Institute for Financial Management and Research

Small Enterprise Finance Centre

Working Paper Series

January 2007

# Chit Funds - A Boon to the Small Enterprises

Preethi Rao

Under the Guidance of

Prof Mudit Kapoor, Indian School of Business

Prof Antoinette Schoar, Massachusetts Institute of Technology

Preethi Rao preethi.rao@ifmr.ac.in is a Research Associate at the Small Enterprise Finance Centre in IFMR. The views expressed in this note are entirely those of the author and should not be attributed to the Institution with which she is associated.

# Contents

***Acknowledgement***

*We are extremely grateful to Kapil Chit Funds Pvt. Ltd. for providing us with data on their chit members' bidding patterns for the final research project. Kapil Chit Funds is a 25 year-old private limited company with over 90 branches in Andhra Pradesh. It is among the top chit fund companies in India. We would like to personally thank Mr. Vaman Rao, Chairman, Kapil Chit Funds and Mr. Venu Gopal Rao, Assistant General Manager (I.T.), Kapil Chit Funds, for their unwavering support to our research.*

# 1 Introduction

Chit funds are the Indian equivalent of the Rotating Savings and Credit Associations (ROSCA) that are famous throughout the world.[1] ROSCAs are a means to 'save and borrow' at the same time. It is considered one of the best instruments to cater to the needs of the poor.

The concept of chit funds originated more than 1000 years ago.[2] Initially it was in the form of an informal association of traders and households within communities, wherein the members contributed some money in return for an accumulated sum at the end of the tenure. Participation in chit funds were mainly for the purpose of purchasing some property or, in other words, for 'consumption' purposes. However, in recent times, there has been tremendous alteration in the constitution and functioning of chit funds.

With the advent of the Chit Funds Act, initially in the year 1961 (Madras Act)[3] and amended subsequently in the year 1982 (Central Act),[4] chit funds have been highly regulated and governed by stringent rules. The purpose of the said Act and its proposed benefit to the chit funds industry is, however, questionable.

Chit funds are also, more importantly, a means of easy and profitable access to finance for the Small and Medium Enterprises (SMEs). The limited access to funds of SMEs from banks and the formal financial domain had begun to strangle the growth prospects of these enterprises.[5] Thus, the advent of chit funds is really a boon to these businesses. To understand more about the workings of chit funds and the difficulties that they face in their business, we interviewed a number of chit fund managers in Chennai, Tamilnadu (India).[6] These in-depth interviews gave us an idea about the possible research questions that may be addressed in this area. The questionnaire used for the purpose is annexed at the end of the document. The following sections relate the findings from these interviews.

[1]Besley, Coate and Loury (1993)

[2]Simcox (1894)

[3]http://chitfund.delhigovt.nic.in/madras_chit_funds_act_right.htm

[4]http://gov.ua.nic.in/society/acts/hchit.htm

[5]CII, Kolkata (2006)

[6]We are grateful to the following 8 Chennai-based chit managers, whom we interviewed: 1. Mr. Vaidhyanathan of Balussery Chits, Triplicane; 2. Mr. Radhakrishnan of Shriram Chits, Alwarpet; 3. Mr. Chitrarasu of Kurinji Chits, Arumbakkam; 4. Mr. Krishnaprasad of Thiripura Chits, Saidapet; 5. Mr. Bawarilal of Giri Chits, Parrys; 6. Mr. Subramanyam of Abhimaan Chits, Parrys; 7. Mr. Harigopal of BFC Chits, Parrys; 8. Mt. Satishkumar of a chit company in Parrys

## 2 How Do Chits Work?

A chit scheme generally has a predetermined value and duration. Each scheme admits a particular number of members (generally equal to the duration of the scheme), who contribute a certain sum of money every month (or everyday) to the 'pot'. The 'pot' is then auctioned out every month. The highest bidder (also known as the prized subscriber) wins the 'pot' for that month. The bid amount is also called the 'discount' and the prized subscriber wins the sum of money equal to the chit value *less* the discount. The discount money is then distributed among the rest of the members (or the non-prized subscribers) as 'dividend' and in the subsequent month, the required contribution is brought down by the amount of dividend.

To illustrate the above, let us take the example of a chit scheme with the following characteristics. Chit Value = Rs.500000, Duration = 50 months and Members = 50. The contribution in this case would be initially Rs.10000 per month per member. In the first month, the collection would, therefore, be Rs.10000 multiplied by the number of members i.e. Rs.500000. This amount is called the 'pot' which is auctioned out at the end of the month. Now let us assume that the highest bid in the first month auction is Rs.100000. This is called the 'discount'. The highest bidder now gets the amount equal to the chit value, Rs.500000, less the discount, Rs.100000, i.e. Rs.400000. The discount amount of Rs.100000 is then divided among the other 49 members equally (the dividend for the 49 members work out to roughly Rs.2040 each). For the subsequent month, therefore, the contribution of these members reduces by the amount of dividend (i.e. the contribution in the second month for the 49 members would be Rs.10000 less Rs.2040 which is equal to Rs.7960). This process gets repeated for all months till the end of the scheme.

There are many variations to the above mentioned process depending on the scheme, preference of the members, capability of the company and so on. Generally, the chit manager or the company is also a member in each scheme. This is because the chit manager has to deposit an amount equal to the chit value of the scheme with the Registrar of Chits for the particular jurisdiction. We will discuss this in detail in the Regulations section.

## 3 General Characteristics of the Chit Funds Interviewed

The chit companies we approached were in the business for the past 10 to 60 years. In most cases, the owner or manager was already involved in a similar line of business (like income tax consultant, chartered accountant, and jeweler or kirana shop owner[7]) and expanded or diversified into the chit business. All the chit companies interviewed were running registered funds. The number of schemes open at a particular time ranged from 10 to as many as 80. The chit values ranged from Rs.10000 to Rs.1000000 and the duration from 20 to 50 months. The majority of members of the chit funds were small traders and businesses.[8] Households (mainly housewives) and salaried employees also participated extensively in these schemes.

The funds generally allow multiple-membership in each scheme, which means that a member can contribute double or more number of times the amount and participate in that many auctions during the tenure of the scheme. For instance, in a 20 month scheme where the contribution is Rs.1000 per month per member, a member who pays a contribution of Rs.3000 per month can participate in 3 out of the 20 auctions. However, the members can bid again only after 50% of the duration is completed (for instance, in case of a 20 month scheme, the member who has won the pot in the first 10 months can bid again only after the completion of 10 months). Usually only members with high credit worthiness will be allowed such a privilege.

The chit companies do not require much documentation, which is their advantage over banks and other financial institutions. Some of the companies, however, ask for income proof and address proof from new members. Most of the companies require the members to have a bank account, as 100% of the transactions are done through check payments. No business or address verification is undertaken by the chit funds unless it is deemed absolutely necessary.

Most chit companies admit only members who are either connected to other existing chit members or known to the chit manager personally. Some chit funds employ agents to acquire new members. However, in case the members are not personally known to

[7] Kirana shops are small shops that generally sell food items like grocery, rice, tea, spices and so on

[8] This is only a brief estimate of the membership composition. A detailed survey of the members will be subsequently undertaken wherein the exact proportion of small traders and other members will be brought to light

the managers, rigorous verifications are made to ensure the credibility of the member. In some cases, the new members are not allowed to participate in the auction for the first few months of the scheme and will only contribute to the pot during that period. Generally, the members who want to bid in the auction are asked to produce a guarantor or surety who is trusted by the chit manager. In some cases, collaterals are also demanded from members prior to their participation in the auction. However, if the members are well known, only a promissory note is collected from them for admission to membership.

# 4 Regulations and Costs of Registration

Registration of a chit scheme entails numerous fee payments and other formalities, such as filing of returns, maintaining minutes of the meeting, auditing of accounts and so on, that need to be satisfied by the chit manager. The Registrar of Chits of a particular jurisdiction is responsible for registering the chit funds in that jurisdiction. As a first step in the formation of a group or scheme, prior sanction needs to be obtained from the Registrar. The prior sanction is granted at the filing of an application and at the payment of fees of Rs.50. Subsequently the company needs to file a chit agreement with every member in that particular group. The fee for the purpose is around Rs.20 per member. Once the chit agreement is filed and approved, the certificate for commencement of the scheme is issued.

The chit manager needs to deposit 100% of the chit value with the Registrar prior to the commencement of the scheme. This deposit will be refunded to the chit manager on the successful completion of the chit cycle. Normally, in the first month of each scheme, there will be no auction, and the amount collected from the members would be taken by the company to compensate for the deposit made. However, as this would be considered unfair to the members (who will lose the entire contribution in that particular month) the chit manager also takes part in the group and makes regular monthly contributions to the scheme. Therefore, in essence, the chit manager is the bidder in the first month who takes a loan to make the deposit.

The registration process generally takes around two months to complete. There is no subsequent requirement for renewal of the registration. Once the scheme commences, the chit manager has to file the minutes of each auction with the Registrar every month along with a fee of around Rs.4. Other costs of registration include fees payable on transfer of membership and on any other filing requirement that may arise during the course of the scheme. The total quantum of fees to be paid by a chit manager was raised by 200% in 2003 by the Tamil Nadu Government's order 'Revision of Fees under Chit Funds Act, 1982'.[9]

A registered chit fund needs to have its accounts audited by a qualified Chartered Accountant. The fixed deposit made at the beginning of the scheme will be refunded only on the submission of the audited Balance Sheet and Statement of Accounts. The Act also requires all registered chit funds to impose a 30% (now increased to 40%) cap on the bidding amount. This 30% (or 40%) is calculated on the chit value of the scheme. This bid-cap is administered to ensure that the bid does not rise uncontrollably leading to subsequent default by the bidder. The minimum bid is restricted to 5% of the chit value which is the foreman's commission.

According to the chit managers, the registration of chit funds ensures more transparency and accountability in its operations, which in turn helps to boost the confidence of the members. The risk involved in a registered chit fund is far less than in an unregistered fund, even though the cost involved is higher. And of course, in case of defaults by the parties involved, there is the possibility of legal recourse. More importantly, registration of chit funds leads to more revenue for the exchequer.

## 5 Defaults - How Are They Handled?

The default rates in the chit industry hover around a meager 1-2%. This is because the chit members are, in most cases, personally known to the chit managers. However, even the default by a single member can shake the foundation of the chit scheme as it is totally dependant on the dedicated participation of all the members. Hence, it becomes essential for the chit managers to screen the members before admission.

When members fail to make their contribution for any particular month, they are initially requested by oral correspondence to pay the dues. If this fails, a reminder is sent

[9]The Hindu Business Line - 'TN order stuns chit operators' (March, 2003)

by mail and finally a legal notice is issued and the person is taken to Court. There is an arbitrary provision under the Chit Fund Act that provides for immediate redressal. The Registrar may admit or dismiss the case depending on the strength of the argument on both sides. In some cases, there may also be partial recovery depending on the financial solvency of the member. The Court attaches the salary, collateral and sometimes even the personal property of the member to the unpaid dues. In case the member is not traceable, then the guarantor or surety is asked to make the payment and, in their absence, the company is obliged to do the same.

In case of delay in payment of dues, interest is charged on the delayed payment and sometimes even the dividends are forfeited if the delay is for too long. In case the reason for delay is genuine then the interest is waived. To minimize delays, discounts are given for prompt payments.

## 6 Auctions

The chit manager auctions out the 'pot' every month on a particular date. The members who wish to participate in the auction assemble at a particular place (generally the chit manager's office) and call out their bids. The auction essentially lasts for five minutes preceded by five minutes of preliminaries and succeeded by five minutes of closing procedure. At the end of the fifth minute of the auction, a bell will ring to indicate the closure. The highest bid at the time of the bell will be recorded as the winning bid. If a member, interested in participating in an auction, is unable to be physically present, then he/she may send a sealed bid to the chit manager/foreman 24 hours prior to the auction.

In case there is an equal bid, the decision of who is entitled to the loan is made by means of a lottery. When none of the members require the loan, a lottery is conducted among the non-prized subscribers and the member selected is given the loan amount at the minimum bid of 5%.

Where two members are equally in urgent need of the loan in any particular month, the chit manager may allow them to make compromises among themselves wherein they may divide the 'pot' equally between them. However, in such cases, one of them will be held liable directly to the group for the entire amount and the other would be liable to the former for his/her share of the loan.

## 7 Source of Income to the Chit Manager

The chit manager gets a high return on the chit business which is justified by the high risk involved in such a business. His/her major source of income is the foreman's commission of 5% of the chit value for every scheme. This provides a regular monthly income of around Rs.10000 on an average for every scheme that is in vogue. This steady income flow is sufficient to cover the operating cost and other statutory costs of running the scheme. The interest lost on the deposit that needs to be made *ab initio*, and the monthly contributions as part of every scheme that has to be borne by the manager, require such an income source to keep him/her afloat.

Apart from this formal and transparent source of income, chit managers also make money in other less evident ways. For instance, it is a common phenomenon for the loan to be disbursed a month after the auction date. This means that the chit manager will earn interest on the loan amount for a whole month. When this repeats for every scheme in force, a large quantity of money accumulates. To illustrate this, let us consider a chit scheme that has an auction on the 7th of January. The contributions will be collected on the 1st of January. Now, the prized subscriber at the auction will be provided with the loan amount or the 'pot' only after a month, i.e. on the 7th of February. The chit manager will earn the interest on the collected amount essentially from the 1st of January to the 7th of February. Hence, the chit managers have a very rich source of income. However, with the increase in costs of registration and other costs prescribed by the Government, and the increased risk faced by the managers, little can be said regarding the profits they make.

## 8 Use of the Chit Money

Chit managers do not require the members to specify the purpose to which they deploy the funds. Generally, chit loans are used by households for consumption purposes like marriages, buying property (land, vehicle etc.) and education. It is primarily considered a means to saving free cash by the women of the household in order to provide for any contingencies that may arise in the future.

Sometimes, the chit fund loans may also be used to settle outstanding loans with the money lenders. The chit member may use the 'pot' to pay off the money lender loan which is at a much higher rate and thus save money. Such members, who have several loans from varied sources, may run the risk of defaulting in some cases, as they may be caught in the 'vicious circle of debt' or the 'debt trap'.

## 9 Chit Funds and Small Businesses

Small traders and businessmen participate extensively in chit funds. Chit funds provide an opportunity for them to save their excess cash on a daily or monthly basis and, at the same time, to have access to easy finance in case of emergency or other requirement. Generally, the funds are used as either working capital, for expansion of business or as emergency funds.

Small enterprises have been historically wedged between the money lenders, with their exorbitant cost of loans, and banks, with their stringent procedures. Chit funds are a welcome measure for such enterprises to overcome their financial constraints. This is evident from the enthusiastic participation of small businessmen in the chit funds we came across.

Small businesses usually have free cash which they can profitably invest in chit funds to earn returns. Some chit funds allow small traders to make daily contributions, instead of monthly, to coordinate with their income cycle (small traders in the cash and carry business generally have daily cash flows from their business). As and when the need arises, they bid in the auction and receive the loan *out of their own funds*. Once they receive the loan, they continue to pay the monthly contributions, and this accounts for the payment towards *both* the interest *and* the principal which makes the repayment easier and less arduous. Also, in chit funds, small traders can decide their own interest rates depending on the need (chit fund interest rates are in effect the *market determined interest rates*).

Small businesses are traditionally avoided by banks and formal financial institutions because of their sloppy accounting procedures and lack of proper recordkeeping. Chit funds are a more suitable financing model for small businesses mainly because they do not require filing of income tax returns and other rigorous documentation. Having a bank account is in most cases sufficient to make a small business eligible to chit fund membership.

## 10 Scope for Future Research and Preliminary findings

In view of the importance of this source of finance and the obvious advantages it presents to the small enterprises it is only prudent to study the industry in more detail. There are many blindsides to the chit fund industry that need to be more thoroughly explored. More importantly, it is necessary to bring the positive aspects of chit funds to light, so that the stringent regulations that strangulate the industry may be lightened.

Therefore, the research questions that need to be addressed are as follows:

1. How are the chit fund loans being used?
2. Are chit funds used as a source of capital? If so, what? - a) Working Capital, b) Emergency Capital, c) Rotation funds
3. What are the other sources of finance the chit members have and what is the cost of such sources? (Benefits vis-à-vis outside options)
4. Why do chit members not wait till the end to take the loan when the interest rates come down?
5. Do the uses of chit funds vary according to the nature of the business like age, size, etc.?
6. What is the impact of participation in chit funds on the growth of the business of chit members?
7. Are the low default-rates in the chit industry due to cautious member selection or does the structure of the chit fund compel the members to borrow from other sources to repay?

8. Why do chit members participate in more than one chit scheme?

9. Do chit funds provide the bulk of financing for its participants?

In order to answer the questions enumerated above, we propose to undertake a two-pronged approach to the research - (a) collect bidding data from various chit companies geographically spread throughout South India, and calculate the loan and savings interest rates that are available to the members and (b) conduct a comprehensive survey of the chit members (mainly small traders) to understand why they use chit funds and how it affects their business.

From the bidding data collected so far, we see that the loan interest rate varies between 1-2% per month on the reducing balance. This works out to around 12% per annum which is much lower when compared to the interest rate charged by the money lenders (that work out to as much as 72% per annum in most cases).[10] Though quoted loan interest rates by banks are similar, and sometimes much lower, to the chit fund interest rates, in reality, the transaction costs for small business loans cause the effective interest rates to be much higher.

The loan interest rates generally follow a near bell shaped curve which means that the interest rates tend to increase mid-way of the scheme and decrease towards the end. This is because there are generally no takers for the loan towards the end of the scheme. The following example from a chit company in Chennai called Thiripura Chits illustrates the above:

[10]This data is based on the pilot surveys of small traders in Hyderabad and Chennai who access money lender loans

**Table 1: Loan interest rates for different chit schemes run by Thiripura Chits with the same duration but different chit values**[11]

| Month | CV 10000 | CV 25000 | CV 50000 | CV 100000 | CV 300000 |
|---|---|---|---|---|---|
| 1 | 0.0139 | 0.0132 | 0.0139 | 0.0139 | 0.0139 |
| 2 | 0.0153 | 0.0146 | 0.0153 | 0.0153 | 0.0153 |
| 3 | 0.0169 | 0.0161 | 0.0169 | 0.0169 | 0.0169 |
| 4 | 0.0187 | 0.0179 | 0.0187 | 0.0187 | 0.0187 |
| 5 | 0.0209 | 0.0199 | 0.0209 | 0.0209 | 0.0209 |
| 6 | 0.0235 | 0.0224 | 0.0234 | 0.0234 | 0.0234 |
| 7 | 0.0265 | 0.0252 | 0.0264 | 0.0264 | 0.0264 |
| 8 | 0.0300 | 0.0287 | 0.0300 | 0.0300 | 0.0300 |
| 9 | 0.0344 | 0.0328 | 0.0343 | 0.0343 | 0.0343 |
| 10 | 0.0290 | 0.0239 | 0.0290 | 0.0290 | 0.0290 |
| 11 | 0.0260 | 0.0231 | 0.0259 | 0.0259 | 0.0259 |
| 12 | 0.0218 | 0.0185 | 0.0217 | 0.0217 | 0.0217 |
| 13 | 0.0160 | 0.0122 | 0.0160 | 0.0160 | 0.0160 |
| 14[12] | 0.0032 | 0.0101 | 0.0083 | 0.0083 | 0.0083 |

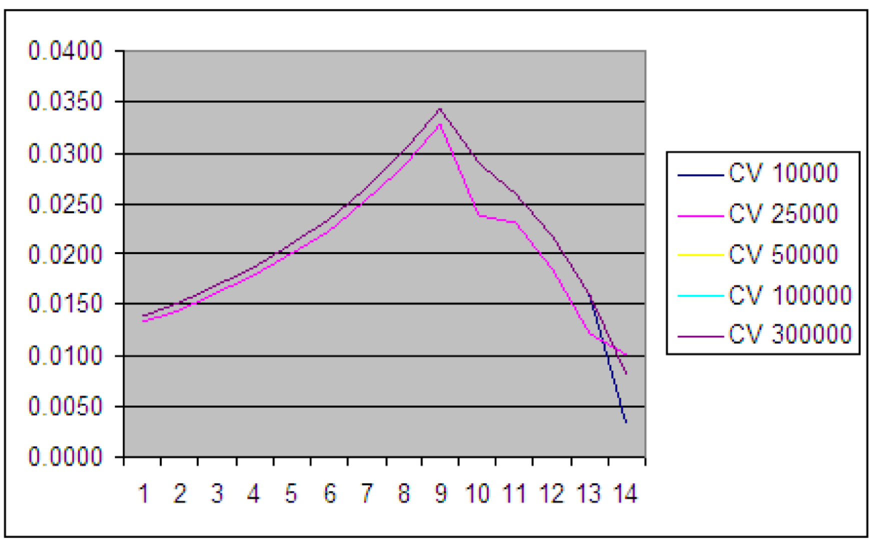


**Figure 1: Comparison of loan interest rates**

Such a recurring pattern indicates that the members do not apriori calculate the interest rates that they pay. This is an interesting aspect that can be explored further. The

[11]The effective loan interest rates were calculated using solver

[12]The duration of the chit schemes is 20 months. However, after 14 months the interest rates were negative and were thus excluded from the comparison

hypothesis that 'more experienced chit members pay a lower loan interest rate because they calculate apriori the required rate of return and bid accordingly' needs to be tested.

The preliminary research has put forward various new ideas and has increased the scope of the actual research.

## 11 Conclusion

Chit funds are a very good tool for financing the activities of small businesses. In recent years, there have been some unscrupulous activities in the industry that have instigated the Government to take serious measures. The occasional failure of chit funds is generally attributed to expansion beyond capacity. A chit fund is not a scalable model unless the chit manager or company has sufficient personal resources as a backup for financial contingencies. However, in recent times, big companies like Shriram Chits and Margadarshi Chits have given a new meaning to the concept of chit funds with their national outreach and presence.

The regulatory hurdles that the chit companies face due to the stringent rules proposed by the Government progressively, have been a setback to the growth of the industry. The effect of the increased costs of operations for the registered chit companies has been to push these companies 'underground'. Many companies have, in the recent past, either folded up or shifted their operations entirely to the informal arena becoming an 'unregistered' chit fund. The unorganized chit fund market is huge and growing (6000 unregistered chit funds in Hyderabad out of the total 7300)13. This causes serious problems not only for the industry and its participants, but also for the Government, which loses its revenue.

Therefore, in order to promote this concept, which is generally beneficial to all the parties concerned, it is imperative that more rigorous research be done on the issues that they face. A strong lobby should also be developed in their favor. The day when the Government and the industry participants alike understand the importance of chit funds to the economy would mark the beginning of a new era.

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# 13 Appendix

**Questionnaire for the Chit Managers**

1. How long have you been running a chit fund?

2. Did you start the chit fund? If yes please tell us about how it was started, at the start how did you get members for the chit fund, if you got it registered - how long did it take?

3. How many different chit fund schemes are you running presently? For each scheme answer Questions 4 to 7 separately:

4. Is this scheme registered or unregistered?

5. Please describe the functioning of the scheme? (amount, duration, number of members, etc)

6. Please describe in detail a typical profile of a member? (For example, his occupation, age, income, education, purpose of joining a chit fund etc.)

7. Are there any new members (first timers) in this scheme? If yes how many new members are there? What procedures were followed to induct new members? Are there any restrictions on the new members - if yes please describe in detail?

8. What are the key differences between a registered chit fund and a non registered chit fund? Please give as many factors which distinguish the two?

9. In case of default by a member:

   (a) What steps were taken by you?

   (b) Who pays the future fees?

   (c) Do you allow new members mid way of the scheme? If yes how are they chosen?

10. What steps do you take to minimize defaults?

11. If you are able to determine that a member has defaulted for a genuine reason (for example, sickness, death or some other emergencies) do you take different actions than otherwise? If yes please describe?

12. In case of delayed payment by a member:

    (a) What steps are taken by you?

    (b) Who pays for the delayed amounts?

13. What steps do you take to minimize delayed payments?

14. If delay is due to some genuine reason (for example, sickness, death or some other emergencies) do you take different actions than otherwise? If yes please describe?

15. Are the members who delay payments, the ones who generally default?

16. In your opinion what are the advantages vis-à-vis other financial intermediaries (like banks, money lenders, pawn brokers, etc) to a member in participating in this scheme? (*Please compare the advantages (or disadvantages) with respect to different financial intermediation*)

17. Do you allow multiple memberships in a scheme? Is there a restriction on the number of memberships?

18. Are there any restrictions on the bid? If yes, please describe the restrictions and why are the restrictions imposed?

19. If two or more members have equal bids then how is it resolved?

20. If none of the members have bid for the amount then what happens to the funds?

21. When members apply to the scheme, do you match them into different schemes according to the type of member?

22. What is the duration of each auction? Please describe the auction in detail.

23. What is the procedure in case a member is not able to be present in an auction? Can the member send a proxy to take part in the auction or can he mail his bid to the chit manager?

24. In your opinion who are the main competitors to the chit fund industry?

25. What are the documents that you would ask for before admitting a member to a scheme? Is it necessary for the member to have a bank account? If so, why?

26. What are the verifications that you would undertake before admitting a member?

27. Do you require your chit fund members to use the chit fund money for a specific purpose? If so, how do you ensure that the money is being used for the specified purpose?

28. What, in your opinion, are the uses for which the members allocate the chit fund money?

29. Is your chit fund used as a savings tool or as a loan product by the members?

30. Do you also undertake any other business apart from chit funds? If so, please specify and explain about the other operations.

31. Have you heard of any frauds in the chit fund business? If yes, have these frauds affected the confidence of the customers? Explain.

## 14 Glossary

1. **Auction** - Auction is a procedure for identification of the non-prized subscriber who wants to take a chit amount at the highest permissible discount. All non-prized subscribers who have paid their installments up to date are allowed to participate in the auction for bidding the highest auction discount, within a period of five minutes, allowed for each auction.

2. **Contribution** - The amount payable by each member of the chit fund every month is called the contribution.

3. **Discount** - The difference between chit value and the amount at which a successful bidder takes a chit in an auction is known as auction discount.

4. **Dividend** - Auction discount minus company commission (5% of chit value) is the total group dividend. Total group dividend is distributed equally amongst all the subscribers. This dividend so distributed is deducted from the next installment payable by the subscriber.

5. **Kirana** - Small shops selling food items like groceries, cereals and so on.