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Chit Funds an Alternative for Creative Savings

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Abstract

In the Financial System of India, the Non-Banking Financial Sector which consists of various financial institutions and Chit Funds play a major role even though there is a dominance of banks, financial corporation and other investment companies. The Non-Banking Financial Companies plays a significant role in the financial system of India. The Indian market is getting to be consumer-led. This is the reason behind the unprecedented boom in consumer financing. The chit fund is also known as chitty or kuri in India and ROSCA (Rotating Savings and Credit Association) internationally, occupy a unique position in the financial system of India. This is an indigenous system which has its origin in India; particularly in the southern region.

Keywords: Chit funds, NBFC and Chit Schemes.

Conceptual Framework

The concept of chit fund can be explained as "a voluntary grouping of individuals who agree to contribute financially at each of a set of uniformly spaced dates towards the creation of a fund, which will then be allotted in accordance with some prearranged principle to each member of the group in turn". Once a member has received a fund, he/ she is excluded from the allotment of future chits until the ROSCA ends. The term 'chit' stems from the Tamil word 'chitty', meaning a written piece of paper, which directly points to one important allotment mechanism, where a lot determines each date's ' winner' of the chit. The highest bid wins the chit and the price the winner pays is distributed among the other bidders.

Chit funds are good for savings or finance. Few realize that the cost of intermediation is the lowest in chit fund schemes and is strictly governed by legislative and RBI guidelines. The service charges are fixed at 5% for each individual subscriber for the entire duration of the series, which may be 2 to 3 years.

Literature Review

The researcher has reviewed the literature related to Non-Banking Financial Companies such as ROSCAs, Chit Funds, Micro Credit Institutions, Nidhis and their role in the Financial Sector.

Business Line, (2009),[1] points out that The Reserve Bank of India has cautioned non-banking finance companies that in the event of an existing customer or the beneficial owner of an existing account subsequently becoming a politically exposed person (PEP) then the companies should obtain senior management approval to continue the business relationship. Further, the account has to be subjected to customer due diligence measures as applicable to customers in the PEP category including enhanced monitoring on an ongoing basis. They should verify the identity of the person and seek information about the sources of funds before accepting the PEP as a customer. The decision to open an account for PEP should be taken at a senior level.

Rajagopalan. C. (2009),[2] said that the Chit funds play a vital role in improving the economic base of the poor in the country, besides adding to the significant growth of our economy. Despite scams by bogus companies here and there, people still find chit funds a viable alternative in terms of easy accessibility, good return on savings and timely availability of money to meet all types of family needs. A study by IMFR, Chennai, on the scope and functioning of the registered chit fund industry in India has revealed that low-income households still preferred chit funds to other financial vehicles for their economic needs.

Vaidyanathan. R. (2005)[3], indicates that in a large country like India with substantial service sector activity, it is important that the role played by NBFCs in credit provision is recognized. They have an extensive network and credibility among their constituents, both borrowers and lenders. In fact, for the unorganized sector they are the source of finance. But they are being given the short-shrift.

Bhujanga Rao .K.N.(2002)4, claims that in the financial sector, it is conservatism that leads to stability. The Nidhis of South India, the oldest form of institutionalized banking in the country, have

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consistently proved this point. The 200-odd nidhis in the country do about Rs 2,500 crore of business. A few of them are more than 100 years old such as the Egmore Benefit Fund, and the Nungambakkam Saswatha Dhana Rakshaka Nidhi. Even in a market where large banks are getting into housing and jewel loans, some of the nidhis have stood their ground, although they lend at much higher rates than banks.

Jaffee and Russell (1976)[5], show how imperfect information and uncertainty can lead to rationing in credit markets. They introduce a model with honest borrowers (who want to repay) and dishonest borrowers (who are ready to default when the costs of defaulting are low). The lenders only know the distribution of these two types of borrowers but not the exact type of each individual applicant.

Present Status

From a humble beginning to its present gigantic growth, the chit fund has now attained the status of a quasi banking system, and has turned out to be a boon to the aggressively growing economy of the nation. According to a report of Asian Development Bank, the turn over of some 1066 chit fund companies, as far back as 1986 was, an astounding Rs.81.6 billions. From individuals to large institutions like Public Limited Companies, now functioning as chit promoters, remarkably well cater to the financial needs of different strata of the society.

Regulations Governing Chit Funds

Way back in 1965 several state Governments had enacted their own statutes to control chit business. In order to bring about uniformity of legislations all over the nations and to protect the interest of the subscribing public more effectively, Government of India enacted The All India Chit Funds Act in 1982. This comprehensive Act imposes rigid control on each and every aspect of chit business. Among other factors, this Act prescribes capital requirement, furnishing of security deposit, registration of chit group, submission of accounts, furnishing of statutory return etc. This Act has, on the whole, brought about a salutary effect on the healthy functioning of chit business.

Chit Funds Compared to Bank Schemes

Chit schemes are organized on a personal basis and have lesser stringencies involved. Decision-making is comparatively faster. The income from chit schemes comparatively favorably with the incomes from bank schemes in many cases. Liquidity is compromised when you make a FD or join a recurring deposit scheme. You may get a loan up to 75% of your deposits. In chits, the prize amount is always more than the amount of deposits made in the chit. Bank schemes and chit schemes are two absolutely different financial instruments offering benefits in their own different ways. Chit schemes are unique and as such the two may not be comparable.

Problems of NBFCs

Controlling is the major problem regarding NBFCs because they are heterogeneous in nature and they are more in numbers. The NBFCs are spread every nook and corner of the country. So RBI has huge limitations regarding control of NBFCs. Then many of the NBFC's are not registered with the RBI. So the authorities do not even know about the business of the NBFCs.

Table I. Status of Registration of NBFCs

Application Received	37,274
Approved to Accept Deposits	679
Approved for registration without authorizations to accept deposits	8,451
Rejections	14,986
In consideration	13,158

Source: www.rbi.org.in

The NBFCs are not showing their Annual reports to the RBI because of that RBI is not able to assess the performance of the NBFC's.

Table II. Submission of Accounts by NBFCs

Total registration	9,130
Submitting the Accounts	1,536

Source: www.rbi.org.in

Even though the NBFC's showing their Accounts it is not possible to RBI to cross check the accounts by internal audit as the NBFCs are more in number. As the NBFCs are not submitting the accounts, the RBI is not able the monitor the performance of NBFCs whether it is paying interest or not? Whether it has invested the deposit in a better manner or not?.

Scams are the other important problem of the Non-Banking Financial Companies. As seen in the beginning of the report the major reason for the scams is the unethical practices of the management of Non-Banking Financial Companies. There is a possibility of scams in the Non - Banking Sector from the Registration stage itself. In the Registration process some NBFCs are showing the fake records. Also in the case of receiving deposits there are scams. The approved companies are only allowed to accept deposit but many of the unincorporated companies are also accepting deposits. Another major reason for the failure of NBFC's is that they are unable to ascertain the right portfolio for the investment which ultimately leads to scam like situation. Some of the Non-Banking Financial Companies use these deposits for the purpose of speculation and gambling as per the Financial concept "where there is a high return there should be a High Risk "These two are high risk business so there may be a chance of scam.

Success Factors

For the following reasons most of the people prefer Non-Banking Financial Companies rather than Banks, Financial Institutions and other investment options.

- Simplified Transaction procedure.
- Orientation towards customers.
- Attractive returns.
- Flexibility.
- Timeliness in meeting the credit needs.

Even though there are many reasons for depositing in NBFCs, attractive return is the most important reason and in the case of lending simplified sanction procedure is the most important reason for the preference of NBFCs. ROSCA groups typically do not exceed 100 members. Bidding ROSCAs thus face an issue of strategic interaction as well as one of volatility if the world is not perfectly certain. On the other hand, their limited size makes ROSCAs particularly suited for setting in which financial intermediation through banks often fails.

Chit funds In The Near Future

There are around 2851 registered chit fund organizations in Tamilnadu and the contributions made to the National Income by these chit fund organizations are keep on increasing. The turnover made by the registered ROSCAs is around 100 billion rupees, about 2.5 billion U.S. dollars in 2001, while bank deposits averaged 55 billion rupees during the same period. This shows that the status of chit funds has risen to the greater extent than that of other Financial Institutions. Elevating chit fund industry to the level of an alternate banking system, to the masses that have no access to formal banking will make the chit funds more successful.

Suggestions to Governing Body

The submission of accounts should be made as a mandatory one and a surprise internal audit should be there in order to verify the accounts of the NBFCs. The governing body should take necessary steps to eliminate the unincorporated bodies or other wise it may try to make the unincorporated bodies into an approved one. The RBI should take necessary steps to create some awareness among the investors about the registered and unregistered Non-Banking Financial Companies through media. RBI is the Regulating Authority of the NBFCs the RBI is doing these functions as a one among of many. A separate sector which deals with the thousands of crores of money, lakhs of investors and thousand of companies should be treated as a unique one so the NBFC's should be treated as separate one so there is a need for a separate regulating authority such as IRDA, TRAI, SEBI. There is no separate legislation such as the banking companies and limited liability companies have. So the legislation which completely deals with non-banking should be enacted. The Reserve Bank of India can insist the NBFCs to go for a Asset Management Company because Asset Management Company is a professional one they will know what is going to happen in a particular investment avenue. So it is always useful to have the presence of asset Management Company in the non-banking sector. The regulating authority can take necessary steps to cover the deposits of NBFCs under Deposits Insurance Scheme. At present the deposits in NBFCs cannot be insured under the Deposits Insurance Scheme.

Suggestions to Investors

Before investing the money in NBFCs the investors should answer the following questions.

1. Is it registered?
2. Is it reliable?
3. Is the company allowed to accept deposits?
4. Is it possible to give high return?
5. Is our money invested in a prosperous avenue?
6. Are the company's past records a good one?

If the investor gets a positive answer for many of the question he can think of investing in that company. If not, he should reconsider the investment avenue.

Suggestions to NBFCs

The suggestion to the Non Banking Finance Companies is only one that is to follow the business ethics because ethics is the major problem in the world of business. They should register with RBI, they should run their business according to the regulations, they should invest the money or deposits in appropriate avenues and they should not try to cheat the investor.

Conclusion

In India, the financial Institutions have attained an enormous growth in the recent past. The chit funds come under the category of non-banking financial companies (NBFC). Even though there are many institutions providing the financial assistance and financial facilities, the chit funds organizations laid down their own path in the NBFC sectors. The chit fund is a complex institution, and unlike a standard financial market, the payoff a participant receives cannot be not directly summarized. Rather, it depends on the endogenous composition of participants in each group.

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