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Chit Funds as an Investment option- A comparison with other Investment options – An Investor perception

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Abstract

This study examines the evolving preference of investors towards chit funds in India, an age-old Rotating Savings and Credit Association (ROSCA) model, amidst the increasing availability of formal financial instruments. Despite offering potentially higher returns (averaging 15-30%) compared to alternatives like mutual funds and recurring deposits, the preference for chit funds has significantly decreased, with only 39.68% of respondents currently investing in them. The research identifies that investment in chit funds is now predominantly concentrated among specific strata: informal traders and self-employed individuals. Key deterrents to their widespread acceptance include the unfamiliarity of the system, high dependency on peer subscribers, a lack of common rules across states, and the overall efficiency hinging on the foreman's efficacy. The availability of convenient, low-risk formal options like personal loans and credit cards further reduces dependency on chits for emergency needs. Interestingly, a large proportion (56%) of chit fund investors prefer informal or unregistered chits due to established trust in the foreman, the immediate release of prize money, and the absence of the stringent collateral requirements imposed by registered chit funds. Discriminant analysis confirms that investment choice is significantly influenced by gender, income, and occupation, with informal traders prioritizing liquidity and adequacy of funds in times of need, while employed individuals are more concerned with period of investment, growth rate, and security. The paper concludes that while the chit fund remains a vital 'save and borrow' vehicle for those with low financial inclusion, particularly in the informal economy, its long-term viability is challenged by issues of trust, lack of institutionalization, and the rising availability of structured financial products.

Keywords

- Chit Funds
- Rotating Savings and Credit Associations (ROSCA)
- Informal Finance
- Investment Preference
- Foreman
- Liquidity
- Risk
- Financial Inclusion
- Systematic Investment Plan (SIP)

Introduction

In India, there are 10269 registered chit funds in which the oldest one being PURASAWAKAM SANTHATHA SANGA NIDHI LTD and it was incorporated on 06/06/1879 in Chennai. (https://www.mca.gov.in/Ministry/pdf/Chit_Fund_Companies_6nov2008.pdf). There are many unregistered chit funds as well. At the same, there are many fraudulent cases reported and legal processes are going on. Though it is one of the oldest forms of systematic investment plans, generally run by individuals and those who trust the operator join the chit funds. Trust is the prime driving force in starting a chit fund. Being a systematic and regular investment plan, the subscribers have to pay their committed dues before a particular day. One of the reasons for the collapse of the chit fund system is the non-payment of subscription amount in time the operator find it difficult to pay the amount to the subscriber who took the lot or auction for a particular month. Hence, the success of a chit fund is a joint effort of both operators and subscribers.

Structure of Chit Fund

A chit fund operator is operating illegally in India if the value of the chits they are selling is more than Rs. 10 and they are not registered. Every licenced chit fund guarantees the highest level of security and customer service. Let's start with a glossary of chit-fund-specific terms before diving into the chit-fund business model.

- Foreman and investors sign a chit agreement, a legal document outlining the project's rules and regulations.
- Chit Group: a collection of individuals who have joined together to form a legal "chit fund."
- The sum of money investors pay at a certain time is known as the "chit amount."
- Foreman: The individual or business in charge of keeping records, collecting payments, and leading auctions
- Foreman's Commission: 5% of the total chit fund's gross amount

- The total of all collections for each period minus the highest bid (the highest bid includes the foreman's fee) is the prize money.

There is a predetermined number of members in a chit-groupwho all contribute to the same chit-fund programme. These backers are obligated to pay a predetermined sum (let's say Rs. 1,000) over a predetermined time frame. Payments to investors are typically made once a month. The scheme lasts for as long as the chit-group has participants. If there are 15 people in the group, the payment commitment is for 15 months. The monthly contributions from the members are pooled into a general account. One person is then selected at random to receive the cash prize. Money can also be distributed to a single community member through an auction. The auction is being led by the foreman, who is also in charge of collecting the instalment payments.

Each member is given one vote in the monthly auction for the chit-fund money. The member with the lowest bid wins the auction. The discount percentage that the bidder is willing to offer on the total amount collected is the basis of the bid. There's a 40% cap on how much you can save. The bidder that is willing to accept the least amount of money is the successful bidder. The winning bidder is known as the "prized member" and is awarded the "prize money." After deducting the winning bidder's proposed discount and the foreman's fee, the remaining sum is awarded. All members of the chit fund receive a dividend equal to the discount accrued, minus the foreman's commission. The winning participant is barred from making any further bids during the campaign's final months. But he is liable to pay the chit amount every month.(Saikat & Tripathy, 2015)

Why does the chit funds attractive

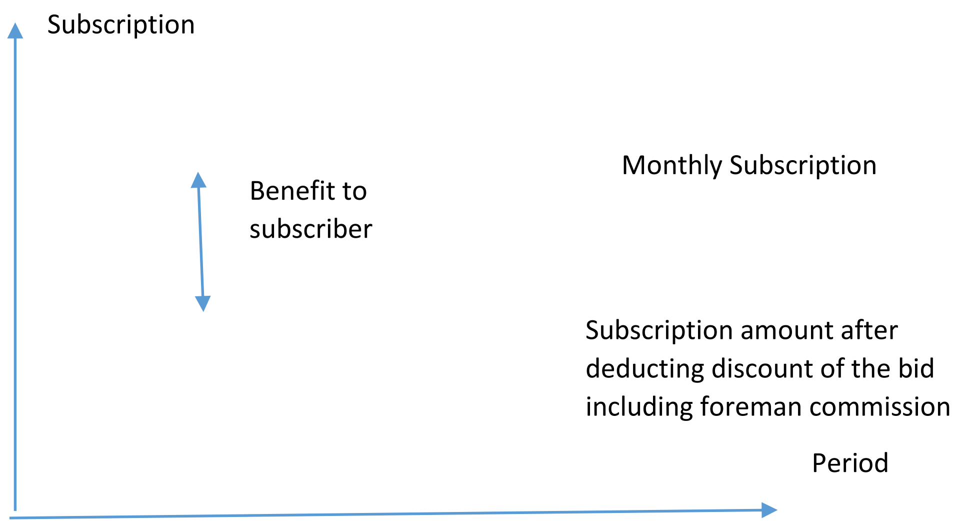
Table 1: A comparison of chit funds, mutual funds, recurring deposits and insurance is given below.

Parameter	Chit fund	Mutual fund (SIP)	Recurring deposits	Insurance
Period of fund	Equal to the number of subscribers	Fixed period	Fixed period	Fixed period
Return method	Bidding discount	Interest rate, NAV	Interest rate	Bonus
ROI	Depends on the number of subscribers and the bidding rate	Depends on portfolio	Compound interest annuity	Bonus
Average return	15-30% approximately, depending on the bidding method	If secure fund, rate of interest, else NAV of the fund on that date	Compound interest	Guaranteed bonus and other add-on bonuses
Safety of fund	If registered, then the fund is secured	Depends on the market condition if the fund is a growth fund	Secured	Secured

The results show that the average return is higher compared to other funds and the period of the fund depends on the number of members in the fund. But, generally, it will be less than the maturity period of five years as in other funds or prolonged payments in insurance policies.

The return depends on the type of bidding. In lot bidding, the prize winner will be selected by drawing a lot from the names of all subscribers. A fixed percentage, generally 30-40% will be the bid rate. Towards the end, the bid rate decreases and the members who get the lots towards the end of the chit get the full amount.

Fig 1: **Benefit of Chit funds and subscription pattern**



The maximum benefit is gained by the subscriber who takes money after the maturity of the chit fund. The only drawback of this method is that the needy subscriber may not get the benefitof the lot drawing. So the auction method is preferred by most of the investors and foremen. In the auction method, the bidding rate may increase based on the need of the subscriber and may compromise high to meet the emergency. This further increasesthe benefitto the subscribers who go for a bid towards the end

(https://chitfund.delhi.gov.in/sites/default/files/2022-12/chitfundsact1982.pdf.)

Factors that influence preference for Chit-funds Though the chit-funds are of more return, preference to chit funds is decreasing due to the following reasons

- **Stringent norms in disbursing price money in registered Chit funds**

The registered chit funds demand collateral security or a guarantee of two employees to disburse the prize money. Else, the amount had to be deposited there only till the maturity of the fund. This causes the investors to go for private or unregistered chit funds. It may increase risk.

- **Availability of personal loans and credit cards**

The availability of personal loans from banks and registered NBFCs at lower risk compared to private chit funds reduced investment in Chits. Stringent norms for disbursal prize money are solved with a personal loan as the amount is disbursed in the starting. Also, the cost of funds for the subscribers who take money at first is high in chit funds compared to personal loans

- **Availability of formal investment options**.

Chit funds were prominent when there was difficulty to get loans and limited investment options. Now, there is a wide range of investment options to get more return in a short period. A few other investments are personal loans, mutual funds, recurring deposits, insurance products, etc. But Chit funds had been a common man's investment mode, even common among lower income and education populations. The prime difference is that the recurring deposit is a banking product while mutual funds, chit funds and insurance are non-banking products.

Review of literature

(Nahas, 2018)identified a few variables to analyse the investment avenues and they are Region, Return, Safety, Liquidity, Income, and Urgency. Investor's preferenceis taken as the dependent variable and it was found the chit fund is a rural and informal investment opportunity while bank-based investment opportunities are formal in nature. Chit funds fall in the category of Rotating Savings and Credit Associations (ROSCA), a famous saving concept in the world. It is a concept of 'Save and borrow'. It has a dual purpose- save to preserve or save to consume. The need for institutionalization of chit-funds helps all sorts of investors whether literate or illiterate and rich or poor, to understand the process, rules and their rights.Institutionalization of chit funds made it legal, and systematic mobilization of large amounts from small savings (Mudit & Antoinette, 2011).Chit funds in India are governed as per the chit funds act 1982 (except the state of Jammu and Kashmir) and laws passed by different states in their legislates like Kerala Chitties Act 1975; Tamil Nadu Chit Funds Act, 1961; The chit Funds (Karnataka) Rules, 1983; The Andhra Pradesh chit fund, 1971 etc. But there are no statutory bodies like SEBI or RBI to control these chit funds. So, there are differences in chit laws in different states (Sankararaman, 2012).

One of the reasons for the scope for chit funds as a save and borrow vehicle for investment is the low inclusiveness of the low-income strata population. The branch distribution in low-population-density areas is less and the only facility available is through post office saving schemes. Another reason is the low awareness of banking among the rural population. So they depend on trustable individuals who run chit funds (Anupam & Mamta, 2012).

The evolution of the formal financial system is afterthe independence of India and many of the regulatory bodies were established after the reporting of many fraudulent cases. But all of them are in the formal sector. But the curies or chit funds were a very old financial service informal sector in which investment is based on trust and commitment. It still exists as the supporting element in the informal economy in which informal traders and wagers accumulate their small savings through curies for meeting future or upcoming expenses. It is an informal financial system. It is a protection against exploitation from money lenders(Aliber, 2002)

At the same, there are many fraudulent cases registered against the chit companies by subscribers for misusing guarantee documents like cheques or against the subscribers for non-payment of subscriptions. As there are no central rules to deal with such cases, higher risk evolves in chit funds from state to state. These cases reduce investment confidence among investors. There are 18 reasons identified as the negative factors in preference for chit funds (Deb, 2014).

Rotating Savings and Credit Associations (ROSCA)

Rotating Savings and Credit Association is an informal cooperation of individuals for saving and accumulating savings exist many parts of the world (Smets, 2019). It is helpful for low-income individuals (Ryu & Suzuki, 2021). ROSCAs are a type of group savings arrangement in which a group of people agree to pool their money and save it for the future in exchange for a regular charge (Bauchet & Larsen, 2018). A ROSCA can have a wide range of members, contribution frequencies, contribution amounts, and allocation procedures. Based on the method employed to distribute the pot, ROSCAs fall into one of three broad categories: random, fixed, or bidding ROSCA(Baland, Guirkinger, & Hartwig, 2019).

. At the beginning of each cycle (the time needed for each member to get the pot once) in a random ROSCA, the order in which members will receive the pot is selected at random. For cycles, the order in fixed ROSCAs is always the same (Baland et al., 2019). Finally, in bidding ROSCAs, members with larger contributions or higher bids receive the first turns(Ke & Ye, 2019).

Statement of Problem

Chit funds are one of the oldest investment options and once it was of higher preference. Compared to other investment options, it has a higher return for those members who do not need money in an emergency at the cost of those who take prize money in the early period of the chit. This paper analyses why investors avoid chit funds

Research Methodology

The respondents of this research include regular investors in chit funds and those who do not prefer chit funds. A structured questionnaire is used to collect data. The reliability of the questionnaire is expressed using Cronbach alpha and it is more than .78. Hence, the data is reliable.

The sample size is 389 and a stratified convenient sample is used. The study analyses the reasons for using Chit funds and not using chit funds.

Data Analysis

Descriptive Analysis

Table 2: Descriptive distribution of respondents

Categorising variable	Sub variables	Data tool	
		Response	**%**
Gender	Male	196	50.33 %
	Female	193	49.60 %
Age	<20	85	21.84 %
	20-40	102	26.23 %
	40-60	87	22.26 %
	60 <	116	29.68 %
Occupation	Employed	86	22.10 %
	Business	85	21.84 %
	Informal labour	103	26.4%
	Self employed	116	29.68 %
Type of investment	Fixed Deposit	82	20.97 %
	Chit funds	155	39.68 %
	Stock-based investments	72	18.39 %
	Insurance	20	5.17%
	Recurring deposits	62	15.83 %

From the data, it is observed that only 39.68% of respondents invest in chit funds while 61.32% invest in other modes of investments. Other findings from this data reveal that 79% of the respondents who are investing in Chit funds are informal traders and the remaining are either self-employed or labourers or farmers. 56% of them invest in individual-run chit funds while 44% invest in formally registered chit funds.

Table 3: Reasons for not joining Chit funds

Variable	Mean	Standard deviation
It is an unfamiliar system of investment	3.9	.9
Dependency on peer subscribers is high and the irregularity of more members in paying subscriptions may affect others as well	3.7	.82
Lack of common rules and variation from one state to another increases the risk	3.65	.62
The efficiency of the system depends on the efficacy of the foreman	3.59	.99
Highly individual-oriented and low-level institutionalization leads to a demeaning of the case as a dispute between two individuals	3.54	1.02
Availability of a better saving system in banks and other NBFC institutions	3.4	1.05
Lack of highly efficient documentation may lead to fraudulent activities	3.2	1.25

The prime reason for the low preference is the availability of many financial instruments like personal loans. Credit cards. Over draft facilities, reduced the dependency on chit funds. Now convenience, independency and low risk are prime concerns over a higher rate of return. This reduced the popularity of the young generation. There are plenty of loans like education loans, home loans etc. reduced the need to accumulate savings through chit funds. Another reason is the protection through institutionalization in the banking system. But, still small traders who may not get loans prefer chit funds.

Table 3: Analysis of reasons for informal or unregistered chit funds

Variable	ean	Standard deviation
Known foreman	4.2	.6
No need for security or guarantees for releasing prize money	4.1	.82
Immediate release of prize money	3.9	.65
All subscribers are known to each other	3.8	.89
Being auction or bidding, the benefit is high	3.6	.79
Difficulty to use banking facilities	3.4	1.1
The relative benefit is high in chit compared to recurring deposits due to the auction	3.2	1.15

The results show that the prime reason for preferring informal or unregistered chit funds is due to two reasons – trust inthe Foreman or manager of chit due to long years of acquaintance. The second is the low level of complication in releasing prize money. The second reason is the confidence that other subscribers are also known to each other. If any issues in chit management, it is easy to solve with known people. A short period of chit funds than a prolonged maturity period of insurance and fixed deposit schemes for a lower rate of return is attractive for investors.

But, many investors avoid individually-centred chit-funds due to the risk of trust in an individual in their decision-making and their fund usage. In the default case, there is a chance of extortion to collect money from the subscribers. These reasons reduce preference to chit funds.

Preference to Formal NBFC-run Chit funds

49% of respondents do not prefer formal chit only due to the stringent rules to release prize money. Another constraint is that the subscribers may not know each other and hence, there will not be a common platform for all investors to protect their interest.

Discriminant Analysis

4.12.1 Effect of legal recognitionon Attributes on investment choice

Test Results

Box's M		63.545
F	Approx.	2.232
	df1	28
	df2	689774.267
	Sig.	.000

Wilks' Lambda

Test of Function(s)	Wilks' Lambda	Chi-square	df	Sig.
1	.943	12.288	7	.041

Classification Function Coefficients

	Gender	
	Unregistered	Registered
Liquidity of fund	3.984	2.199
Growth rate	1.839	2.399
Period of investment	18.181	18.562
Credit rating of fund provider	1.236	14.946
Safety and security in fund	4.287	9.567
Bidding pattern	4.990	8.909
Adequacy of fund at the time of need	11.551	5.434
(Constant)	-108.902	-108.593

Fisher's linear discriminant functions

Gender has an effect on attributes of the investment.

The discriminant coefficients have a clear variation in the both types – formal and informal. Liquidity of fund, adequacy fund at the time of needs are high for informal chit funds. For other variables, the investors prefer organised or registered funds. The Wikis lambda and Box M are statistically significant and hence the model exists.

Effect of Income on Choice of Chit funds as an investment choice.

Test Results

Box's M		263.545
F	Approx.	2.232
	df1	28
	df2	689774.267
	Sig.	.000

Tests null hypothesis of equal population covariance matrices.

Wilks' Lambda

Test of Function(s)	Wilks' Lambda	Chi-square	df	Sig.
1	.913	12.388	7	.042

Classification Function Coefficients

	Income		
	<21K	21-42K	42-63K
Liquidity of fund	3.684	3.389	3.399
Growth rate	1.639	1.889	1.899
Period of investment	18.281	18.572	18.562
Credit rating of fund provider	15.420	14.946	14.946
Safety and security in fund	6.387	6.577	6.567
Bidding pattern	8.690	8.919	8.909
Adequacy of fund at the time of need	11.521	11.444	11.434
(Constant)	-108.902	-108.593	-108.593

Fisher's linear discriminant functions

Gender has an effect on attributes of the investment

4.12.2 Effect of Savings on Investment decisions

Wilks' Lambda

Test of Function(s)	Wilks' Lambda	Chi-square	df	Sig.
1 through 3	.881	55.828	21	.000
2 through 3	.940	27.488	12	.007
3	.952	23.330	5	.049

Test Results

Box's M		333.517
F	Approx.	2.332
	df1	63
	df2	763554.452
	Sig.	.029

Tests null hypothesis of equal population covariance matrices.

Classification Function Coefficients

	Saving1			
	Employed	Business	Informal labours	Traders
Liquidity of fund	1.856	3.420	3.547	3.430
Growth rate	2.755	1.869	1.869	2.030
Period of investment	20.389	18.228	18.341	18.494
Credit rating of fund provider	14.547	15.056	15.061	14.907
Safety and security in fund	7.462	6.273	6.504	6.526
Bidding pattern	8.119	9.015	9.003	9.461
Adequacy of fund at the time of need	11.091	11.417	11.524	11.692
(Constant)	-110.983	-107.200	-109.222	-111.514

Fisher's linear discriminant functions

Both Box M and Wlki's lambda are statistically significant. This shows that there is a significant variation in perception based on occupation. The results show that the employees are more concerned on period investment, growth rate and security of funds. At the same time, the traders are looking for adequacy of a fund in need, bidding pattern, and liquidity of the fund.

Conclusion

The results show that the preference for chit funds is shrunk to a few types of investors – informal traders and self-employed. Though there are formal chit-fund providers.investors prefer informal individuals to run chit funds. The main reason is trust and acquaintance. The higher liquidity in informal chit funds is a blessing who needs quick money while the prize money release is highly complicated. More guarantees and supporting documents are needed to release funds. The type of fund, income and occupation influence the chit-choice. Individuals run chit funds are based on trust than occupation.

Chit fund is an attractive investment choice but the registration, liquidity, prize distribution strategy, and risk involved atc play a significant role.

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