INTERNATIONAL JOURNAL OF ADVANCE RESEARCH, IDEAS AND INNOVATIONS IN TECHNOLOGY
IJARIIT
ISSN: 2454-132X
Impact Factor: 6.078
(Volume 11, Issue 4 - V11I4-1218)
Available online at: https://www.ijariit.com

Unregulated Chit Funds in India: Risks, Loopholes, and the Need for Policy Reform

Aquin Manuvel
mypublishedpaper@gmail.com
Christ University Central Campus, Bengaluru, Karnataka

ABSTRACT

Chit funds, a conventional and prevalent financial mechanism in India, remain crucial in facilitating access to savings and credit, particularly for low-income people and in areas with inadequate formal banking infrastructure. Despite being governed by the Chit Funds Act of 1982, there is no single pan-Indian regulatory authority, and implementation and monitoring are still dispersed throughout the states. The growth of unregistered and informal chit funds, many of which function without accountability or transparency, has been made possible by this decentralisation. Driven by persuasive agents and trust-based networks, social engineering frequently persuades people to engage in chit schemes without fully comprehending the hazards, especially in rural and semi-urban settings. The interest rates in chit funds, especially for early bidders, are often not economically feasible in the long term, resembling high-cost borrowing rather than profitable investments. Moreover, the returns are variable and contingent upon bidding dynamics and member defaults, exposing participants to systemic risks. Despite their popularity, financial literacy surrounding chit funds remains low at the grassroots level, leading to poor decision-making and increased vulnerability to fraud. This paper explores how the interplay of weak regulation, social trust networks, and limited financial awareness perpetuates the risks within the chit fund ecosystem, emphasising the urgent need for stronger national oversight and grassroots-level financial education.

Keywords: *Financial Literacy, Informal Finance, Unregistered Chit Schemes, Social Engineering, Regulatory Oversight, Financial Fraud, Regional Disparities, Socioeconomic Vulnerability, Credit Risk Assessment.*

INTRODUCTION

As defined by Section 2(B) of the Chit Funds Act, 1982, a chit fund is a rotating savings and credit association system, commonly practised in India. These schemes can be managed by financial institutions, unorganized money market players, or informally among friends, family, or neighbors. Some chit funds are tailored with specific savings goals in mind. They are especially popular in areas with limited banking access, where people prefer investing their money in a chit fund. (Mathur and Dutt 93)

The Chit fund model is an easy and innovative method of access to finance for low-income households. (Kapoor and Schoar, 10). The percentage of households participating in chit funds is between 5-10% of the total household population in each state (except Delhi). (Kapoor and Schoar, 8 The majority of the current and non-current Chit Fund members belong to low-income households.Our analysis of the bidding data shows that the average loan interest rate ranges between 0%when the member is a saver in the scheme and does not bid) 3.5% per month for a 25-month scheme. Registered Chit Funds find it less lucrative to serve the poor due to the increased cost of operating such schemes imposed by the regulators. (Kapoor and Schoar 9). Considered very safe and also offers loans at lower interest rates than moneylenders. (Kapoor and Schoar 10). Compared to banks, Chit Funds require less documentation, are more flexible about collateral, and allow one to determine their own interest rate (within the constraints of a given chit scheme). Furthermore, there is no need to determine upfront whether funds are used for saving or borrowing. (Kapoor and Schoar 1As).

As only one person in every auction can win the "pot", participants cannot be sure that they get loans whenever needed. This could potentially be detrimental to people who cannot delay their consumption or investment, as they are in desperate need of funds. They might have to resort to money lenders or other informal sources offering very high interest rates. A member in desperate need of the money is actually successful in winning the "pot", but ends up with an extremely high interest rate. (Kapoor and Schoar 16).

Competitive Interest Rates: In contrast to the high-interest rates imposed by moneylenders, chit funds provide a more economical avenue for borrowing. Interest rates on loans are typically determined via auctions or predetermined calculations, potentially resulting in lower overall costs.

Encouraging Financial Responsibility: The mandatory regular contributions within chit funds instill a sense of financial discipline among participants. This commitment to consistent saving can contribute positively to individuals' broader financial habits and stability. (Mathur and Dutt 94)

Unregistered Chit Funds are unorganized and run by friends, relatives or personal groups. They are personal contracts that do not depend on market forces but more on personal ties. Unregistered Chit Funds which exceed Rs. 100 ($2) in chit value are illegal in India, although it is widely known that the unregistered Chit Funds industry is still very popular in rural areas and among the poor population in urban and semi-urban areas. (Kapoor and Schoar 16)

According to this Act(Chit Funds Act (1982)), the chit manager needs to deposit 100% of the chit value with the Registrar of Chits prior to the commencement of the chit scheme. This deposit will be refunded to the chit manager on the successful completion of the chit cycle. The Act also requires all registered Chit funds to impose a 40% cap on the bidding amount.(Kapoor and Schoar 18)

The Chit Fund industry seems to be moving towards fewer but more expensive schemes. This is evident from the fact that there is a general decrease in the number of chit companies and schemes being registered but there is an increase in the individual ticket sizes. (Kapoor and Schoar, 28).

Towards the end of 2003-04 and early 2004-05, the government implemented a law which required Chit Fund companies to deduct tax from dividend income earned by subscribers irrespective of the size of prize money. This tax reduced the profitability in lower value schemes much more than higher value schemes. (Kapoor and Schoar 28,29)

Because, the revenue to the Chit fund company is higher from large value schemes but the increase in cost due to taxes is identical across schemes of differing sizes. As a result many chit companies drastically reduced their exposure to lower value schemes. This led to a financial exclusion of a large number of small businesses and low income households from the registered chit industry. (Kapoor and Schoar 29)

Saving is seen as the most important ex-ante reason for participating in the Chit Fund schemes. Other prominent reasons across the states are consumption and business requirements. Overall and across all the states, the most important ex-post reason given for bidding in a scheme is the emergency requirement (Kapoor and Schoar 40.

As income goes up, the proportion of chit members bidding in Chit Funds for business investment goes up. However, the proportion of chit members bidding in Chit Funds for consumption needs (like buying goods, marriage, etc.) goes down with increase in income. This could mean that the poor among chit members usually use chit loans for consumption purposes whereas the rest of the population (majority business people) use them more for business related purposes. (Kapoor and Schoar 41)

It is evident that women usually bid in a chit scheme to meet marriage expenses; either their own or their family members". On the other hand, men usually bid when there is a requirement in their business. (Kapoor and Schoar 41)

For the state of Tamil Nadu, the reason is primarily jewel purchase while in the case of Delhi it is marriage purpose that drives people to save in the Chit Fund schemes. (Kapoor and Schoar 42)

Table 1

Variable	Overall	By State				
		Tamil Nadu	Delhi	Karnataka	Kerala	Andhra Pradesh
Reasons for saving in Chit Fund schemes (%)						
House purchase	26.9	33.8	13.7	21.6	27.6	29.1
Marriage	16.8	21.3	23.6	10.6	11.5	18.3
Jewel purchase	12.6	35.8	2.2	1.8	8.2	6.1
Vehicle purchase	12.5	17.8	7.7	5.7	17.2	10.1
General	30.7	11.8	46.7	48.1	28.4	32.2
Other	26.5	35.5	29.7	25.1	21.0	22.3
Unknown	3.9	0.0	0.6	0.7	11.2	4.7

(Kapoor and Schoar 42)

Here from the table, we can infer that the divide between South and North Indian states is cultural. South Indian families primarily save to buy gold as an investment to give to their daughters or son whereas in north indian states chit funds is used for wedding expenses which may be a bigger hall or a fancy car , etc which is not economically wise as their will be no return in the end .Reasons for saving in chit fund scheme for home purchases jewellery as a whole is more in South India than North India . (Kapoor and Schoar 42)

Better returns and better interest rates are the most important reasons for people to participate in Chit Funds rather than using a bank except in Kerala where 82% quote less documentation or collateral requirement as the reason for participating in Chit Funds rather than banks. (Kapoor and Schoar 45) the preference is based more on perception than actual knowledge (Kapoor and Schoar 45)

Analyzing the methodology followed by the people while calculating the maximum bid amount, it has been observed that they mainly use the interest rate of outside options available to them as the guideline. People in Kerala, however, also use the rate of return for the intended project to calculate the maximum bid amount. In Delhi, both the interest rate and the rate of return are used for deciding the bid amount. (Kapoor and Schoar 49)

Around 85% of the chit members who consider Chit Funds to be safe are also loyal to the Chit fund company they are participating in. This brings out the fact that Chit Funds operate based on the trust relationship with their members. (Kapoor and Schoar 51). Chit funds in a way is a community in itself where people pool their money with the people they know, joining schemes with people of their standing (in terms of wealth to show their standing in the society as well).

Chit fund participants view chit funds as a source of "saving". This is applicable to both the population groups and across all the states.The basic difference in the reasoning of the two population groups is that a lower proportion of the people in the poorer group participate for business purposes. All the people in all the states bid to satisfy their emergency needs. Apart from business investment, buying goods for the household is also a main reason for the poor to bid in the chit auctions. (Kapoor and Schoar 64)

Members, in general, do not observe ex-ante the pay-off of participating in a particular group as it typically depends on the choices made by other participants. (Kapoor and Schoar 72).

One of the salient features of Chit Funds is that members pay non-uniform rates of interest for their borrowings and receive non-uniform rates of return on their investments. (Kapoor and Schoar 75)

Unregistered chit schemes: If no commission is charged, as in 60% of the cases, managers claim the first or second pot as substitute income. Contrary to registered chit schemes where the rules are laid down by the law, unregistered chit managers decide on their own bidding parameters. (Kapoor and Schoar 87)

Unregistered chit schemes are seen as an excellent source to put in untaxed money (money that is not shown in the tax returns), especially since there are hardly any requirements for sureties or collateral. Although unregistered chits are often preferred to other saving options (e.g. banks) they are not regarded entirely safe; as much as 75% of the respondents in Delhi have encountered financial losses due to misconduct by the manager or fellow members. (Kapoor and Schoar 88)

Some people take chit funds from smaller chit funds and invest it in other chit funds to get more interest. (inference).

One of the most common reasons for participating in unregistered chits is the introduction to the scheme by a friend or relative. This also indicates that the social network is a prominent feature in unregistered chits. (Kapoor and Schoar 90)

Chit Funds play a major role for borrowers and savers in these Indian states. In particular, Chit Funds tend to provide alternative access to financial services in geographic areas and parts of the population that are underserved by the formal bank industry. (Kapoor and Schoar 93) conclusion

"The chit fund industry is one such indigenous financial system that mostly relies on personal judgement assessments and contacts to assess the potential clients.The absence of efficient credit bureaus makes it costly for financial institutions to collect information on clients' credit-worthiness. Furthermore, because they rely on the relationship with their customers to assess their risk, they often do not feel the necessity" (Rao and Buteau 4) "Most chit fund companies do not collect in-depth socio-economic information of such clients, and are satisfied with the private information collected over the introduction" (Rao and Buteau 5).

Major financial institutions take into account all the necessary analysis (risk assessment) to check for the financial strength of all the clients that they then extend access to, for their various credit instruments.

"The lack of a standardized risk assessment creates a residual risk in the selection of groups, since officers might vary in their ability to assess the credit and savings behaviour of clients, and a departure of an officer from the company would result in the loss of valuable information for the business. The need of the hour, therefore, is a systematic collection of financial and socio-economic information from all prospective clients, and a standardized assessment and evaluation of said information to rate the credit worthiness of a client."(Rao and Buteau 5)

Chit fund companies primarily focus on onboarding clients and getting the finance needed to start the scheme, not focusing on how it will continue throughout the duration of the scheme as a result of which credit worthiness of clients is not a major concern. (inference)

"The amount required to be borrowed from any of the banks will need a Collateral security and security of one individual person. Post borrowing from the subsequent month equated monthly installment has to be remitted to the bank on a specified date mentioned in the loan passbook. The borrower will have to provide collateral for nearly 125% of the borrowed amount and will get back only on the repayment of the last installment. (V 502)"

"86% of the respondents said the current interest rate of banks and post office is low; 65% of the respondents believe that a bank in their locality would have avoided them to invest in chit funds; 48.4 % believe that due to lack of Govt. sponsored small investment schemes investors invested in chit funds; 42% believe that the present banking formalities are rigid and somewhat responsible for chit fund scams. (Mallick and sahoo 77)"

"Majority of the respondents claim that they were unknown about the chit fund companies and they believed the chit fund agent. (Mallick and sahoo 77)"

"The respondents also believe that the business models of the chit funds are unsustainable in the long run and believe that the rate of interest offered by chit fund companies is unfeasible. (Mallick and sahoo 77)"

Now that we have a better understanding of how chit funds work, let's look at some of the biggest frauds that have revealed the negative aspects of this system.

Saradha Chit Fund : Since the exposure of India's largest chit-fund scandal, over 200 agents, depositors, and executives have tragically ended their lives. Primarily hailing from low-income backgrounds, these victims, feeling hopeless after losing their life savings, resorted to suicide. The Saradha group, the orchestrator of the scam, had amassed an estimated US$ 4-6 billion from over 1.7 million depositors before its collapse in 2013. This scandal has been coined 'Bonzi,' a merging of Ponzi and Bengal, in reference to its magnitude and geographical origin. (Mathur and Dutt 94)

The group's operations persisted for an extended period due to payments made to several politicians. Additionally, to discourage investors from voicing concerns about the investment programs, Saradha employed the wives of local police officers.A network of agents, often sourced from local rural communities, was enlisted by the group to solicit investments from potential investors. These agents were motivated with substantial commissions and other incentives for attracting new deposits. (Mathur and Dutt 95)

“Non-filing of Mandatory Documents: Many companies fail to submit the required documents to the Registrar of Companies (RoC) by the due date. This lack of compliance allows fraudulent companies to operate undetected for extended periods. • Outdated Records: Records are often not updated promptly, leading to situations where stakeholders cannot access the current status of a company. This opacity provides a cover for fake companies to continue their operations without scrutiny. • Inspection Challenges: The inability of stakeholders to inspect updated records makes it easier for fake companies to avoid detection and continue their fraudulent activities (Mathur and Dutt 96)”

The Saradha Chit Fund purportedly offered exceedingly high returns, a common trait of Ponzi schemes. These returns were likely sustained by using new investor funds to fulfill promised returns to earlier investors, creating a facade of sustainability. • Regulatory Oversights: Chit funds in India are typically subject to state-level regulations, resulting in varying rules across different regions. This fragmented regulatory landscape may have allowed the Saradha Chit Fund to operate with limited oversight, potentially concealing their true financial status. • Socioeconomic Influences: The level of financial literacy among investors significantly impacts their decisionmaking process. In areas with lower financial literacy, individuals may be more susceptible to enticing yet unsustainable investment opportunities. The Saradha Chit Fund may have exploited this lack of awareness to attract investors seeking high returns. • Psychological Tactics: The Saradha Chit Fund could have utilized psychological strategies to exploit investor trust. Methods such as celebrity endorsements, a charismatic leader, and a perceived sense of community might have persuaded individuals to invest without questioning the legitimacy of the returns. (Mathur and Dutt 97)

The collapse of the Saradha Chit Fund in 2013 serves as a poignant reminder of the vulnerabilities inherent in informal financial systems and the devastating repercussions of Ponzi schemes.Furthermore, it highlighted the critical role of financial literacy initiatives in empowering individuals to make informed investment decisions. (Mathur and Dutt 104)

Chit Funds are registered by State Governments under the Chit Funds Act, 1982 – an Act administered by the Ministry of Finance but with responsibilities of implementation resting with the States.**(inference)**

There are two obvious reasons why such Ponzi schemes persist. One is regulatory overlap and confusion. Regulators work in silos, making it possible for fraudsters to come up with ingenious schemes to bypass individual regulators - also called "regulatory shopping". The court notes that while SEBI has claimed that chit funds are not within its jurisdiction, it has also passed two orders directing the winding up of such schemes and refund of deposits. (Padma and Kulkarni 14)

Social aspect of chit fund - Social engineering

Social engineering uses psychological manipulation to trick users into making security mistakes.Chit funds make use of the agents who have personal connections with the clients to buy schemes (where there commission is as high as 10-20%-which is a very huge incentive which makes them sell it as hard as possible) to get money for the fund .

Chit funds are Built on mutual trust among community members as chit funds create a sense of financial security.it is easier to persuade someone when other people in his group have already invested in something and it create a feeling unease among others that they may miss out on something good .People are invited by friends, relatives, or neighbors, making it hard to say no. Organizers present themselves as community leaders or successful investors.Some funds feel distinguished or reliable because they are marketed as "invite-only" or community-specific. Members are promised that "everyone gets a turn" — but in a scam, new members’ money is used to pay early ones (Ponzi-like).

Social capital is essential for chit funds to succeed, but the same social networks that foster trust can also be used to take advantage of users. Social engineering techniques have the potential to transform a communal savings instrument into a trap, particularly when transparency is circumvented through trust.

CONCLUSION

Chit funds are a fascinating activity that pulls people from all walks of life .

The public is being offered a wide range of products by financial institutions. The product must be carefully chosen; otherwise, their hard-earned money will be lost. A key component of the financial inclusion initiative is financial literacy.

hit funds do not function as schemes with guaranteed returns. Because rewards are decided by the bidding procedure, which changes every month depending on member involvement and the urgency of cash, the system naturally carries financial volatility. The chit fund is effectively used as a borrowing mechanism by early bidders, who receive the pooled cash at a discounted value while continuing to make contributions over the course of the tenure. This is functionally comparable to taking out a loan with variable and frequently high implicit interest. Similar to investors, late or non-bidding members depend on the accrued discounts to provide a return on their investment. Nevertheless, there is no guarantee of profit because these returns are not set and are subject to large fluctuations.

Additionally, the system is extremely susceptible to member defaults, which can impair cash flow and have an impact on all parties involved, particularly those who are waiting for future rewards. The danger of non-payment presents a systemic hazard to the entire group because most chit fund operations, especially unregulated or informal ones, lack a proper credit evaluation or a strong default detection mechanism. Chit funds therefore entail inherent dangers that necessitate increased financial knowledge and control, even though they may provide financial flexibility.

The Chit Funds Act of 1982 offers a framework for regulating chit funds throughout India, but unlike some other financial rules, it is not a single, cohesive, pan-Indian statute. This implies that although the fundamental ideas are the same, state-by-state variations may exist in particular laws and practices. This implies that although the fundamental ideas of the Chit Funds Act are universal, state-by-state variations may exist in the particular laws and regulations pertaining to registration fees, reporting obligations, and other operational elements. For instance, the minimum capital requirements for chit fund companies may differ amongst states. The Registrar of Chits in each state manages licensing and monitoring.There's no central portal or national oversight body for chit fund operators.While the Chit Funds Act provides a legal framework, many unregistered or informal chit funds operate outside its purview, posing significant risks to investors.

Financial literacy in India has not effectively penetrated the grassroots level, especially in the context of chit funds, which remain widely used in rural and semi-urban areas as informal saving and borrowing tools. Many individuals participate in chit funds without a clear understanding of how the system operates, often mistaking them for fixed-return investment schemes.Participants are exposed to exploitation and financial loss as a result of this ignorance, which also creates irrational expectations.

REFERENCE

[1] Kapoor, Mudit, and Antoinette Schoar. "Chit Funds as an Innovative Access to Finance for Low-income Households." *Chit Funds as an Innovative Access to Finance for Low-income Households- sage journals*, vol. 3, no. 3, 2012, p. 135. *Google scholar*, https://www.researchgate.net/profile/Sharon-Buteau/publication/258183109_Chit_Funds_as_an_Innovative_Access_to_Finance_for_Low-income_Households/links/5592250308ae47a34910d18f/Chit-Funds-as-an-Innovative-Access-to-Finance-for-Low-income-Households.pdf?_sg%. Accessed 24 04 25.

[2] Mallick, Santosha kumar, and Dr. Ansuman sahoo. "The Behavioural Finance Aspects of Chit-Fund Scams of Odisha: Loss is almost certain Profit is Not." *International Journal of Business and Management Invention*, vol. 5, no. 8, 2016, pp. 71-78. *google scholR*, https://www.researchgate.net/profile/Santosha-Mallick/publication/353609111_The_Behavioural_Finance_Aspects_of_Chit-Fund_Scams_of_Odisha_Loss_is_almost_certain_Profit_is_Not/links/6105abeb0c2bfa282a12b3f2/The-Behavioural-Finance-Aspects-of-Chit-Fund-Scams-. Accessed 07 06 25.

[3] Mathur, Sonakshi, and Dr Shailza Dutt. "A Fractured Trust: Examining the Case of the Saradha Chit Fund." *International Journal of Interdisciplinary Innovative Research &Development (IJIIRD)*, vol. 8, no. 2, 2024, p. 104. *google scholar*, https://ijiird.com/wp-content/uploads/080217.pdf. Accessed 19 06 25.

[4] Padma, Dr. Amarish, and Dr. Swapnali Kulkarni. "CHEATING THROUGH CHIT FUND: A CASE OF SARADHA CHIT FUND SCAM." *Cases in Management*, vol. 11, no. -, 2020, -. *google scholar*, https://www.sbpatilmba.com/pdf/Cases-in-Management.pdf#page=11. Accessed 20 06 25.

[5] Rao, Preethi, and Sharon Buteau. "Modelling credit and savings behaviour of chit fund participants." *GATES OPEN RESAECH*, vol. NA, no. NA, 18, p. 32. *Gates Open Research*, file:///C:/Users/cinda/Downloads/c7295eaf-63e3-4844-b230-34803f444de1_12767_-_preethi_rao%20(1).pdf. Accessed 30 05 25.

[6] V, Pramod A. "INDIVIDUAL FINANCIAL PORTFOLIO TO CHANNELIZE CAPITAL AMOUNT WITH REFERENCE TO CHIT FUNDS AND PERSONAL LOAN." *International Journal of Management*, vol. 11, no. 7, 2020, pp. 500-509. © *IAEME Publication*, https://d1wqtxts1xzle7.cloudfront.net/66042087/IJM_11_07_047-libre.pdf?1615985547=&response-content-disposition=inline%3B+filename%3DINDIVIDUAL_FINANCIAL_PORTFOLIO_TO_CHANNE.pdf&Expires=1749284875&Signature=HP2Fno9GTnrA8X1r7mhUqyrZVQQzfpMxv8eyeR-wcU0Za0FLH. Accessed 07 06 2025.