registrar, after completion of the formalities.

Suggestion: As physical presence of subscribers especially towards the end of the chit is almost impossible, it is suggested to amend the Section in a manner to provide for only one subscriber to be present and that too not necessarily from the same group.

<u>SECTION 20</u> Security to be given by foreman
(1) For the proper conduct of the chit, every foreman shall, before applying for a previous sanction under section 4, -

(a) deposit in the name of the Registrar, an amount equal to, -

(i) fifty per cent of the chit amount in cash in an approved bank; and

(ii) fifty per cent of the chit amount in the form of bank guarantee from an approved bank;

or

(b) transfer Government securities of the face value or market value (whichever is less) of not less than one and a half times the chit amount in favour of the Registrar; or
(c) transfer in favour of the Registrar such other securities, being securities in which a trustee may invest money under section 20 of the Indian Trusts Act, 1882 (2 of 1882), of such value, as may be prescribed by the State Government from time of time: provided……………………………………

Suggestion: ***It is suggested to modify the relevant sections to provide for security to the extent of 50% of the chit value, the value of the Government Security and security referred under sub sec (c) from 1 ½ times to 100% that too at the time of the commencement of the chit.***

Sec 21 (1) (b) - Right of the Foreman to charge commission to a maximum of 5%
Section 21 (1) (b) provide for a maximum of 5% of the Chit amount by way of commission, remuneration, cost of meeting the expenses to the foreman. Five percent was fixed way back in 1932 under Kochin kuries Act, Due to differential bank interest rates, increase in commercial costs, manpower, multiplicity of tax structure, and increase in the fee charged by the Registrar of Chit Fund etc it is necessary to enhance the commission for providing better services to the subscribers.

Suggestion: It is suggested to increase the commission to a maximum of 7%. As the market forces and the competition will have an automatic check on such commission, there could be no harm in increasing the cap.

Section 21 (a) - Act not to apply to certain chits. (A new sub section)
The Chit Funds are unable to cater to the economically weaker sections and offer lower denomination chits as they do not find it commercially viable to do so, on account of factors like statutory fees, transaction and establishment costs etc.

Conclusion: It is prudent to give concession in the fee for smaller denomination chits in light of the role of chit funds in the National Financial Inclusion Program and the enhanced reach of this sector to the segments not catered even by banking were taken note of.

If Chit Funds are to be encouraged to play a more effective role in the Financial Inclusion Program, and why not since they already doing a fine job of it, some amendment to Act, in tune with the ongoing liberalization, are to be attended to, and in priority.

A Key Advisory Group on Chit Fund / Nidhi Companies had been constituted by the Ministry of Finance, about three years back, with a view to Review the existing legal/regulatory / institutional framework for Chit Fund/Nidhi Companies and its efficacy; to decide the Action plan including policy initiatives for orderly growth of the Sector; and to recommend the legal / institutional / regulatory initiatives related measures required for orderly growth of the Sector etc. Though the recommendations of this KAG which includes amendment to the Chit Funds Act, 1982 has been ready for more than a year, it has not been taken forward due to State-Centre as well as inter-departmental procedural wriggles.

The said recommendations seek to address many of our grievances and smoothen the functioning of our industry. **The reason for the enormous growth in the unregistered sector is on account of the fact that the legislation is not user-friendly.**

__Unregistered Chit Funds__

- With insufficient and/or volatile income streams, rural households heavily depend on various credit options from a basket of formal and informal financial sources. The interim report of a survey by Institute of Financial Management and Research, Chennai reveal that 71% of the households take loans mainly for health expenditures (28%), which highlight an urgent need for not only providing affordable subsidized health facilities but also financial services and schemes directed to health services. People clustered around the poverty line have different incentives and requirements when compared to the middle and high income groups. Essentially what we see is that poor and vulnerable segment is particularly at risk of being further squeezed as they are dependent on informal sources for credit like friends/family and money lenders and use credit to meet basic needs like household consumption requirements (21%), meeting expenditures during financial difficulties (17%) and also to repay loans (15%). While friends and families are a convenient and relatively benign form of finance, it is worthwhile to take cognizance of the fact that typically friends and families of people in this segment may not have sufficient money to spare since in all likelihood they also belong to this segment and are also hard pressed for their needs. Also in situations when the demand for credit is inelastic, money lenders can take advantage of the urgency and charge exorbitant interest rates. Middle and High Income groups rely more on formal sources like banks and SHG's to avail loans. General credit behavior predicts the chit usage between these two groups with the poor and vulnerable group focusing on immediate and basic needs like household consumption expenditure, emergency needs and repaying loans while the middle and high income groups have a more diversified usage.

- The unregistered chits operate in different models. The profile of the participants of the 'Beesi' model in Maharashtra is typically a married woman who is not the main bread winner of the house. Frequent contributions in Beesi not only provides her a safe outlet for savings, but also helps her to get a degree of control over her household resources which she can use to increase household assets and smoothen out consumption needs. It is a forced savings mechanism, sometimes even without the knowledge of the husband which increases the saving rates of the household, which may not be possible if the same amount was saved at home. In Karnataka, the pot money is mainly used to meet business expenses (25%) where as in Andhra Pradesh, the pot money is used more to meet basic needs of household expenses. Kitty parties among the urban housewives need no introduction.

- The unregistered chits are popular because of various improvisations in the chit model at the informal and local level in the villages to overcome drawbacks like conducting multiple auctions to increase liquidity, availing loans from the wining chit scheme member and leeway in making late payments etc; which is not possible in the case of registered chits. Philanthropic organizations like Bill and Melinda Gates

Foundation find huge scope in streamlining this activity and enhancing its reach to the underprivileged, due to the inherent merits of the scheme when compared to Micro Finance Institutions and other financial institutions.

- There are unregistered chits in wholesale markets in the metropolitan cities where the volume of such single pot is as high as Rs.5 crore. **Relaxing the rigors of the Chit Fund Act 1982 could be an effective remedy to eradicating the evil of unregistered and unregulated chit funds and curtailing the parallel economy.**

Efficacy of legislation on Collective Investment Schemes

Though this is not, in any way, related to our industry, except for the connection that the media at large is bent upon making in their erroneous reporting, still as a responsible, legal, financial intermediary that has been serving the masses since inception, even before the advent of banking, we can only hope that the new bill granting sweeping powers to SEBI, to curtail the menace of CIS & other such Ponzi schemes proves effective. Also, this new statute needs to be constantly screened for loopholes and ways that the perpetrators of such scams will try to figure out to work around this legislation.

Way Forward:

Our Association, over the years, had been actively involved in the formulation of various State & Central Legislations; and many companies in existence for several decades have an impeccable reputation doing excellent service especially catering to the credit needs of lower and middle income households in certain sectors, where even banks are unable to reach. As the need of the hour is smart, and not a hard regulation, it will be prudent to suggest that ours and similar other associations be involved, more meaningfully, in the formulation and implementation of the legislation and the rules as well, as it will not be possible make the distance till all stakeholders give it a push. We reiterate our commitment for the investor protection measures and assure this august committee of our full assistance in doing everything possible, within our means, to ensure compliance level.

We shall be privileged to get a chance to depose before this august committee and look forward to the opportunity, to enable us to present our views and contentions, in person.

Thanking you,

Warm Regards,

All India Association of Chit Funds (Regd.)