Article

Making sense of the West Bengal "Chit Fund" mess

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April 24, 2013

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Analytical Speaking

As the bottom-of-pyramid population continues to fret having lost life savings in the West Bengal "chit funds", it is interesting to find politicians promising new stern laws against such funds. In fact, law-making is the least of the reasons for such schemes to have flourished in the State. However, as political connections of one of many that has gone bad are exposed, the easy face-wash for the politicians is in law-making, to cover-up what is quint-essentially an implementation issue. The reality is that we are not short of such laws – in fact, we have a plenty of laws that prohibit such schemes and impose sternest penalties for the perpetrators of such scams. But if a Rs-22000-crore scheme question the very institutions that define our system – Supreme Court, SEBI, or whoever else – there is little surprise that the only succour for political face-saving is in law-making. And this is what we have done over the decades - as the write up below shows.

This article gives a quick overview of the laws regarding "chit funds" or devices of sourcing public deposits.

First of all, the West Bengal "chit funds" are not chit funds at all. Chit funds are a different structure altogether. Chit funds are mutual credit groups where money circulates among the group members, and the monthly contributions of the chit members are received circularly by one of the members who bids for the same at the highest interest rate or lowest "net present value". Chit funds are perfectly legal, if they are registered under the Chit Funds Act 1982, and run under the provisions of the law. The several names that keep popping up in West Bengal are not chit funds – these are collective investment schemes or public deposit schemes which on the face of it do not fall under any law, as they are structured so as to be neither a "public deposit" nor a "collective investment scheme". But that facial structure is so gullible that any regulatory investigation may easily expose that these schemes were effectively nothing but public deposit schemes.
The evolution of regulatory structure in India is a rare case of human learning – we have burnt our fingers every time to learn that fire is too hot to handle. So, every scam brought a law; in essence, the law is the edifice built on scams and not on intuition.

- Deposit regulation: These rules were inserted in the Companies Act in 1975 after several cotton mills in Gujarat and Maharasthra burnt public savings. In fact, India is one of the few countries in the World which allows non-banking companies to raise deposits from public. World-over, access to public deposits is allowed only to banks. In India, companies may raise pubic deposits – however, subject to provisions of sec 58A of Companies Act. This allows only deposits to the extent of 25% of net worth of the company, places restrictions on interest rates, brokerage, etc.
- Chit fund laws and money circulation scheme laws: Money circulation schemes were banned by a law in 1978, after Sanchayita Investments went down with money

pooled from a few lakh investors in West Bengal. Soon after, chit funds became a hot political issue, leading to chit fund law in 1982.

- NBFC Regulations: Non-banking financial companies (NBFCs) are allowed to raise deposits upto 10 times of their net worth, but this privilege is granted only to so-called "depository NBFCs". This is a fairly well-regulated institution coming under the RBI, and the regulations have been toned after hard lessons were learnt with the CRB scam of 1997. Accordingly, NBFC Directions were framed in 1998 after few hundreds of NBFCs had gone down with public savings.
- Private placement scams: Several hundred companies raised money by way of "private placement" of shares taking advantage of a Companies Act provision whereby only "public offers" required regulation by the securities regulators (now SEBI, earlier Controller of Capital Issues). This resulted into a "deeming rule" in sec 67 of the Companies Act, inserted in 2000, whereby any offer of securities to 50 or more persons was deemed to be a public offer.
- Collective investment scheme regulations: Plantation companies with schemes such as "money grows on trees" continues to raise public money against collective investment schemes, and it took SEBI several years before the Collective Investment Scheme Regulations were framed in 1999. A collective investment scheme is one where public money is raised for investment in any asset or scheme, other than by way of shares, deposits, mutual funds, etc.
- Alternative investment funds: This is a new a regulatory instrument under SEBI, to regulate privately pooled vehicles for collective investments. This became effective in 2012. This is by far the only regulation which is not "reactive".

So, with all these laws, how to scamsters still end up raising several thousands of crores? Obviously, so much money is neither raised overnight, nor raised silently enough, as there is a massive machinery of agents who raise the money from the very bottom of the population pyramid. Each scamster innovates an ingenious device, but none of these devices are not iron-clad to avoid regulatory action, provided there was a will power.
Here is an inclusive inventory of the schemes currently in use:

- Debentures: Sahara used the argument that (a) Sahara was issuing optionally convertible debentures which were not "securities" under securities laws, and hence, were free from the securities regulations, and were not "deposits" under the deposit regulations, and therefore, to be regulated by none. Supreme Court ruling has rubbished the first argument.
- NBFC companies: The Companies Act rule restricting issue of securities to less than 50 in order to escape the "deemed public offer" rule does not apply to NBFCs – hence, several of the "chit funds" use an NBFC to raise instruments such as debentures not regulated under public deposit rules.
- Preference shares: Some of the entities issue preference shares to the depositors. A preference share is essentially the capital of the company, and not a deposit.

- Land deals: Some companies contend as if the so-called depositor places order for purchase of land by the promoter. Later on, the land deal is cancelled, and money is returned with interest.
- Advances for purchase of goods: Some operators show as if the "deposit" had actually placed an advance for purchase of goods. The order is later cancelled and money is refunded with interest.

No matter what is the device used, the common thread in each of these schemes is that the flow of new "depositors" must keep coming in, because the only source from which maturing deposits could be serviced is by inflows from new depositors. Money is initially raised at hefty interest rates, and with attractive periodic prizes, gifts, gala parties, and so on. The agents who mobilise the deposits are given hefty commissions, because the structure essentially relies on a highly incentivised structure of brokers or agents, who reach right to the doors of the depositors to collect deposits. The cost of interest, plus the agency commissions, the luxurious spendings on so-called depositor prizes, and add to all this the lavish remunerations of the promoters themselves – all adds to a huge cost of interest, say, about 25% to 30%, which no lawful business may produce. It is not that these promoters are blue-eyed investors who know tricks of investing – so, they end up investing money in illiquid properties, resorts or hotels. Now, the only way to keep servicing investors is that new depositors must flow in, so that old depositors can be repaid. That is, the base of the depositor pyramid has to continue to expand so that those up in pyramid can be paid – this is what Ponzi schemes are all about. This is what we call "tiger riding".

Soon, the ride comes to and, and guess what happens at the end of any tiger ride! But in the process, thousands of gullible investors have lost their life savings.

As hundreds of crores are raised though tens of thousands of agents, surely enough, the exercise is not invisible to the regulatory eye. The massive money which is raised, irrespective of the label, surely shows somewhere on the balance sheet of the company, which is filed regularly with the MCA. The primary recipient of the information about these companies is the MCA, and surprisingly, it is the MCA which is the least proactive in the entire process of bringing these perpetrators to regulatory focus, sooner before tons of money vanish.

No, it certainly is not the lack of laws that allows these scamsters to rob people of hard-earned money. It is clearly an implementation issue.

The article was also published in moneylife on April 23, 2013 and can be viewed at the link below:
http://www.moneylife.in/article/west-bengals-chit-fund-mess-and-inaction-of-mca/32336.html