



Chit Funds & Saradha Scam

What is a chit fund?

- Chit fund means transaction in which a person enters into an agreement with a specified number of persons that every one shall subscribe a certain sum of money by way of periodical instalments over a definite period.
- Each such subscriber in his turn, as determined by lot or by auction or by tender be entitled to the prize amount.

How does it work?

- Let's assume that the 12 people come together and decide to contribute Rs 5,000/month.
- This means a total of Rs 60,000 will be collected every month.
- This amount is then auctioned among the 12 members after a minimum discount has been set.
- Let this minimum discount be Rs 5,000. This means the maximum amount any person can get from the total Rs 60,000 collected is Rs 55,000 (Rs 60,000 - Rs 5,000).
- After this discount bids are invited.
- One person bids the highest discount of Rs 12,000. And hence he gets the money.
- Since he has agreed on a discount of Rs 12,000, that would mean he would get Rs 48,000 (Rs 60,000 - Rs 12,000). He will also have to bear the organiser charges of around Rs 3000 (5 % of Rs 60,000).
- This means he would get Rs 45,000 (Rs 48,000 - Rs 3,000) after deducting the organiser charges.
- The discount amount of Rs 12,000 is basically a profit that the group has made. This is distributed equally among the members, with each one of them getting Rs 1,000.
- This money that is distributed is referred to as a **dividend**. The person who got the money, will have to keep contributing Rs 5,000 every month for the remaining eleven months.
- If two or more person bid the maximum discount their names will be written on chits of paper and a chit is drawn. The person, whose name is on the chit drawn, gets the money.
- The winner will be **opted out of the future biddings**.

- This is how chit funds work and they are perfectly legal if they are registered under the **Chit Funds Act 1982**, a central statute or various state-specific acts.

How is it helpful?

- A chit fund helps those people who are facing a liquidity crunch.
- Of course they will have to keep paying Rs 5,000 for the remaining eleven months.
- But by doing that the person gets an opportunity to get a bulk amount once.
- The chit fund company typically does not ask what the winner of the amount wants to do with the money.

What is the nature of the returns?

- The kind of return an individual participating in a chit fund gets depends on the **maximum discount** that is bid in each of the months.
- The higher the discount, greater is the dividend that is distributed among the members of the chit fund.
- The returns also depend on the **organiser charges**. Higher the organiser charges, lower is the returns.
- While organiser charges are fixed in advance, the maximum winning discounts are likely to vary from month to month. Therefore the returns are not fixed and cannot be predicted.
- The organiser of the chit fund also cannot know in advance the kind of returns that a participant can get.

Was Saradha a chit fund?

- Saradha Group was a consortium of over 200 private companies with Sudipto Sen as a Chairman.
- It was believed to be running collective investment schemes popularly but incorrectly referred to as chit funds.
- As we know, chit fund cannot declare in advance the return an individual is likely to make. But returns were promised in Saradha chit fund.
- They offered fixed deposits, recurring deposits and monthly income schemes. The returns promised were handsome. High-value depositors were also promised foreign trips.
- The fact that a rate of return was promised in advance and the amount of 4 times return to the principal, clearly means that it was not a chit fund.

So what was Saradha then?

- It can be categorised under what SEBI calls a collective investment scheme.

- A **collective investment scheme (CIS)** is defined as any scheme or arrangement made or offered by any company under which the contributions made by the investors are pooled and utilised with a view to receive profits, income or property, and is managed on behalf of the investors. Investors do not have day to day control over the management and operation of such scheme or arrangement.
- Against the money collected Saradha promised allotment of land or a flat.
- The investors also had the option of getting their principal and the promised interest back at maturity.
- The investors did not have day to day control either over the scheme or over the flat or land for that matter.
- The money/land/flat came to them only at maturity. Given these reasons Saradha was actually a CIS.

What was the scam?

- If the Saradha group was collecting money and promising land or flats against that investment, it should still have those assets. Saradha was trying to create an illusion it was doing all of it. But there was nothing really that it was doing.
- They were using money brought in by the newer investors to pay off the older investors whose investments had to be redeemed. At the same time they were creating an illusion of a business as well, which really did not exist.
- They were prompt with payments in the first year. Later agents were told to make payments for maturities with fresh collections or make adjustment against renewals.
- They also pay high commission to agents to keep bringing new investors. And as long as money brought in by later investors is greater than the money that has to be paid to earlier investors, these schemes keep running.
- The day this equation changes, these so called chit funds go bust. The same happened in case of Saradha chit fund as well. The group collected around 200 to 300 billion from over 1.7 million depositors before it collapsed in April 2013.

Category: Mains | GS - III | Economy

Source: Firstpost

