

Comprehensive Credit Ratings by Chit Funds

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Introduction

- Age of Information
 - Information helps to make rational or informed decisions
 - Information helps us to reason when the solutions to problems are not clear cut
- Today we have the technology to collect, store, analyze and synthesize the data
 - The analysis and synthesis of data leads to information
- Some of the large companies and their businesses are centered around Information
- Chit Fund companies should also participate in the age of information and take advantage of the unique opportunities presented to them
 - Credit Ratings could be a part of that revolutionary break through

Outline

- Risk vs Uncertainty
- Information and Risks?
- Risk in Chit Funds
- Information and Chit Funds
- Value Creation and Chit Funds
 - Future Challenges and Opportunity

Risk vs. Uncertainty

- Difference between Risk and Uncertainty
- When *objective* probabilities can be applied to all the states of nature then uncertainty regarding the final outcome becomes Risk otherwise the event is uncertain
 - For example, in chit funds the inherent uncertainty that can make a chit scheme unviable is whether subscribers (savers and borrowers) will pay or not pay
 - If the probabilities of the future outcome are objectively determined through using rigorous data analysis and the observable characteristics (like gender, age, occupation, etc.) of the individual then we can estimate the Risk *But* if it is based on guess work or subjective analysis then it is classified as Uncertainty

Risk vs Uncertainty

- When there is uncertainty decision making is very difficult
- When there is risk decision making is a lot easier
 - Its for this reason businesses spend a lot of resources on risk analysis and risk management
- How is Uncertainty translated into Risk?
 - For example, banks use the credit history data to assess the risk of default
 - For example, consumer durable companies in order to increase their sales encourage consumption by allowing consumers to pay in easy installments. However, in order to do that they need to do a risk analysis
 - In advanced countries this is facilitated through Credit Ratings

Information and Risk

- If data is available on individual behavior then statistical analysis can be used to analyze it
- Data through analysis is then translated into Information
- Synthesis of information helps in making prudent decisions where the risk is calculated
- Caveat: Even with all the information human judgement is still required. The recent financial crisis perhaps is a classic example. One cannot look at the rear view mirror and drive the car.

Risk in Chit Funds

- Chit Funds is a unique financial instrument - saving cum borrowing instrument
- So the Risk is dual in nature
 - The borrowers might default
 - The savers might not honor their commitment
 - In this way Chit Funds are different from Banks where the risk is primarily from the borrowers

Risk in Chit Funds

- Another type of Risk is that there might be a run on the Chit Fund - every saver in the scheme wants to withdraw from the schemes. This is similar to risk banks face when depositors run for their deposits
- However in case of banks the RBI provides deposit insurance to the banks
 - But in case of Chit Funds there is no such deposit insurance, moreover, in case of a run they might lose their fixed deposits which they keep with the Regulator of Chits
- Chit Funds should balance Risk and Growth
 - If they grow fast then risks might go up
 - If they become too conservative then growth suffers - real danger of going out of business as consumers move to alternative financial instruments

Risk in Chit Funds

- Two types of Risky behavior of the Individual
- Adverse Selection: In this case the borrower might not be credit worthy. He has very high likelihood of default or delay payment
- Moral Hazard: After borrowing the behavior changes and does not honor his or her commitment
- These Risks also apply to delayed payments - which impose a liquidity constraint on the firm

Information and Chit Funds

- Good news: Chit Funds collect data on Financial Transactions of the Clients
- Bad news:
 - Chit Funds collect data but have not done anything about it (a large part of our efforts were to digitize the data)
 - As a result the data is either Incomplete or important details regarding the individuals are missing or the data is not accurate
 - The emphasis for data collection is primarily due to regulatory environment
- Potential: if this data is accurately collected and properly analyzed then this can be a Gold Mine for creating credit histories

Information and Chit Funds

- Why should Credit History matter?
 - It has been observed that analyzed data and gut based analysis is very different. Simple information like age, gender, occupation have a lot of explanatory power in predicting default or delayed payment
 - If one can predict default or delayed payment for each client then customized service can be provided. With adequate capital provision both high risk and low risk individuals can be served
 - This allows for efficient risk management, more reach, better customization, higher sustainable profits

Information and Chit Funds

- We are using the information to create a credit score for the Chit Fund clients based on universally available information
- The big advantage is that the model is general in application. But the credit score will help companies to decide their risk appetite
 - There is no free lunch high return implies high risk
 - We would also like to make the credit score portable - individuals should be able to take their credit scores credibly from one company to another
 - This helps company to incentive clients to behave well
 - A bad credit score means it is highly likely no one would want to do business, however, a good credit score might make the customer more competitive to retain
 - On the whole it allows firms to price discriminate and therefore higher profits

Value Creation and Chit Funds

- A portable Credit Score provides a potential linkage between commercial banking and Chit Funds
- In the absence of Credit Score, Banks have found it very difficult to reach out to Small and Medium Enterprises (SMEs)
 - Chit Funds could play a very important role in financial inclusion via the Credit Score
 - Profitable opportunities for all parties concerned
 - Banks get access to new clients
 - Chit Funds get advantage in terms of better customer behavior
 - Customers who otherwise would not have access to banks and therefore are credit constrained get access
 - For providing the information Chit Funds get a share in the pie from the Banks. This incentivizes the Chit Fund companies to provide accurate information