Chit Fund

Why in News?

- Recently Unregulated Deposit Schemes Bill, 2018 was passed by Lok Sabha.
- The Bill seeks to provide for a mechanism to ban unregulated deposit schemes and protect the interests of depositors.
- It also seeks to amend three laws, including the **Reserve Bank of India Act, 1934** and the **Securities and Exchange Board of India Act, 1992**.

What is Chit Fund?

- Chit funds are a popular type of savings institutions in India. It is one of the main parts of the unorganized money market industry.
- It refers to an agreement arrived at by a group of individuals to invest a certain amount through periodic instalments over a specified period of time.
- The chit fund provides access to savings and borrowings for people with limited access to banking facilities.
- Chit funds in India are managed, conducted, and regulated according to **Chit Funds Act of 1982**.
- They are governed through central legislation while state governments are responsible for their administration.
- Chit funds are the Indian versions of **Rotating Savings and Credit Associations** found across the globe.

Rotating Savings and Credit Associations

- A Rotating Credit and Savings Association or ROSCA is an alternative financial vehicle in which a group of individuals fills the role of an informal financial institution.
- In a ROSCA, members pool their money into a common fund, generally structured around monthly contributions.
- Single members withdraw money from it as a lump sum at the beginning of each cycle.

Types of Chit Funds

There are three types of chit funds:

- **Chit funds run by state governments**
  - These funds are managed and regulated by state governments.
  - Funds run by PSUs (public sector undertakings) also belong to this class.
  - These are safe and chances of loss are limited. Business processes are transparent and clean.
- **Private registered chit funds**
  - These chit funds are registered as per Chit Funds Act of 1982.
  - These are normally floated by prominent financial institutes or business houses.
  - Participating in these funds is not as safe as in state governments or public sector undertakings.
  - However, as they are under the management of leading private sector companies or institutes the risk is calculated and bearable.
- **Unregistered chit funds**
  - Unregistered chit funds are not legal and participation in these is up to the risk of members.
  - Such types of chit funds are common throughout India and are usually formed by a close group of associates.
  - Participation in these funds should be avoided as disputes are subject to members' integrity and honesty.

Why Chit Funds?

- Low rate of interest on small saving provided by commercial banks are usually not coherent with the market rate, resulting in middle income group moving towards unregulated deposit schemes.
- Obtaining formal loan still remains a huge task for a common man as banks, financial institution are plagued by stringent procedures.
- Less regulated regime at fairly competitive interest rates prevailing in the market makes these schemes easily accessible.
- Chit funds come handy to meet exigencies like death or ill-health as well as joyous occasions like marriages and child-birth in the family.
- These types of scheme promote savings culture as each member is supposed to contribute a fixed amount every month towards the fund.

Existing Regulation

- At present chit funds are governed by **Chit Funds Act of 1962, RBI Act of 1934, and SEBI Act of 1992** etc.

- Under the Chit Fund Act of 1962, businesses can be registered and regulated only by the respective State Governments.
- **Regulator of chit funds** is the Registrar of **Chits** appointed by respective state governments under Section 61 of **Chit Funds** Act.
- Functionally, Chit funds are included in the definition of **Non-Banking Financial Companies (NBFCs)** (LINK) by RBI under the sub-head **Miscellaneous Non-Banking Company (MNBC)**.
- RBI however has not laid out any separate regulatory framework for them.

Need for Stricter Regulations

- **Fraudulent companies:** There have been raising instances of people in various parts of the country being defrauded by illicit deposit taking schemes such as Saradha Chit Fund Scam, Rose Valley Scam etc.
- **Financial Illiteracy:** Lack of financial literacy results in people getting duped as they are promised huge return on their investment which has no substantial basis to fulfil.
- Despite the presence of staunch rules against scams by chit funds, a lot of these funds run **Ponzi schemes** and make away with a lot of people's money.

Ponzi Schemes: Ponzi schemes are investment operations that pay returns to old investors from the money garnered from new investors.

- **Non-Transparency:** Chit funds, especially those catering to a large number of members, are opaque both in their operations and eliciting of bids.
- **Administrative Loopholes:** Companies running such schemes exploit existing regulatory gaps and lack of strict administrative measures to dupe poor and gullible people of their hard-earned savings.
- **Lack of Accountability:** There is no deposit insurance for investors. If a registered chit fund company files for bankruptcy neither the government nor the Reserve Bank of India can help the investors.

Way Forward

- The proposed amendment will prohibit unregulated deposit-taking and provide for deterrent punishment for promoting or operating such schemes, besides introducing other changes.
- The focus need to be on implementing the rules without political interference and strengthening the judicial mechanism without which any amendment to the law will be of little help to the citizens.
- Amendment in the proposed legislation will only safeguard the depositor interests, without addressing the structural problems of lack of financial inclusion, skewed bank ratio in rural areas etc.

- Better and accessible banking alternatives will not only check undue exploitation of poor people but will also correct leakages in the economy.