

RGICS Legislative Brief

RAJIV GANDHI INSTITUTE FOR CONTEMPORARY STUDIES
JAWAHAR BHAWAN, DR. RAJENDRA PRASAD ROAD, NEW DELHI-110001



RGICS LEGISLATIVE BRIEF

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**The Chit Funds (Amendment)
Bill, 2018**

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PART I. KEY MESSAGES

1. **The unorganized companies/individuals of the industry continue to stay out of the formal structure:** While the whole idea of introducing a new Bill was to bring the unorganized chit companies or individuals into the formal net, and by not doing it, the government misses its opportunity to ensure safety and security of public money in the case of a high risk industry that largely impacts the poorer sections of society.
2. **Bill does not adequately safeguard consumers:** While the government had promised to bring in laws that regulate chit fund schemes to protect investors, the proposed amendments in the new Bill, however do not guarantee to do so. Moreover, the importance of promoting of financial literacy for the public before investing in such schemes has been neglected.
3. **Bill does not incorporate most of the recommendations of the Parliamentary Standing Committee on Finance and the Advisory Groups on Chit Funds set up by the Central government:** It is surprising that despite several recommendations suggested on the orderly growth of the said sector, the government has hardly given any importance to these recommendations in the new Bill. Some of important recommendations include, insurance cover, regulatory authority, redressal cell, whistle blower mechanism etc

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PART II-INTRODUCTION

What is a Chit Fund scheme

Chit fund is a traditional financing system practiced in India wherein a few people (known as members or subscribers) come together and invest a fixed amount every month for a fixed period. It provides succor to those who are looking at an alternate to money lenders and the stringent procedures followed by banks. During the process of collection, any member can draw a lump sum through various ways like a lucky draw, an auction or a member can even fix a payout date based on a known expenditure.

How does a Chit fund work?

A Chit fund may be conducted by companies incorporated to do this as a business, governed by state or central laws. There is an office of “registrar of chit funds” in every state that monitors operations which are quite stringent and utilization and appropriation of subscribers’ money is strictly prohibited and is managed by one of the members, who is known as the Foreman. The Foreman is responsible for collecting the subscription amount from the subscribers, recording details of members and conducting the auctions etc. Some Chit Funds also function as unregistered businesses and could also be unorganized schemes conducted between friends or relatives.

Current Status of Chit Fund Industry

The Chit Fund industry is pegged at a value of Rs 25,000 crore¹ and represents roughly one third of the industry nationally. There are approximately 30, 000 registered companies and over five million members currently active in the market and they have grown at an average of 10-15% per year over the past few years. An estimated 72% Indians have used chit funds at some point or the other (individuals mostly belong from rural/ low income households) and a number of them have been duped from time to time. In 2016 alone scams worth at least Rs 80,000 crore came to light. Despite these risks individuals with poor access to credit or awareness, usually from the poorer sections of society continue to invest in them.

Advantage of Chit Funds

- Ability to borrow money (pot) by paying just the first monthly instalment.
- The non-prized subscriber who is a saving member up to the last instalment gets a dividend which is comparatively higher than the interest that are accrued by way of other Deposit Schemes.
- It’s not compulsory to disclose the purpose for which the money will be used

Disadvantage of Chit Funds

- No guarantee of fixed returns.
- Chance of fraud is high
- A winning subscriber may disappear after winning the first bid.
- The subscriber may default on next instalments.

¹ <https://www.pressreader.com/india/business-standard/20151104/281509340059417>

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- High degree of risk with very little protection.

Amendments to the Chit Fund Act

According to the Ministry of Corporate Affairs, Government of India, till 31 October 2014 there were more than 5,000 listed chit fund companies in India out of which some have even been running for over 100 years. However, the Chit Fund Act came up only in 1982. Before that, chit funds were not governed by any central law.

As per the Act, if 'Chit Fund' companies were caught cheating their investors, action could be taken against them under the Chit Funds Act 1982 and the Prize Chits & Money Circulation Schemes (Banning) Act, 1978. Violations of the provisions of the Companies Act, 1956 by such companies are to be investigated by agencies under the Ministry of Corporate Affairs including the Serious Fraud Investigation Office (SFIO).

1. In the year 2013, the Serious Fraud Investigation Office (SFIO) submitted a status report of investigations into the affairs of 54 'Chit Fund Companies' operating in East India, who were caught mobilizing huge funds from the public for booking of land, flats and various other activities to camouflage receipts of deposits from public in violation of provisions of the above Acts. Post this, the Ministry of Corporate Affairs found out that there were more than 34,754 finance companies operating without registration as Non-Banking Finance Companies (NBFCs) and sent a request to initiate criminal action against them under the Reserve Bank of India Act sent to the Finance Ministry².
2. Later RBI in 2014-15 reported that there are 1176 NBFCs operating in different States/ Union Territories which are not registered with RBI, against whom complaints regarding Non Payment of investor's money have been received or noticed by the RBI .However only 90 cases relating to chit fund companies/ Non-Banking Finance Companies (NBFCs)/Multi Level Marketing (MLM) and Directorate of Enforcement were registered/investigated by the CBI till 2016.³

A shortcoming of this Act is that it vests the responsibility of framing the rules with the state governments. It has been found that a number of state governments are yet to frame any rules to implement the Central Act. Other issues in the existing Chit Fund Act include- chit fund companies can collect subscriptions up to 10 times their net worth; they can legally conduct bids even when only two members of a group are present; there was no deposit insurance for investors; and there was no regulator. In such a case if a registered chit fund company filed for bankruptcy, neither the government nor the Reserve Bank of India can help the investors. Also sometimes, money collected by chit funds has been diverted into other businesses by the promoters.

Recommendations of the Key Advisory Group in 2013

Based on an increasing number of fraud cases (such as the Sarada, Sahara and Rose Valley scams), concerns had been expressed by various stakeholders regarding challenges being faced by Chit Fund customers. Therefore, a Key Advisory Group on Chit Funds was formulated in 2011 to review the existing legal, regulatory and

² As only 12,375 Companies are registered with RBI as NBFCs (as on February, 2013).

³ <http://164.100.47.194/Loksabha/Questions/QResult15.aspx?qref=34533&lsno=16>

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institutional framework for Chit Funds and its efficacy and to suggest legal and regulatory initiatives required for orderly growth of the said sector. Some of the key suggestions included:

- **Insurance coverage:** Providing insurance coverage to the subscribers' money in the hands of the Foreman may be a prudent initiative.
- **Securitization:** RBI prohibits Chit Fund companies from accepting deposits from the public but at the same time there should be some options for arranging liquidity, in order to enable the foreman to honor their commitments to the chit subscribers. Securitization can be a right step in this direction.
- **Value addition to the Chit Fund Industry:** The availability of Credit history is essential in the context of selling financial products such as insurance policies from the banks and other deposit taking institutions. Data available with chit fund companies qualifies them to undertake procurement, processing and disbursement of such products very effectively.
- **Setting up of a Grievance Redressal Mechanism:** A grievance redressal cell may be constituted which can consist of a representative of the Registrar of Chit Funds, a representative of the Chit Association and representative of the subscribing public/or anyone as decided by the advisory panel so that complaints, as and when they occur, can be resolved at the preliminary stages.
- **Rating of chit fund companies:** Chit fund companies should be rated by agencies like M-CRIL / CRISIL which will be beneficial both to the subscribing public and also motivate the chit promoters to improve business standards
- **Formation of Self Regulatory Organization (SRO):** Formation of an SRO that can keep a tab on the chit promoters and can act as a deterrent for the erring companies thereby reducing the burden on the administrators.
- **Requirement of a Common Registrar:** Creation of the post of a 'Common Registrar' for all the States since one major drawback is that activities of any company in one State are not made known to the Registrar of another State With the help of the 'Common Registrar', the respective State Registrar can then keep posting computerized financial and other reports on a periodic basis making it easier to gain access to the computerized information to the public from the office of the Common Registrar, based on a few points, and not the entire balance sheet, and some awareness.
- **Formation of Advisory Committee for future control:** Setting up of an independent Advisory Committee, that incorporates members from the RBI, Central and the State Governments will be helpful for greater transparency and better coordination. The tenure of this panel should be for a period of three years and the members should be replaced on a partial rotation basis in order to maintain continuity. and
- **Amendment to the 1982 Act:** Section 2(b) which implies the word 'Chit Fund' be changed to 'Fraternity Fund' in the definition, the change from the word Prohibition to Permission in the Section 12, Section 16 to amended as to allow virtual presence of atleast2 subscribers or proxy during auction and sections 20 and Section 63 to allow the foreman to borrow money from the prized subscribers to the extent of their future liability and lend it to the non-prized subscribers to cater to the subscribers' urgent financial needs.

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Parliamentary Committee Standing Committee Report 2015-16

Similar recommendations were later suggested in the Parliamentary Committee Standing Committee Report on Finance (Sixteenth Lok Sabha), in its twenty-first Report on Efficacy of Regulation of Collective Investment Schemes (CIS), Chit Funds, etc which largely recommended finalization of the legislative and administrative proposals for strengthening and streamlining of the registered Chit Fund sector. Some of the key recommendations were:

- **Need for Financial Literacy:** Promote financial literacy and awareness by launching countrywide media campaign.
- **Need for protection of public money:** Appropriate legislative provisions, coupled with effective administrative and enforcement measures should be brought in without further delay so that the hard-earned savings and investment made by millions of people are protected, and fraudulent operators are also brought to book. It would also help create a deterrent for fly by night operators.
- **Redressal Mechanism:** Grievance Redressal Mechanisms should be set up for citizens to lodge their complaints, as the earlier provisions of on-line forums for complaints redressal are not adequate.
- **Unification of all entities under one regulation authority:** Unification and harmonization of regulation of all entities engaged in acceptance of deposits from public, whether it is a NBFC or a non-NBFC
- **Implementation of a whistle blower mechanism:** An effective whistle blower mechanism should be developed to allow preventive action as provided in the Act.
- **Creation of Special Courts:** The special courts provided for in the recently enacted Securities Laws (Amendment) Act, 2014 may be extended in order to complement strict enforcement action, economic offences courts may be set up or designated in every State for trial of such economic offences including those under SEBI Act, RBI Act, State Depositors Protection Act, Prize Chits and Money Circulation Schemes (Banning) Act etc
- **Deposit linked insurance for consumer protection:** Deposit-linked Insurance for all the collective investment schemes. There should also be a provision for a minimum capital reserve to be maintained with the regulator as a safety valve against default.
- **Delay in action by Ministry of Finance:** The Committee expressed their opinion on delay in action by the Department of Financial Services as it has not taken any follow-up action on the report presented by the Key Advisory Group, although more than two years have lapsed. It was strongly recommended that the Department should take a decision on the legislative and administrative proposals within a period of three months from the presentation of this Report.

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PART 111-KEY FEATURES OF THE BILL

The provisions of the Current Bill:

A Bill to streamline and strengthen the chit fund sector was introduced in the Lok Sabha this Budget session. The proposed Bill provides⁴:

- **Video recording and conferencing:** While it retains the requirement of at least two members for conducting a draw and preparing the minutes of the meeting, it proposes that the draw of chits must be recorded on video. Also, these two members may now join the proceedings via videoconferencing, and sign the minutes within 2 days.
- **Increasing the Foreman's commission from 5% to 7%:** The Bill proposes to increase the ceiling to 7%, as the rate has remained static since the commencement of the Act while overheads and other costs have increased manifold
- **Power to the state government:** The Bill also proposes that state governments are to designate a competent authority to ensure repayment of deposits, in case of default.
- **Use of the term "Fraternity Fund" instead of "Prize Chits":** The proposed amendment mentions the use of the term "Fraternity Fund" to signify its inherent nature and distinguish its working from "Prize Chits" which are banned under The Prize Chits And Money Circulation Schemes (Banning) Act, 1978.

⁴ http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/72_2018_LS_Eng.pdf

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PART IV. ANALYSIS

Status of recommendations made by the Key Advisory Group, Parliamentary Committee and the proposed amendments in the Chit Fund Bill 2018:

Recommendations-Key Advisory Group/Parliamentary Committee Report	Proposed Amendment in 2018	Status
The Key Advisory Group in 2013 had recommended to amend Section 2(b) which implies the word 'Chit Fund' be changed to 'Fraternity Fund' in the definition	The proposed amendment mentions the use of the term "Fraternity Fund" to signify its inherent nature and distinguish its working from "Prize Chits" which are banned under The Prize Chits And Money Circulation Schemes (Banning) Act, 1978.	The recommendation has been incorporated
The Key Advisory Group in 2013 had recommended to amend Section 16 to amended as to allow virtual presence of at least 2 subscribers or proxy during auction	The Act prescribes that every draw of chit shall be conducted in the presence of not less than two subscribers, and the minutes of the proceedings of every draw shall be prepared and signed by and at least two other subscribers who are present. The Bill proposes that the required subscribers may join through video conferencing.	The recommendation has been incorporated. However, while the option of video conferencing for smooth functioning is a welcome step, it is doubtful whether the new laws can check fraudulent deposits without any oversight mechanism to monitor such proceedings nor have the State governments been asked to create awareness among consumers so that they take informed decisions and know about grievance mechanisms etc. .
No such recommendation was proposed. However as for the security amount, the State Government will have to specify the amount, by notification, up to which any chit fund shall be exempted under section 85 (b)	The Bill proposes to increase the ceiling to 7%, as the rate has remained static since the commencement of the Act while overheads and other costs have increased manifold	Increasing the percentage of commission will mean an increase in the security deposit paid by subscribers. The Key Advisory Group on the other hand had recommended reducing the security to be deposited with the Registrar under Sec 20 (1) to 50 per cent of the chit value, that too at the time of commencement.
Financial Literacy and awareness on		These recommendations directed

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a big scale, redressal cells, insurance coverage, special courts, whistle blower mechanism etc were some of the other recommendations out forward by both the committees

towards safeguarding public money and creating awareness and promoting protection of investors have not been incorporated.

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PART V. CRITIQUE

1. Despite the fact that Standing Committee had expressed its disappointment over the delay in the incorporating the recommendations suggested by the Key Advisory Group, the Bill does not incorporate most of the key recommendations of the Parliamentary Standing Committee on Finance and the Advisory Groups on Chit Funds set up by the Central government, .
2. Representatives of the All India Association of Chit Funds have also expressed their concern on the proposed legislation. While the whole idea of introducing a new Bill was to bring unorganized chit companies or individuals into the formal net, it is doubtful that the current amendments will facilitate that objective. It is also surprising that this government, which has ostensibly focused on formalization of the economy, has missed this opportunity to do so in the case of a high risk industry that largely impacts the poorer sections of society.
3. There is no provision for a regulatory authority that ensures public money is safe and secure. The Bill has missed an opportunity to protect consumers by unifying and harmonizing regulation of all entities engaged in acceptance of deposits from public, whether it is a NBFC or a non-NBFC.
4. Establishment of effective oversight mechanism is crucial in order to prevent and reduce the incidence of frauds and related irregularities. The first step in this regard should have been to ensure all the companies running such schemes were forced to register with the government and create awareness among the consumers to differentiate between fake and certified companies before they invest their money. Unfortunately The Bill is silent on both these issues which are important for protecting consumer rights and funds.
5. Apart from these, major recommendations for investor protection , promoting financial literacy, insurance policy for the subscribers, grievances redressal cell, rating mechanism, have remain unaddressed

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