ISSN 2321 - 371X

Chit Fund – Is it an Ideal Financial Instrument?

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Abstract

Chit funds are considered as the poor men's banks in India. Individuals who live in rural and semi-urban areas find chit fund as a means of finding solution to their financial problems to a great extent. Presently, the chit fund business in India is governed by Indian chit fund Act 1982. Chit funds operate in different forms like private organized institutions, private unregistered institutions, co-operatives and government sector institutions. The various principles of chit fund business are equity, assurance, probability, co-operation, reward and legitimacy. Chit fund is a dual financial instrument as money can be invested in it in anticipation of a fair return and it offers loan facility, on the guarantee of the amount invested, at a reasonable rate of interest.

Key Words: *Chit Fund, financial instrument, prize money, net rate of return*

I. Introduction

The development and prosperity of an economy depends on how successfully the nation can mobilize its domestic savings. Individuals used to save a part of their income for meeting their future needs and also to meet contingencies. The funds so saved need to be channelized for financing productive activities to augment the process of economic development of a nation. The domestic savings in India originate from 3 sectors viz., public sector, private corporate sector and household sector.

In India, more than 65% of the domestic savings come from household sector. In order to mobilize this household sector savings, banking and non-banking institutions are operating in our country. A chit fund is one of the important non-banking financial institutions. Government, private and co-operative sectors run their own chit funds business based on the chit fund act. These chit funds function as an important agency for mobilizing the household sector savings towards productive purposes.

II. Chit Fund – The Concept

According to section 2 of the Indian Chit Fund Act 1982, "chit means a transaction whether called chit, chit fund, chitty, kuri or by any other name or under which a person enters into an agreement with specified persons that everyone 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 such subscriber, shall, in his turn, as determined by lot or auction or in such other manner in the chit agreement, be entitled to the prize money".

III. The Research Problem

The chit fund business is considered as poor man's bank. Basically it caters to the requirements of low income people in the rural and semi-urban areas. Chit funds maintain a balance between savings and borrowings. It is an organization where savers and borrowers meet together. Chit fund is considered as in important institutions which relieve the common people from the clutches of money lenders. The rate of borrowings and savings is determined internally based on demand and supply for money. In India, nearly 10% of the people associate with the operation of chit fund business. Chit fund is considered as an important financial instrument of the common man. Being a financial instrument it should satisfy the requirements like profitability, safety, liquidity and transferability. In this context, it is highly relevant to examine whether the chit fund can be considered as an ideal financial instrument both from the point of investors and borrowers.

IV. Objectives of the Paper

The specific objectives of the paper are;

1. Examine the structure and types of chit fund business prevailing in the country.
2. Identify the principles of chit fund business; and
3. Assess whether chit fund is an ideal financial instrument or not.

V. Methodology and Data

The study makes use of both secondary and primary data. Secondary data are collected from books, articles and reports of different agencies. Primary are collected through a series of formal discussions with the foremen of chit funds in the private (registered), co-operative and Government sectors. Data are also gathered from the clients of these three sectors through formal means. Personal discussions are also held with clients to collect their views and attitudes as investors and/borrowers of the chit funds.

VI. Operational Terms and Definitions Used

VI. (A) *Gross Amount (Sala) of Chitty*

The agency/individual or firm which is registered with the registrar, will determine the gross value of chitty amount out of past experience and expectation by using the formula:-

Gross Amount of Chitty = Monthly Premium × Duration in months.

For e.g., Rs. 1000 × 50 months = Rs. 50,000, where Rs. 1000 is the maximum monthly contribution needed from a subscriber, 50 is the duration of the chitty in months and Rs. 50,000 is the maximum sum assured. The duration of the chitty equals to the number of subscribers, as there must be one subscriber (not more or less) to receive the prize money every month.

VI. (B) *Prize money determination*

The minimum prize money is determined as per the norms given in chitty Act. At present it is fixed at 70 per cent of the gross amount of the chitty. If more than one subscriber is willing to accept the minimum prize money, lots are conducted and the lucky subscriber gets the prize money each time. In the absence of any subscriber willing to accept the minimum 70 per cent prize money, a reverse auction is conducted where subscription open-bid for lowest amount. The following illustration elaborates the prize money determination process.

Illustration

Gross amount of chitty Rs. 50,000

Monthly premium Rs. 1000; Number of months 50

The prize money = 50,000×70% = Rs. 35000

Total discount = Gross amount – Prize money

= 50,000 – 35000 = Rs. 15000

$$\text{Discount per member} = \frac{\text{Total discount}}{\text{No. of members (No. of instalment)}}$$

$$= \frac{\text{Rs. } 1500}{50} = \text{Rs. } 300$$

When the bid is fixed at Rs. 45000;

Total Discount = Gross Amount – bid amount

= 50,000 – 45,000 = 5,000

$$\text{Discount per member} = \frac{\text{Total discount}}{\text{No. of members}} = \frac{5000}{50} = \text{Rs.}100$$

VII. Results and Discussions

The results obtained from examination of the secondary sources and discussions held with respondents are given below.

VII. (A) Forms of Chit Funds Operation

The chit funds operation in India take place in 3 forms (1) Simple chits (2) Prize chits and (3) Business chits.

1. *Simple Chit Funds:* It is a non-profit earning scheme. The rules and regulations are oral and mutually agreed upon by the interested parties. There is no official promoter. Each member agrees to contribute a specific amount at regular intervals. The prize winner is selected by lot out of the regular and needy subscribers.

2. *Prize Chit Funds:* This is also called as lottery chitty. It involves an element of gambling. The promoter of the chit fund invites the public to join the scheme and enrolls more subscribers than the number of installments. The prize winners' name will be removed from the list of subscribers and they need not pay further installments. The other members get back the total subscription plus interest on the termination of the chitty. No commission is charged because the promoter derives enormous profit by way of interest from prize chitty business.

3. *Business/Auction Chitty:* This is the only type of legally approved chit funds business in India.

Based on the authority which conduct the chit business, chit funds are grouped as follows:-

1. Private chit funds
2. Co-operative chit funds, and;
3. Government chit funds.

A brief description of each type is given below.

1. *Private Chit Funds:* The private chit funds may be organized sector chit or unorganized sector chit. Organized sector chit funds are functioning as sole proprietorships, partnerships and joint stock companies registered with the Registrar. The interest of both the foreman (promoter) and subscribers are legally protected.

   The unorganized sector in the private chit funds covers unregistered units. It functions using personal contacts, influence and other forms of relationships. The interests of any of the parties to such a chit fund are not legally protected.

2. *Co-operative chit funds* – The co-operative societies can conduct chit fund business by registering with the registrar of co-operative societies. Primary co-operative societies, employees' co-operative societies etc. can undertake chit fund business subject to the provisions of both the Co-operative Societies Act and Chit Fund Act, and the related rules and regulations.

3. *Government Chit Funds* – Kerala State Financial Enterprises (KSFE) Ltd. is the sole agency of conducting chitty business in the government sector in the state of Kerala. It was formed in 1969 with a capital of Rs. 2 lakh. It is a non-banking financial institution conducting chits of different gross values ranging from monthly subscription of Rs. 500 to Rs. 250,000 with different duration of 30, 40, 50, 60 and 100 months. At present KSFE Ltd. has a customer base of more than 25 lakh and the annual business of Rs. 14,646 crores as on 31-3-2012.

VII. (B) Principles of Chit Funds Operation

A close examination of the operational mechanism of chit funds reveals that it follows the important principles in economics, commerce, management and co-operation. The important principles of chit fund business are;

1. *Principle of Co-operation:* A chit fund is an association of subscribers to meet their financial requirements. It follows the motto of 'each for all and all for each and self help through mutual help'.

2. *Principle of Probability:* Every subscriber of a particular chit fund has the same probability of winning the prize money. No subscribers have any preference over others. In other words, all the subscribers' probability of getting the lot remains the same.

3. *Principle of Equity:* Though a member did not get the prize money, he is eligible to get the share of discount (*Veethappalisa*) on an equitable basis. The share of discount per member will be equal to total discount divided by total number of members.

4. *Principle of Assurance:* The right of every subscriber to receive the sum is legally protected by the chit funds Act 1982. There is no uncertainty in getting the sum assured or prize money either at lot or at the end of the chit funds.

5. *Principle of Reward:* Chit fund is an economic activity as it is designed to a return. The promoters of the chit funds (foremen) shoulder the risk of gathering a group of persons to contribute towards the chitty. As a reward of his service, 5% of the gross value of the chitty will be the commission for him.

6. *Principle of Economics:* The chit fund business follows the important principle of economics like laws of demand and supply. When there are more members to take part in the lot or bid, the prize money reduces and the amount of discount per member increases and vice versa.
7. *Principle of Legitimacy:* Chit fund is formed in accordance with the Chit Fund Act passed in India. The chitty operations in the various states were conducted subject to the different Acts passed in the respective states as shown in Table 1. At present, the functioning of all the chit fund activities in the country are governed by the Indian chit fund Act 1982 which came into effect from April 30, 2012.

Table 1: Chitty Fund Acts Prevalent in States

S. No	Name of State	Chit Fund Act
1	Tamil Nadu	1961
2	Pondicherry	1966
3	Andhra Pradesh	1971
4	Goa	1973
5	Maharashtra	1974
6	Kerala	1975
7	Uttar Pradesh	1975
8	New Delhi	1982
9	Karnataka	1983

VII. (C) Chit Fund – As an Instrument of Investment

An investment always ensures some income subject to the risk involved in the class of investment. In addition to return, the characteristics of an ideal investment include liquidity, transferability, and certainty. Whether, chit fund is an ideal investment avenue or not can be examined with the following example.

Gross value of the chitty (*Sala*) Rs. 100000 (monthly installment of Rs. 2000 and duration 50 months). Suppose the chitty is auctioned at 18th installment to Mr. A at 11% discount.

The prize to be received by Mr. A at the 19th installment would be Rs.100000 – 11% = Rs.89000/-

Assume that Mr. A intends to invest the Prize money in the chitty business (Chit fund as an investment) and the rate of interest available is 10% p.a. Interest at 10% interest for the remaining period of the chitty 31 months (50 months – 19 months) will be

Rs.89000 ×10% for 31 months = Rs. 23,733.

Total cash inflow of Mr. A = Principal + Interest

= Rs. 89000 + 23733 = 1, 12,733

If the total dividend earned by Mr. A during 50 months period

= Rs. 6000.

Mr. A's net cash outflow for 50 months chitty

= 100000 – 6000 = Rs. 94000

Net surplus of Mr. A = Total cash in flow – Total cash out flow

= Rs. 112733 – 94000 = Rs. 18733

Average return per month

$$= \frac{\text{Total surplus}}{\text{Total months}} = \frac{18733}{50} = \text{Rs. } 375$$

Gross average rate of return per annum

$$= \frac{375}{2000} \times 100 = 18.75\%$$

Net average rate of return

$$= \frac{375}{1625\ (2000 - 375)} = 23\%$$

In a nutshell, if Mr. A invests the prize money in the chitty business, he is expected to get a gross margin of 23% and a net margin of 18.75%

VII. (D) Chit Fund – As a Borrowing Instrument

Chit fund can be used for borrowing finance also. The various factors that are usually considered for borrowing money will be;

- rate of interest payable
- security to be offered
- period of repayment

Consider the same example of the chitty having gross value Rs.100000 (2000 × 50)

Mr. X. borrows money from the chit funds

(Chit fund – A borrowing instrument)

If the chitty is auctioned to Mr. X at the maximum discount of 30%.

Total amount receivable by Mr. X

= 1,00,000 – 30,000

= Rs. 70,000

Annualized cost of borrowing

$$= \frac{\text{Total cost}}{\text{Total no. of months}} = \frac{30000}{50} \times 12$$

= 7.2%

Also assume that if the total auction discount for the period of 50 months is Rs. 6000.

Net cost of the chitty = Gross discount – discount

= Rs.30, 000 – 6,000 = 24,000

Net annual cost of borrowing

$$= \frac{24000}{50} \times 12 = 5.76\%$$

When the duration of chitty increases, say 60, or 100 months, the cost of borrowing will further come down.

In short, If Mr. X borrows money from the chit fund business, his gross cost of borrowing will be 7.2 per cent and net cost of borrowing will be 5.76 per cent.

VIII. Conclusion

Chit fund is a conventional form of mobilizing finance for the rural and semi urban people. It is considered as the poor man's bank. People who need financial aid associate themselves and mobilize money to meet their requirements. It is a meeting place of depositors and borrowers. In other words, every member of a chit fund discharges dual roles, one as a saver and the other as a borrower.

Every subscriber's interest is legally protected by the chit fund Act. The total amount of discount (*Veetha Palisa*) is equitably distributed among all the members. Principles of co-operation, equity, probability, reward, assurance and economics are the hall marks of chit fund business. The whole chit fund business in India is presently governed by Indian chit fund Act 1982, which ensures the safety and protection of all those who are involved in the business. Chit fund is considered as an ideal financial instrument as it gives high rate of return to the investment. At the same time, the cost of borrowing from chit fund is comparatively less. Therefore, it may be concluded that chit fund can be treated as an ideal financial statement. At one side, it saves the subscribers from the indigenous money lenders and on the other side, subscribers are relieved from the enormous legal formalities associated with the banking transactions.

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