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Unregistered chit funds having a field day

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The total size of unregistered chit funds is almost Rs 30 lakh crore.

Viswanath Prasad, a peon at a broking house in Kolkata, subscribed to a "chit fund scheme" two months back. He didn't understand the documents provided by the fund, but agreed to contribute Rs 200 a month for one reason: The chit fund promised him that he would have enough money in five years to marry off his daughter.

Prasad has since discontinued the scheme, but only after his boss trashed the documents as absurd.

Prasad isn't the only one to be taken in by the "absurd" promises made by chit funds. Sample this: At a village in Murshidabad, 200 km from Kolkata, a group of villagers recently mocked at the coordinator of an investor awareness camp as he did not know the art of doubling money in three months.

"It was difficult to convince the villagers that no investment instrument can give assurance of doubling the money in two months," says the coordinator. In fact, like any other investment instrument, returns from registered chit fund schemes vary between eight and 12 per cent per annum, while the interest rate for borrowing is one to three per cent per month.

So it's obvious that agents who earn up to 25 per cent commission to bring in deposits are doing a "good" job of convincing people to aim for a pie in the sky. And most of them are from unregistered chit funds which pose as friendly neighbourhood money lenders and fleece the people.

By definition, under a chit fund scheme, a foreman enters into an agreement with a number of subscribers. Every one of them agrees to pay a certain sum for a certain period and each subscriber, as determined by a lot or by an auction, is entitled to a prize amount. But that's just theory and has no relation to what actually happens.

The clout of unregistered chit funds is tremendous, which is obvious from the fact that their number is almost 100 times than the registered ones, taking the combined yearly turnover close to Rs 30 lakh crore, says T S Sivaramakrishnan, general secretary of the All Indian Association of Chit Funds (AIACF). He belongs to one of the biggest chit fund companies — Baluserry Benefit Chit Fund. The size of the organised chit fund industry is, however, estimated to be just Rs 30,000 crore.

A study by Institute of Financial Management and Research (IMFR), Chennai, points out that the unregistered chit fund industry in Delhi is 67 times larger than the registered industry. In Chennai, over Rs 5,000 crore is circulating in unregistered chit fund schemes.

These bad apples are spoiling the show for an industry which can do wonders because of its access to the lowest strata of the society. IMFR, along with professors at Indian Business School and MIT Sloan School of Management, US, recently conducted a research on chit funds in India in over five states — Tamil Nadu, Andhra Pradesh, Karnataka, Kerala and Delhi.

According to the findings, chit funds, which are highly regulated as an industry, can be an innovative finance instrument for the low-income group which is excluded from the formal financial system. While chit funds are decreasing in terms of numbers, they are growing in terms of value. This implies that registered chit funds find it less lucrative to fund the poor due to the rising operating cost imposed by regulators.

The trust, with funding from the Bill & Melinda Gates Foundation, is planning to take up pilot projects in four states — Tamil Nadu, Kerala, Andhra Pradesh — to assess how registered chit fund companies can be developed as effective financial instruments for equitable growth among the rural poor.

"Chit funds provide outright finance to poor, at a lower rate of interest. They involve less documents and are good saving instruments. We are trying to do an objective study, assess if it can be promoted as an effective financial tool for the poor. In our project, we are trying to find out if chit funds can provide loans outside the scheme," said Preethi Rao of IMFR. The default rate in registered chit funds is as low as one to two per cent, she points out.

"Many people who use chits have no access to banks and other forms of finance, thus chits provide a good 'local' solution that helps them pool savings and provide funding to businesses and individuals. Our research also finds that people are smart at comparing the effective interest rates between chits, banks and money lenders and thus there is competition between some of these institutions," said Antoinette Schoar, professor of economics at MIT, USA.

In contrast, the average number of registered chit funds has gone down by around 10 per cent in the last two-three years, although the average fund size has increased from less than Rs 1 lakh a few years ago to up to Rs 4 lakh, says Sivaramakrishnan.

"Running a chit fund is no longer viable. Until 2003, we had steady growth, but after that, though the money circulated has increased, the number is going down. Out of the five per cent commission we get, a large part is government fees," says Sivaramakrishnan.

Some bigger players in the chit fund industry are now thus systematically diversifying into other finance activities.

Shriram Group, which runs one of the largest chit funds in India, with an annual auction turnover of close to Rs 3,000 crore, has a customer base of about 500,000-600,000. The company is leveraging this to expand other business lines like consumer and vehicle finance.

"Chit is not a remunerative and scalable business these days. Earlier, people used to participate in chits to buy small things like TVs and refrigerators. These days, they have finance from banks. In the last three years, we have consciously reduced the number of customers by 100,000-200,000. It may come down further in the years to come," said a Shriram Group executive.

On the other hand, unregistered chit funds have found a utility in evading tax and access to large public deposits, which no chit funds are allowed to accept, or Ponzi schemes.

The All India Chit Funds Association is pitching for an amendment to the present chit fund act of 1982 to legalise unregistered chit funds. It is also trying to work on an insurance mechanism to protect the investors.

Recession was a blessing in disguise for chit funds, when many small businesses started borrowing from chit funds at lower rates than banks.

"Last year, there was five-seven per cent additional growth in the chit fund market in Delhi alone. People could get loans without many documents," said Sivaramakrishnan.