

# ARTICLES

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## How Consumer Bankruptcy Reforms Can Help Save Microfinance in India

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### INTRODUCTION

Lalitha Nursilmula was a cheerful sixteen-year-old girl, who could often be found singing along to popular Bollywood tunes on her way to class.<sup>1</sup> She was also bright and determined, focusing on studying commerce and economics at a local college in Godhumagudu.<sup>2</sup> One day, while she was home alone, an employee of a microfinance company came to her village and asked her to travel to the community office where he could ask her a few questions.<sup>3</sup> Once they arrived, the agent, the village head, and four members of the family’s “joint liability group” (villagers that had assumed collective responsibility for the debt) cornered Lalitha and demanded payment on an outstanding loan of 66,000 rupees that her family had borrowed to pay for the wedding of their elder daughter.<sup>4</sup> The group threatened that they would humiliate her and her entire family if she didn’t bring the money by the end of the day.<sup>5</sup> “Sell your body if you have to,” the agent reportedly said.<sup>6</sup>

Lalitha ran home, crying the whole way.<sup>7</sup> She called her mother and tried to explain what happened, but her mother could barely make out the words in the midst of Lalitha’s sobbing.<sup>8</sup> Lalitha then

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<sup>1</sup> *Under Water*, ECONOMIST, Dec. 9, 2010, at 56; see also Andrew Buncombe, *Suicides and Pressure Tactics Tarnish Image of Micro-Finance Lending*, INDEPENDENT (London), Nov. 22, 2010, at 26.

<sup>2</sup> Buncombe, *supra* note 1.

<sup>3</sup> *Id.*

<sup>4</sup> *Under Water*, *supra* note 1.

<sup>5</sup> Buncombe, *supra* note 1.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

swallowed a lethal dose of pesticide,<sup>9</sup> and although her relatives scrambled home to save her, they were too late.<sup>10</sup> Before taking her own life, Lalitha left a note imploring her parents to not take out any more loans, except to invest in the education of their younger son.<sup>11</sup>

Lalitha's suicide was one of many tragedies that swept over rural villages in Southern India this past year. At least seventy-five people facing pressure to repay loans to microfinance firms, have committed suicide in the fall of 2010 in the state of Andhra Pradesh.<sup>12</sup> These suicides are generally linked to the deep shame that Indians feel towards failing to repay debt.<sup>13</sup>

Many Indians have found themselves in desperate straits, taking out new loans to repay old ones, and creating a spiral of crushing debt.<sup>14</sup> Widely reported stories of Lalitha's fate, and many other tragic suicides, have stirred anger against unscrupulous microfinance lenders.<sup>15</sup> In the winter of 2011, the microfinance industry faced a near collapse as nearly all borrowers in Andhra Pradesh, one of the

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<sup>9</sup> *Under Water*, *supra* note 1.

<sup>10</sup> Buncombe, *supra* note 1.

<sup>11</sup> *Under Water*, *supra* note 1.

<sup>12</sup> Buncombe, *supra* note 1.

<sup>13</sup> See, e.g., H.S. Saksena, *Debt Bondage: An Anthropological View*, 31 E. ANTHRO. 291 (1978); Mrinal K. Mitra & S.K. Mishra, *Forward and Backward Linkages of Rural Indebtedness: A Study of Four Tribal Villages*, 16 MAN AND LIFE [Calcutta], 37 (1990); Pradip K. Bhowmick & P. Sahoo, *Tribal Indebtedness: A Socio-Economic Analysis*, 23 MAN AND LIFE [Midnapur], 91 (1997); N.K. Behura & N. Panigrahi, *Tribal Indebtedness and the Functioning of Money Lenders Regulations in the Scheduled Areas of Orissa: An Empirical Study*, 53 J. ANTHRO. SURV. INDIA 1 (2004); Gustav Peebles, *The Anthropology of Credit and Debt*, 39 ANN. REV. ANTHRO. 225 (2010); see also, Lydia Polgreen & Vikas Bajaj, *India Microcredit Faces Collapse From Defaults*, N.Y. TIMES, Nov. 17, 2010, at A5 (quoting Vijay Mahajan, the chairman of a non-profit organization as saying that the aggressive approach of some microfinance firms "led to more indebtedness, and in some cases it led to suicides"); Uzma Qureshi & David Roodman, *Microfinance as Business* 15 (Ctr. for Global Dev. Working Paper No. 101, 2006), available at [http://www.cgdev.org/files/10742\\_file\\_Microfinance\\_as\\_Business.pdf](http://www.cgdev.org/files/10742_file_Microfinance_as_Business.pdf) (noting that public humiliation of women in Indian culture "gives males in the household and in the lineage a bad reputation"). For a tentative exploration into the relationship between the growth of microfinance on suicides, see Arvind Ashta, et al, *Does Microfinance Cause or Reduce Suicides? Policy Recommendations for Reducing Borrower Stress* 9, 23 (Working Paper, 2011), available at <http://www.microfinancegateway.org/gm/document-1.9.49964/Does%20Microfinance%20Cause.pdf> (finding stable suicide rates overall, but noting that "women suicides in Andhra Pradesh by microfinance borrowers are higher than the average female suicide rates").

<sup>14</sup> See Buncombe, *supra* note 1.

<sup>15</sup> See Polgreen & Bajaj, *supra* note 13 (tracing the building crisis over alleged coercive practices of some microlenders).

largest states in India, stopped repaying their loans.<sup>16</sup> These revelations have pushed the microfinance industry to the brink of collapse.<sup>17</sup> Moreover, it appears that the perception of microlending has shifted among elites, marking a dramatic change of fortune for the microfinance industry.<sup>18</sup>

A second line of assault has come from the politicians. Legislators in the state of Andhra Pradesh have responded to abusive practices in the microfinance industry by passing strict new laws regulating how the microfinance industry can make loans and collect payments.<sup>19</sup>

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.* (“Indian banks, which put up about 80 percent of the money that the companies lent to poor consumers, are increasingly worried that . . . they could now face serious losses.”). Moreover, at least one Indian state has enacted laws that would harm the profitability of microfinance firms. See *All Things Considered, India's Poor Reel under Microfinance Debt Burden* (NPR radio broadcast Dec. 31, 2010) [hereinafter *India's Poor Reel*] available at <http://www.npr.org/2010/12/31/132497267/indias-poor-reel-under-microfinance-debt-burden> (“[This] legislation . . . will, in effect, put the microlenders out of business.”).

<sup>18</sup> Microfinance Focus conducted an opinion poll of 165 delegates to the Microfinance India Summit 2009, including key stakeholders in the microfinance world. Notably, when asked whether the government should impose a cap on interest rates charged by microfinance institutions, 51% said “no.” *Opinion Poll Brings Forth Key Trends in Indian Microfinance*, MICROFIN. FOCUS, Nov. 2, 2009, <http://www.microfinancefocus.com/news/2009/11/02/opinion-poll-brings-forth-key-trends-of-indian-microfinance/>. This polling data, though from an unfamiliar source, gives some evidence that, before the microfinance scandals erupted, the elites had opposed capping interest rates, a proposal that has subsequently gained support in some Indian states. See, e.g., *Andhra Law To Curb Microfinance Firms Comes into Force*, BUS. STANDARD, Jan. 2, 2011, 2011 WLNR 38569; *AP Law To Curb Microfinance Firms Implemented*, DAILY PAK BANKER (Pakistan), Jan. 2, 2011, 2011 WLNR 60086 [hereinafter *DAILY PAK BANKER, AP Law*]. Hostile newspaper articles directed at microfinance also provide some evidence of a shift of opinion among the elites, as do articles from pro-business sources defending microfinance against aggressive reforms and offering incremental solutions. See, e.g., Abhijit Banerjee et al., *Help Microfinance, Don't Kill It*, THE INDIAN EXPRESS, Nov. 26, 2010, 2010 WLNR 23517175 (“But politicians also need to be wary - in taking aim at the occasional overstep, they may find themselves inadvertently destroying the whole business, at great cost both to the poor, and the financial institutions that have stepped in to work with them.”); R. Jagannathan, *Why Microfinance is Not Half the Villain it Seems To Be*, DAILY NEWS & ANALYSIS, Dec. 9, 2010, 2010 WLNR 24363054 (“The Andhra ban on coercive collections is a palliative, but the real solution lies in regulating the sector better . . .”); *Leave Well Alone: Capping Microfinance Interest Rates Will Hurt the Poor. There Are Better Ways to Regulate the Industry*, ECONOMIST, Nov. 20, 2010, at 16 [hereinafter *Leave Well Alone*] [http://www.economist.com/node/17522606?story\\_id=17522606](http://www.economist.com/node/17522606?story_id=17522606). Finally, a periodical search did not reveal any polling regarding how the Indian public views microfinance, or whether these views have shifted.

<sup>19</sup> See Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act, 2011, available at <http://indiamicrofinance.com/wp-content/uploads/2010/10/Andhra-MFI-Ordinance.pdf> (imposing registration requirements, conferring authority to an agency to cancel such registration upon complaints from the public and after a hearing, prohibiting individuals from joining more than one self-help group (e.g., a joint liability group),

Proponents of this crackdown point to growing reports of suicides among poor people unable to pay their debts, and argue that an unregulated microfinance industry has led to the proliferation of abusive practices.<sup>20</sup> Proponents also argue that as the microfinance industry has shifted from a focus on charity to a focus on profits, the banks have extended loans without making sure these loans were applied to start-up businesses.<sup>21</sup> Indeed, it seems that many poor Indian borrowers, like Lalitha's family, have started using microfinance loans to pay for education, increase their quality of life, and boost their consumer activity in addition to promoting business production.

Opponents of the crackdown argue that many of these proposals are misguided and would constrict lending to poor villagers.<sup>22</sup> They contend that the microfinance industry, though imperfect, is too important to abandon as India's poor citizens start to gain power through their increased activity as consumers and producers within the capitalist system.<sup>23</sup> Clearly, however, some reforms must be implemented to respond to the legitimate grievances of the public. What has been overlooked in this debate is the role of legal debt relief in addressing these grievances and stabilizing lending in rural India.

Although India has a consumer bankruptcy law on its books, the law has not been significantly updated for one hundred years.<sup>24</sup> Nor does it appear that Indians tend to take advantage of its protections.<sup>25</sup>

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imposing interest rate caps, prohibiting generally the issuance of multiple loans, banning any coercive measures, etc.); *see also* Polgreen & Bajaj, *supra* note 13 (making note of this law); DAILY PAK BANKER, *AP Law*, *supra* note 18 (noting that the governor signed it into law on January 1, 2011).

<sup>20</sup> *See, e.g.*, Polgreen & Bajaj, *supra* note 13; Jason Burke, *Small Loans, Big Problem: How a Good Idea to Lift Indians Out of Poverty Became a Bad Dream: Unregulated, Unscrupulous Microfinance Firms Blamed for Hardship and Suicides*, GUARDIAN (U.K.), Feb. 1, 2011 at Int'l 28; Jaideep Hardikar, *Micro Menace Micro Finance Institutions (MFIs), Which Began Life as a Poverty-Alleviation Tool that Delivered Much-Needed Credit to Rural Areas, Have Today Turned Commercial*, DAILY NEWS & ANALYSIS, Jan. 1, 2011, available at [http://www.dnaindia.com/money/report\\_microfinance-institutions-are-a-menace\\_1489045](http://www.dnaindia.com/money/report_microfinance-institutions-are-a-menace_1489045).

<sup>21</sup> *See India PM Panel: Microfinance Institutions' Business Model is Full of Fault*, DAILY PAK BANKER (Pakistan), Jan. 6, 2011, 2011 WLNR 371051 [hereinafter DAILY PAK BANKER, *India PM Panel*] (“[Microfinance institutions] have been indulging in multiple lending and large parts of the loans are given for consumption purposes.”).

<sup>22</sup> *See Leave Well Alone*, *supra* note 18.

<sup>23</sup> *Id.*

<sup>24</sup> *See* Adam Feibelman, *Consumer Finance and Insolvency Law in India, A Case Study*, 36 BROOK. J. INT'L L. 75, 106 (2010) [hereinafter Feibelman, *India*].

<sup>25</sup> *Id.* at 114.

The failure of Indians to utilize existing bankruptcy protections raises some interesting questions. Does the statutory text of India's consumer bankruptcy law contain provisions that severely restrict who can file for bankruptcy? Do cultural reasons explain why Indians do not take advantage of bankruptcy relief? Is the deep shame associated with failing to pay debts in Indian culture similar to the shame associated with becoming bankrupt? If a rural Indian farmer, overburdened with debt, feels that his situation is hopeless and that there is no way out, could bankruptcy relief provide a way out?

The microfinance crisis provides an opportunity to consider these questions and examine the role of consumer bankruptcy in facilitating economic development. Much ink has been spilled in legal circles writing about microfinance, with many articles addressing the problems and potential of consumer finance as a development tool.<sup>26</sup> However, consumer finance is only one piece of the puzzle when it comes to sustainable and inclusive development. Another big piece, consumer debt relief, has received scant attention.<sup>27</sup>

This article advocates for the role of consumer bankruptcy in facilitating development in India, and argues that strengthening the consumer bankruptcy system would address the root of the grievances raised by the rebellion against microfinance by correcting the imbalance of power that exists between lenders and borrowers.<sup>28</sup> Increasing the role of consumer bankruptcy may reduce the political

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<sup>26</sup> See, e.g., Jay Lee, *Equity and Innovation: Using Traditional Islamic Banking Models to Reinvigorate Microlending and Innovation in Urban America*, 16 IND. INT'L & COMP. L. REV. 523 (2006); Michelle Scholastica Paul, *Bridging the Gap to the Microfinance Promise: A Proposal for a Tax-Exempt Microfinance Hybrid Entity*, 42 N.Y.U. J. INT'L L. & POL. 1383 (2010); R.H. Tipton III, *Microenterprise Through Microfinance and Microlending: The Missing Piece in the Overall Tribal Economic Development Puzzle*, 29 AM. INDIAN L. REV. 173 (2004).

<sup>27</sup> But see Claire Moore Dickerson, *Informal-Sector Entrepreneurs, Development and Formal Law: A Functional Understanding of Business Law*, 59 AM. J. COMP. L. 179, 197 (2011) [hereinafter Dickerson, *Informal-Sector Entrepreneur*] ("Historically, little practical attention has been paid to bankruptcy and insolvency laws in Sub-Saharan Africa . . . . This is unfortunate since these laws can be an effective means of putting unproductive assets back to productive use . . . . OHADA does provide an interesting and flexible three-level approach, allowing a business in sudden crisis to request the court's protection, and then also permitting reorganization, unless liquidation is the only realistic option."); Adam Feibelman, *Consumer Bankruptcy as Development Policy*, 39 SETON HALL L. REV. 63 (2009) [hereinafter Feibelman, *Consumer Bankruptcy*] (advocating for consumer bankruptcy as development policy); Feibelman, *India*, *supra* note 24.

<sup>28</sup> See *infra* note 201 and accompanying text.

pressure to adopt misguided proposals restricting microfinance, which would hurt the very people that such laws are meant to protect.<sup>29</sup>

Part I provides a brief history and overview of microfinance. Part II recounts the recent rebellion against microfinance in India. Part III explores some of the populist legislation aimed at curbing microfinance industry excesses. Finally, Part IV argues that strengthening the consumer bankruptcy laws in India may help stabilize consumer finance while addressing the legitimate grievances that the people have against the microfinance industry.

## I

### MICROFINANCE: A BRIEF HISTORY

This Part will briefly summarize the history of international microfinance and explain how it works. In contrast to the shiny public perception of microfinance, it has evolved into a much darker reality.

The Grameen Bank is credited with starting the microfinance revolution in the 1970s.<sup>30</sup> Microfinance institutions were originally intended to extend small loans to poor borrowers, who used this capital to fund small businesses.<sup>31</sup> Microloans are often short-term

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<sup>29</sup> The preamble to the Andhra Pradesh law restricting microfinance states: “Whereas these [self-help groups] are being exploited by private Micro Finance Institutions (MFIs) through usurious interest rates and coercive means of recovery resulting in their impoverishment & in some cases leading to suicides, it is expedient to make provisions for protecting the interests of the [self-help groups], by regulating the money lending transactions by the money lending MFIs . . . .” Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act, 2011, <http://indiamicrofinance.com/wp-content/uploads/2010/10/Andhra-MFI-Ordinance.pdf>. Despite the stated purpose of this populist legislation, the legislators in Andhra Pradesh may have a variety of motives beyond protecting poor debtors.

<sup>30</sup> See Molly Richardson, *Increasing Microlending Potential in the United States Through a Strategic Approach to Regulatory Reform*, 34 J. CORP. L. 923, 925 (2009); Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why the West has Misperceived the Grameen Bank's Vision of Microcredit*, 41 STAN. J. INT'L L. 217, 219 (2005) (“Formed in 1976, the Grameen Bank’s mission is to lend to those whose needs are not met by commercial lenders . . . .”). A few economists, working for the major neo-liberal funding organizations, helped to lay the intellectual framework for microfinance by championing the development potential of the informal sector. See Dickerson, *Informal-Sector Entrepreneur*, *supra* note 27, at 200. For example, the Peruvian economist Hernando de Soto was highly influential in advocating that property rights in the informal sector should be formalized. *Id.* at 200–01.

<sup>31</sup> See Richardson, *supra* note 30, at 925.

loans, having a duration of less than two years, and typically range from \$10 to \$1,000.<sup>32</sup>

At their best, microfinance institutions offer economic opportunities to poor people, who are otherwise shut out of the formal lending sector. Traditional financial institutions do not typically make loans to small businesses<sup>33</sup> because such loans carry a high risk of default and have high transaction costs.<sup>34</sup> Even now, with microfinance loans widely accessible, many members of the farming classes rely instead on village loan sharks, notorious for high interest rates and abusive collection methods, to provide the bulk of rural credit in poor countries.<sup>35</sup>

Microfinance has been credited with lifting many people out of poverty by increasing borrowers' income and quality of life.<sup>36</sup> Indeed, some scholars say that the rapid growth of global microfinance provides some evidence that "expanding access to consumer finance can promote development."<sup>37</sup> Microlenders often require these loans to be used for productive purposes associated with expanding a business, as opposed to personal consumption.<sup>38</sup> Such productive uses

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<sup>32</sup> *Id.* at 925–26. These loan amounts are typically at the lower end of this range. See Hardikar, *supra* note 20 (reporting that among the loan portfolios of the 146 self-reporting microfinance institutions in 2009, there was an average per borrower loan of \$144.50).

<sup>33</sup> For present purposes, the term small business refers to businesses with fewer than five employees.

<sup>34</sup> See Richardson, *supra* note 30, at 925–26. However, there is reason to believe that the risk of default for microloans was often low because, until the recent crisis erupted, the banks enjoyed repayment rates of approximately 97%. See Buncombe, *supra* note 1. Nevertheless, it is true that microlending is time and labor intensive. See *India's Poor Reel*, *supra* note 17 ("Microfinance lenders do their business on the client's doorstep, meaning that representatives have to travel to slums or rural villages to make the loans and then come back weekly to collect the payments.").

<sup>35</sup> See *Leave Well Alone*, *supra* note 18 (noting 82% of households in Andhra Pradesh hold informal loans).

<sup>36</sup> See Richardson, *supra* note 30, at 925–26; Hardikar, *supra* note 20. However, there is considerable dissent from this view. See Vikas Bajaj, *Microlenders, Honored With Nobel, Are Struggling*, N.Y. TIMES, Jan. 6, 2011, at B3 ("Most borrowers do not appear to be climbing out of poverty, and a sizable minority is getting trapped in a spiral of debt, according to studies and analysts."), ([quoting David Roodman, a senior fellow at the Center for Global Development] "'Credit is both the source of possibilities and it's a bond . . . [and it] is often operating at this knife's edge, and that gets forgotten,'). *The Economist* takes guardedly optimistic position on microfinance, stating "research suggests that it does work—for some people some of the time, as you would expect. It is not a magic bullet, but nor is it intrinsically harmful." See *Under Water*, *supra* note 1.

<sup>37</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 77.

<sup>38</sup> See Richardson, *supra* note 30, at 926.

may include purchasing raw materials or supplies, such as food ingredients or even cell phones.<sup>39</sup>

Unlike traditional financial institutions, which often require the borrower to pass a credit check and put up collateral in exchange for a loan, microfinance institutions employ innovative methods to reduce the risks associated with lending to poor borrowers.<sup>40</sup> In other words, microfinance institutions rely on informal constraints on behavior to encourage borrowers to repay their loans.<sup>41</sup> The Grameen Bank, for example, employs peer lending circles, usually consisting of women, which rely on social pressure to assure loan repayment.<sup>42</sup> The group may have joint responsibility for repaying the loan, or the entire group may be cut off from future loans if one member of the group fails to repay her loan.<sup>43</sup>

The microfinance industry has been widely applauded for extending loans to millions of poor people in over 100 developing countries around the world, including countries in Asia, Africa, and the Americas.<sup>44</sup> One leading microfinance institution, ACCION International, has lent \$12.3 billion to nearly five million people between 1997 and 2006, all while achieving a repayment rate of 97%.<sup>45</sup> Many NGOs and philanthropic groups joined the microfinance bandwagon in the 1970s and started offering microloans in developing countries.<sup>46</sup> The goal was to alleviate poverty in developing countries by vastly increasing accessibility to credit,

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<sup>39</sup> *Id.*

<sup>40</sup> *Id.* However, there is reason to believe that variations of these “innovative” methods have existed for quite a long time at the local level.

<sup>41</sup> *Id.*; Hardikar, *supra* note 20 (“[T]he Grameen methodology [includes] identify the poor, organise [sic] them (so there’s homogeneity and moral liability of repayment in the absence of any collateral), and standardise [sic] products and systems, enforce discipline, and ensure that any breach is dealt with severely and sternly.”). Such group lender works “in part by substituting reputation for conventional collateral—in other words, collateralizing reputation.” See Qureshi & Roodman, *supra* note 13, at 4.

<sup>42</sup> See Richardson, *supra* note 30, at 926.

<sup>43</sup> *Id.* (“Other methods include information gathering about a potential borrower, joint liability contracts, short term contracts, or ‘loan ladders,’ which increase subsequent loan amounts after each repayment.”).

<sup>44</sup> *Id.* A number of articles have explored the potential for importing the microfinance model to developed countries, including the United States. See sources cited, *supra* note 26.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 927.

aiming to reach many of the three-quarters of Indians who survive on less than \$2 a day.<sup>47</sup>

As microfinance has come to be viewed as a high-growth industry, the number of commercial microcredit lenders increased dramatically.<sup>48</sup> The microfinance industry gradually shifted from a non-profit model reliant on donors, to a for-profit model driven by shareholders.<sup>49</sup> Amidst this shift, some microfinance institutions have grown at a rapid clip, achieving growth rates as high as 100% a year.<sup>50</sup> The markets came to view the growth prospects of microfinance so bullishly that SKS Microfinance raised \$357 million in its [2008] IPO on the Mumbai stock exchange.<sup>51</sup>

This shift toward profit-based microlending raises some interesting questions. Did microlending start out with a charitable heart but came to be exploited by big banking interests? Does the microfinance system's transformation from a non-profit philanthropy to a for-profit industry represent good policy? In the midst of this shift, has the balance of power shifted between lender and borrower in a way that is disadvantageous or crippling to borrowers?

## II

### MICROFINANCE ON THE BRINK OF COLLAPSE IN INDIA

The world of profit-based microfinance in India has been badly shaken by recent scandals, pushing the entire microfinance industry to the brink of collapse.<sup>52</sup> Microlending is failing in India for several reasons. First, there has been a cultural backlash generated by widely publicized stories of farmer suicides, abusive lender practices in a changing industry, and the political targeting of microfinance. Second, there have been economic setbacks associated with the fast growth of microfinance in India followed by a wave of defaults.

Interestingly, exploiting the shame of default, coupled with intense peer pressure from the joint liability group,<sup>53</sup> is exactly what has made microfinance so successful. In countries where the shame/peer

<sup>47</sup> See *Under Water*, *supra* note 1.

<sup>48</sup> See Richardson, *supra* note 30, at 927.

<sup>49</sup> See Hardikar, *supra* note 20.

<sup>50</sup> See Bajaj, *supra* note 36. However, the profitability of these lenders has decreased dramatically in light of recent events. In addition, some argue that these high profit margins have made the loans less effective. See *infra* note 74 and related text.

<sup>51</sup> See India's Poor Reel, *supra* note 17.

<sup>52</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>53</sup> This refers to practices such as requiring collective responsibility for loan repayment. See *supra* note 41 and related text.

pressure combination is effective, microfinance institutions have enjoyed extremely high national payback rates.<sup>54</sup> However, the exploitation of the deep shame rural Indians associate with debt has led to the proliferation of farmer suicides.<sup>55</sup> This shame has been compounded by abusive practices of microfinance companies that detractors say have contributed to widespread tragic outcomes.<sup>56</sup>

Critics of microfinance institutions argue that they place too much reliance on community pressure, instead of considering the individual borrower's ability to repay.<sup>57</sup> Second, they assert that microfinance institutions started using coercive methods to collect on debts, including intimidation.<sup>58</sup> For example, bankers have hired underlings to coerce debtors into repaying by threatening to humiliate them before their community.<sup>59</sup> Third, they argue that microfinance institutions, such as SKS Microfinance, have made huge profits on the backs of the poor, impoverishing rural Indians by cajoling them into accepting loans at exorbitant interest rates.<sup>60</sup> To many local

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<sup>54</sup> Although this topic is beyond the scope of this article, it would be interesting to explore how microfinance institutions rely on exploiting informal constraints on behavior to achieve high repayment rates. One could contrast the act of taking out a loan in the United States, which (at least in urban areas) is typically a very individual experience (rather than a communal one). Is the peer pressure model not applicable in the United States, which lacks the kind of communal pressures that make it successful in India? Do the recent debt rebellions suggest that relying on informal constraints is fatally flawed as a model, or can it survive with reforms?

<sup>55</sup> See *supra* note 13, and accompanying text (citing anthropological articles).

<sup>56</sup> See, e.g., Polgreen & Bajaj, *supra* note 13; Burke, *supra* note 20; Hardikar, *supra* note 20. For a discussion of how corporations have engaged in human rights abuses in India in different contexts, see Claire Moore Dickerson, *Ozymandias as Community Project: Managerial/Corporate Social Responsibility and the Failure of Transparency*, 35 CONN. L. REV. 1035, 1048–51 (2003) [hereinafter Dickerson, *Ozymandias*] (detailing human rights abuses in India by Enron).

<sup>57</sup> See Polgreen & Bajaj, *supra* note 13. In other words, the lenders were just in it for the money, rather than channeling money to activities that generate income for poor Indians. *But see* Bajaj, *supra* note 36 (“Many had used the money to pay for televisions or health care or to soften the blow of failed crops, rather than as seed money for businesses.”). On the other hand, Indians can benefit from the smoothing effect that receiving microloans may have on their income.

<sup>58</sup> See Polgreen & Bajaj, *supra* note 13; *Under Water*, *supra* note 1 (“Some ‘recovery’ methods have involved intimidation.”).

<sup>59</sup> See *India's Poor Reel*, *supra* note 17, (in the account of one borrower, “[C]ollectors from the finance companies hounded her day and night, shaming her in front of her neighbors. They told her to get the money any way she could, by stealing if necessary, and they told her she'd be better off dead.”).

<sup>60</sup> See Polgreen & Bajaj, *supra* note 13. These microfinance institutions typically charged interest rates of up to 36%. See DAILY PAK BANKER, *India PM Panel*, *supra* note 21. However, it appears that some microfinance institutions admitted to charging 50 to

politicians, the microfinance industry has become just as bad as the widely hated village loan sharks that microfinance promised to replace.<sup>61</sup>

Arguably, as the microfinance industry shifted from charity to profits, it lost sight of its traditional focus of helping the poor.<sup>62</sup> One might ask whether making profits and helping the poor are ever compatible, or if this is just a pipe dream of “social entrepreneurs.”<sup>63</sup>

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60% interest. See BUS. STANDARD, *Andhra Law*, *supra* note 18. Presumably, the competition with nonprofit firms, as well as with loan sharks, would serve to keep interest rates down. Moreover, these interest rates might be more justified in light of the inflation picture. It seems, however, that part of the anger stems from the very idea of earning profits from making loans to poor people. See Hardikar, *supra* note 20. Muhammed Yunus, the Grameen Bank founder, reflected this mood by criticizing microfinance institutions that have gone public, stating “[w]hen you put an IPO, you are promising your investors that there is a lot of money to be made and this is a wrong message. Poor people should not be shown as an opportunity to make money out of.” *Id.*

<sup>61</sup> See Hardikar, *supra* note 20 (“‘We created microcredit to fight the loan sharks,’ reasoned Professor Muhammed Yunus . . . ‘We didn’t create microcredit to encourage new loan sharks.’”); Polgreen & Bajaj, *supra* note 13. Ironically, one senior official in Andhra Pradesh, Reddy Subrahmanyam, expressed nostalgia for the village loan sharks, stating “[t]he money lender lives in the community . . . At least you can burn down his house. With these companies, it is loot and scoot.” See *id.* In other words, is it better to have the devil you know (and whose house you can set on fire) than the devil you don’t (who lives in a high-rise condo downtown)? However, it appears that the microfinance industry has received a disproportionate share of the blame for farmer suicides in India, for many of these borrowers owed even larger sums of money to the local loan shark. See, e.g., *Under Water*, *supra* note 1 (“Anthaiah took his own life as a payment loomed on a 15,000 rupee (\$333) [microfinance] loan. Heavy rain had waterlogged his cotton crop and left the family struggling to pay the interest rate of 36% a year. But the couple, who had borrowed to build this house, also owed 34,000 rupees to a local moneylender, who charged over 50%.”).

<sup>62</sup> See Hardikar, *supra* note 20 (“But what was pitted as an innovating financial practice to address poverty, is now being viewed as the next big investment opportunity, a concept that critics say is antithetical to its charitable roots.”). In addition, it is not clear whether the interest rates charged by for-profit microfinance firms materially differed from nonprofit firms. Nonprofit firms, like for-profit firms, operate under pressure based on the bottom line. Perhaps, however, the managers of for-profit firms are under a more intense form of pressure.

<sup>63</sup> Generally speaking, “social entrepreneurs” are liberals that want to solve social problems with capitalist and/or market-based solutions. See, e.g., Nicholas Kristof, *The Role of Microfinance*, N.Y. TIMES ON THE GROUND BLOG (Dec. 28, 2009, 2:28 PM), <http://kristof.blogs.nytimes.com/2009/12/28/the-role-of-microfinance/> (praising the “remarkable achievement” of microfinance); Nicholas Kristof, Op-Ed, *Do-Gooders with Spreadsheets*, N.Y. TIMES, Jan. 30, 2007, at A21 (quoting approvingly a description of social entrepreneurs as “the most important historical force at work today”); Nicholas Kristof, Op-Ed, *You, Too, Can Be a Banker to the Poor*, N.Y. TIMES, Mar. 27, 2007, at A19 (“For those readers who ask me what they can do to help fight poverty, one option is to sit down at your computer and become a microfinancier.”); Stephanie Strom, *Thanksgiving Reading: Charity with a Bottom Line*, N.Y. TIMES DEALBOOK BLOG (Nov. 23, 2006, 10:37 AM) <http://dealbook.nytimes.com/2006/11/23/thanksgiving-reading-charity-with-a->

This widespread hostility toward microfinance marks a dramatic reversal of fortune for the industry, which previously was touted as one of the best hopes for alleviating poverty in rural India.<sup>64</sup> Not long ago, the microfinance industry was showered with praise (and cash) by politicians, philanthropists, and bankers.<sup>65</sup> In 2000, world leaders enshrined microfinance as one of the pillars of the United Nations' ambitious Millennium Development Goals for 2015, which sought to reduce the number of people living in extreme poverty by half.<sup>66</sup> This trickle-up form of capitalism was so appealing to leaders in the developed world that Muhammad Yunus, one of the founders of microfinance, received the Nobel Peace Prize in 2006.<sup>67</sup>

The public outcry stemming from these perceived abuses has been thunderous, directed largely at unscrupulous microfinance lenders.<sup>68</sup> In the winter of 2011, the microfinance system faced collapse as nearly all borrowers in Andhra Pradesh, one of the largest states in India, stopped repaying their loans.<sup>69</sup> In fact, loan-recovery rates plummeted from higher than 95% to below 15%.<sup>70</sup> Local politicians, seeing this crisis as an opportunity to burnish their populist

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bottom-line/ (“[This] year, as never before, the line between philanthropy and business is blurring. A new generation of philanthropists . . . believe that [capitalism] can be applied in the service of charity. They are ‘philanthropreneurs,’ driven to do good and have their profit, too.”); Thomas L. Friedman, Op-Ed., ‘Patient’ Capital for an Africa That Can’t Wait, N.Y. TIMES, Apr. 20, 2007, at A23 (“Africa needs many things, but most of all it needs capitalists who can start and run legal companies . . . . People grow out of poverty when they create small businesses that employ their neighbors. Nothing else lasts.”). Perhaps the microfinance movement taps into a famous idiom, “you can give a man a fish, and he’ll eat for a day. But if you teach him how to fish, he’ll eat for a lifetime.” In this case, the microfinancier is not teaching how to fish, but is fronting some money to buy the bait.

<sup>64</sup> See *supra* note 63 and accompanying text; David Leonhardt, *A Fresh Look at Fighting Global Poverty*, N.Y. TIMES ECONOMIX BLOG (Apr. 26, 2011, 2:00 PM), <http://economix.blogs.nytimes.com/2011/04/26/a-fresh-look-at-fighting-global-poverty/> (quoting Yale economist Dean Karlan as stating that microcredit “has generated more enthusiasm and support than perhaps any other development tool in history.”).

<sup>65</sup> See Bajaj, *supra* note 36. “Philanthropists and investors poured billions of dollars into nonprofit and profit-making microlenders.” *Id.* The success of microfinance was also illustrated by SKS’s IPO.

<sup>66</sup> *Id.*

<sup>67</sup> See *India’s Poor Reel*, *supra* note 17.

<sup>68</sup> See Buncombe, *supra* note 1.

<sup>69</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>70</sup> See Buncombe, *supra* note 1; *Under Water*, *supra* note 1; Vikas Bajaj, *Luster Dims For a Public Microlender*, N.Y. TIMES, May 11, 2011, at B1 [hereinafter Bajaj, *Luster Dims*] (noting that only ten percent of SKS’s borrower in Andhra Pradesh repaid their loans during the first three months of 2011).

credentials with the rural poor, encouraged borrowers to default en masse.<sup>71</sup> Ironically, the microfinance industry's success in India has sometimes made it a political target because so many voters owe them money.<sup>72</sup> Championing the cause of poor microfinance borrowers, politicians have characterized microlenders as profiteering on the backs of the poor.<sup>73</sup>

This crisis portends ill for the future of microfinance in India. For starters, the microfinance industry in India is highly concentrated in Andhra Pradesh, where half of all microcredit borrowers reside.<sup>74</sup> Therefore, if the microfinance crisis were contained in Andhra Pradesh, that would be damaging enough. However, the loan rebellion in Andhra Pradesh has rippled across the nation.<sup>75</sup> Lending has slowed down considerably in other states due to growing fears of defaults.<sup>76</sup> Until recently, the microfinance industry was growing at a rapid pace, but political backlash<sup>77</sup> has halted its expansion.<sup>78</sup> Worse,

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<sup>71</sup> See *Under Water*, *supra* note 1. In the past, political parties have used their opponents' ties to foreign banks as a political wedge issue. *Id.* ("The main opposition Telugu Desam Party lost power in 2004 partly because it was seen as in thrall to the IT industry and foreign investors."). However, the extent to which this debt revolt was centrally organized by politicians and/or activists is not clear. In some cases, local activists overstepped the bounds of persuasion by "physically prevent[ing] loan collectors from entering . . . villages." See Buncombe, *supra* note 1. Either way, the effect was to create a massive boycott against microfinance.

<sup>72</sup> See *Under Water*, *supra* note 1.

<sup>73</sup> *Id.*

<sup>74</sup> See Jagannathan, *supra* note 18 ("Andhra Pradesh is now second only to Bangladesh as the most microfinance saturated place on earth, with a full 17% of the population in possession of a microloan account."); *Under Water*, *supra* note 1 ("[Andhra Pradesh] accounts for at least half India's total, with more than 25m borrowers, up from 8m in 2007."); *But cf.* Polgreen & Bajaj, *supra* note 13 (one-third reside in Andhra Pradesh). As *The Economist* has put it, "Andhra Pradesh is not so much the jewel in its crown as the crown itself." See *Under Water*, *supra* note 1.

<sup>75</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>76</sup> *Id.*; see Bajaj, *supra* note 36 ("Banks, the primary source of money for microlenders, have turned off the tap because they are worried about the industry's future. As a result, microlenders have slowed or stopped lending nationwide."); see also Paul Beckett, *The Microfinance Crisis: Is There a Way Out?*, WALL ST. J. ONLINE INDIA REAL TIME BLOG, (Aug. 1, 2011, 9:30 AM), <http://blogs.wsj.com/indiarealtime/2011/08/01/the-microfinance-crisis-is-there-a-way-out/> ("Almost immediately, banks turned off the credit tap that allows microfinance lenders to operate . . .").

<sup>77</sup> There are at least two components to the political backlash against microfinance: first, the mass boycott in Andhra Pradesh; and second, the legislation promulgated to address abusive practices. For present purposes, they are conflated together into one large political backlash that threatens the future of the microfinance industry.

<sup>78</sup> The Indian credit rating firm Crisil Ltd. has downgraded the credit ratings of twelve microfinance institutions to "rating watch with negative implications." See Aweek Datta, *Crisil Puts 12 Microfinance Lenders on Ratings Watch*, LIVEMINT.COM, Nov. 23, 2010,

if these trends continue, they could potentially destroy microfinance in Andhra Pradesh and possibly beyond.<sup>79</sup> For example, SKS Microfinance reported a net loss for the second quarter, based on widespread borrower defaults.<sup>80</sup>

The stringent anti-microfinance law in Andhra Pradesh, however, may soon be superseded by national legislation.<sup>81</sup> In July of 2011, India's Ministry of Finance released a draft microfinance bill that would put the central Reserve Bank of India in charge of regulating microfinance country-wide.<sup>82</sup> Investors cheered the prospect of nationalizing the regulation of microfinance and overriding existing state laws.<sup>83</sup> News of the proposal drove the stock price of SKS, the largest microfinance institution in India, up twenty percent on the Bombay Stock Exchange.<sup>84</sup> This market reaction indicates that investors believe the proposed law will be good for the microfinance industry. However, the proposed law does impose tough regulations on the industry in its own right, including provisions that confer authority to the Reserve Bank of India to restrict profit margins, interest rates, and fees.<sup>85</sup>

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<http://www.livemint.com/2010/11/22213206/Crisil-puts-12-microfinance-le.html?atype=tp>. Moreover, the stock price of the leading commercial lender, SKS Microfinance, had dropped by 36.79% from Oct. 15, 2010 to Nov. 23, 2010. *Id.*

<sup>79</sup> See *Under Water*, *supra* note 1. This crisis has spread to microlenders in other developing countries. *Id.* ("In Pakistan's Punjab province, for example, it became fashionable in 2008–09 for politicians to encourage borrowers to default on microloans."); *Leave Well Alone*, *supra* note 18 ("In Bangladesh the government has capped the annual interest rate that microfinance institutions . . . can charge at 27%.")

<sup>80</sup> See Becket, *supra* note 76.

<sup>81</sup> See, e.g., Nupur Acharya, *India Releases Draft Bill on Microfinance Regulations*, WALL ST. J. ONLINE, July 7, 2011, <http://online.wsj.com/article/SB10001424052702303365804576430911193252084.html>; *India Microfinance Law Would Make RBI Regulator; SKS Shares Rise*, ECON. TIMES, July 7, 2011, <http://economictimes.indiatimes.com/markets/regulation/india-microfinance-law-would-make-rbi-regulator-sks-shares-rise/articleshow/9134864.cms> [hereinafter, *SKS Shares Rise*]; *Microfinance Regulation Bill Boosts India's SKS*, THE DAILY STAR, July 8, 2011, <http://www.thedailystar.net/newDesign/news-details.php?nid=193401> [hereinafter, *Bill Boosts India's SKS*]; Tripti Lahiri, *Markets Cheer Microfinance Draft Law*, WALL ST. J. ONLINE INDIA REAL TIME BLOG (July 7, 2011, 5:12 PM), <http://blogs.wsj.com/indiarealtime/2011/07/07/markets-cheer-microfinance-draft-law>; Samit Ghosh, *India Microfinance Bill—The Good and The Bad*, CGAP (July 21, 2011), <http://microfinance.cgap.org/2011/07/21/india-microfinance-bill-%E2%80%93-the-good-and-the-bad/>.

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> See, e.g., *Bill Boosts India's SKS*, *supra* note 81.

<sup>85</sup> See *SKS Shares Rise*, *supra* note 80.

The current reaction to the scandals associated with microfinance could destroy the industry, an outcome with severe consequences for poor borrowers.<sup>86</sup> First, because traditional banks are unwilling to extend loans in small amounts, or to risky borrowers, destroying microfinance would cut off an important source of capital to poor borrowers.<sup>87</sup> Second, borrowers may be forced to rely on village loan sharks once again.<sup>88</sup>

### III POPULIST LEGISLATION AIMED AT PROTECTING THE POOR HARMS DEBTORS

Responding to a series of scandals in the microfinance industry, Indian policymakers have recently undertaken to address the costs and negative externalities associated with expanding consumer finance, such as consumer financial distress and over-indebtedness.<sup>89</sup> In general, a variety of options are available to policymakers to address these problems, including “usury laws, disclosure requirements, financial education, laws prohibiting particular transactions or terms, limits on debt collection, and debt relief.”<sup>90</sup> This Part will explain how some of these legislative proposals end up hurting poor borrowers by reducing consumer lending, and therefore illustrating the need to empower consumers in a different way, for example, by strengthening the consumer bankruptcy laws.

A number of states in India have advanced policies aimed at stabilizing lending and addressing the costs associated with consumer indebtedness.<sup>91</sup> Legislators in Andhra Pradesh passed a stringent new law regulating consumer finance.<sup>92</sup> This law changes the business practices of microfinance institutions in a number of ways, such as

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<sup>86</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>87</sup> See *Leave Well Alone*, *supra* note 18. Some have portrayed this result, cutting off capital to poor borrowers, as “financial apartheid.” See Polgreen & Bajaj, *supra* note 13. However, this view ignores the important role that the informal lending sector has and continues to play in allocating capital in rural areas. Moreover, modest government lending programs exist that could help fill the void.

<sup>88</sup> *Id.*

<sup>89</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 67. These costs have existed for some time, but it seems that the recent scandals have heightened the urgency to deal with them. See *infra* note 179 and accompanying text (discussing how the costs of expanding consumer finance have been ignored in India).

<sup>90</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 67.

<sup>91</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>92</sup> See *id.*; see also *supra* note 19 and accompanying text.

capping the interest rate an institution may legally charge.<sup>93</sup> Moreover, the federal government is coordinating with the reserve bank of India, the country's central bank, on a new set of comprehensive federal regulations to govern the microfinance industry.<sup>94</sup>

The policy of capping interest rates, despite its good intentions, is misguided for several reasons.<sup>95</sup> Although microfinance institutions appear to charge high interest rates, they typically have thin profit margins due to the high administrative costs associated with making and collecting millions of small loans.<sup>96</sup> Until recently, microfinance institutions were able to attract large amounts of private capital,<sup>97</sup> and this success could be squandered if the government forces down interest rates, thus diminishing the growth prospects of for-profit microfinance firms.<sup>98</sup> Moreover, slow growth would hinder the ability of microfinance institutions to "harness economies of scale in order to lower transaction costs and cut rates of their own accord."<sup>99</sup> Second, capping interest rates may decrease the incentive for new companies to enter the market, therefore reducing competition among lenders.<sup>100</sup>

Should capping interest rates lead to lower loan availability, it is worth considering whether this could have unintended negative consequences. For example, insofar as capping interest rates decreases the amount of capital that microfinance firms are willing to lend, the poor could be forced to rely more on village loan sharks.<sup>101</sup> Notwithstanding that microfinance has made significant inroads into

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<sup>93</sup> See *supra* note 19 and accompanying text.

<sup>94</sup> See Bajaj, *supra* note 36. (the Economist, while rejecting "wrongheaded" interest rate caps, has endorsed a host of "[s]ensible regulation[s]," including setting up a credit bureau and permitting microfinance institutions to take deposits); see *Leave Well Alone*, *supra* note 18.

<sup>95</sup> See *Leave Well Alone*, *supra* note 18.

<sup>96</sup> *Id.* As discussed earlier, although the 97% repayment rate would suggest these investments are not very risky, the extension of microloans is labor and time intensive. See *supra* note 34 and accompanying text.

<sup>97</sup> See *India's Poor Reel*, *supra* note 17 (discussing SKS Microfinance's \$357 million IPO).

<sup>98</sup> See *Leave Well Alone*, *supra* note 18.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> On the other hand, one could argue that lowering the interest rates for microfinance firms would widen the gap with the larger interest rates charged by village loan sharks, therefore reducing the latter's attractiveness. However, this assumes that loan sharks have such high structural costs that they cannot lower their own interest rates in response to these competitive pressures.

rural areas of developing countries, village moneylenders still “provide the bulk of rural credit.”<sup>102</sup> In fact, in the rural areas of Andhra Pradesh itself, only 11% of households held loans from microfinance institutions, but an astonishing 82% held informal loans.<sup>103</sup> Is this the result that policymakers wish to achieve, the empowerment of loan sharks?

In conclusion, policymakers should be cautious of hurting the very consumers they are ostensibly trying to protect, for many of these policies have ambiguous welfare benefits.<sup>104</sup> For example, “most substantive regulations of consumer lending, such as usury laws or property exemptions, are likely to increase the cost and/or reduce the availability of credit.”<sup>105</sup> Additionally, such regulations can slow the expansion of consumer finance, as illustrated by the Indian banks that have turned off the lending spigot due to fear of rising defaults.<sup>106</sup> Should the solution be to put loans out of reach of nano-entrepreneurs? Is there another way to empower nano-entrepreneurs, while preserving the microfinance industry?

#### IV

##### **SOLUTION: BOLSTER THE CONSUMER BANKRUPTCY SYSTEM**

As Indian policymakers consider how to address the costs and negative externalities associated with expanding consumer finance, particularly the plague of over-indebtedness, they would do well to consider strengthening their consumer bankruptcy regime.<sup>107</sup> Doing so would likely provide more stable growth in consumer finance by increasing the predictability of debt collection. However, consumer bankruptcy reform has been largely absent from the debate on how to respond to the microfinance scandals. This absence suggests that Indian elites do not view such reforms as desirable policy. What factors may account for the absence of consumer bankruptcy reforms from the national discourse? Are there structural impediments to making the legal machinery of bankruptcy accessible to farmers and small businessmen? Is bankruptcy so absent from the cultural discourse in India that small farmers and businessmen would not take

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<sup>102</sup> See *Leave Well Alone*, *supra* note 18.

<sup>103</sup> *Id.*

<sup>104</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 67. “Such rules and regimes are thus desirable only if their beneficial welfare effects outweigh their costs.” *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> For present purposes, the term “consumer bankruptcy” refers to the insolvency system that is available to nano-entrepreneurs and ordinary consumers.

advantage of the system even if it were accessible? Would bankruptcy carry the same shameful stigma that caused many farmers to commit suicide?

Part A.1. explores the current Indian consumer bankruptcy law, draws comparisons to U.S. consumer bankruptcy law, and considers what aspects of India's consumer bankruptcy law hinder its accessibility. Part A.2. goes on to explore whether this regime works in practice, finding that there are a number of cultural, administrative, and economic obstacles to making consumer bankruptcy in India accessible on a larger scale. Parts B and C conclude by advocating for the strengthening of India's consumer bankruptcy system to (1) address the dangers associated with expanding consumer finance in India, and (2) help save the microfinance industry by correcting the imbalance of power between debtors and creditors, which in turn, would remove the impetus for misguided populist laws aimed at protecting the poor.

#### *A. How Effective Is India's Current Consumer Bankruptcy System?*

This section starts by comparing the consumer bankruptcy law of the United States and India as it relates to property exemptions and discharge of debt, with a focus on a few provisions of India's insolvency system that discourage consumers and small business owners from seeking bankruptcy protection. This section concludes with a discussion of other psychological and cultural barriers that may limit the Indian bankruptcy system's effectiveness. Indian policymakers ought to remove these barriers where possible.

##### *1. Current Bankruptcy Law*

India has a consumer bankruptcy regime that is approximately 100 years old, dating back to British colonial rule,<sup>108</sup> which has not been significantly altered since its adoption.<sup>109</sup> The Presidency Towns Insolvency Act and the Provincial Insolvency Act, two separate

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<sup>108</sup> See Feibelman, *India*, *supra* note 24, at 106–07. Many developing countries do not have any provisions for consumer bankruptcy. See Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81 (2002) (discussing how many nations, including China, Vietnam, Mongolia, Hungary, Bulgaria, the Ukraine, Brazil, Mexico, Argentina, and Venezuela, do not allow debt forgiveness for consumers).

<sup>109</sup> See Feibelman, *India*, *supra* note 24, at 107.

statutes, provide the formal sources for India's consumer insolvency regime.<sup>110</sup>

*a. Property Exemptions*

Under the Indian insolvency acts, some property is exempt from recovery by creditors.<sup>111</sup> These exemptions generally incorporate those available under the Code of Civil Procedure.<sup>112</sup> Specifically, Section 60 of the Code of Civil Procedure provides that the following property *is* liable to attachment and sale under execution of decree: lands, houses or other buildings.<sup>113</sup> However, Section 60 goes on to list the property exemptions, providing that the following particulars shall not be liable to such attachment or sale:

- (a) the necessary wearing-apparel, cooking vessels, beds and bedding of the judgment-debtor, his wife and children, and such personal ornaments as, in accordance with religious usage, cannot be parted with by any woman;
- (b) tools of artisans, and, where the judgment-debtor is an agriculturist, his implements of husbandry and such cattle and seed-grain as may, in the opinion of the court, be necessary to enable him to earn his livelihood as such, and such portion of agricultural produce or of any class of agricultural produce as may have been declared to be free from liability under the provisions of the next following section;
- (c) houses and other buildings (with the materials and the sites thereof and the land immediately appurtenant thereto and necessary for their enjoyment) belonging to [an agriculturist or a labourer or a domestic servant] and occupied by him;<sup>114</sup>

As a general matter, under the U.S. bankruptcy code, property exempted by the debtor is protected from creditors against any debt deemed to have arisen before the bankruptcy case began.<sup>115</sup> There are two main policy considerations for protecting a portion of bankrupt debtors' property.<sup>116</sup> First, considering basic notions of fairness,

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<sup>110</sup> *Id.* (noting that these two Acts are largely equivalent in substance).

<sup>111</sup> *Id.* at 109.

<sup>112</sup> See CODE CIV. PROC., No. 5 of 1908 (India).

<sup>113</sup> *Id.* at ¶ 60.

<sup>114</sup> *Id.*

<sup>115</sup> See 11 U.S.C. § 522(c) (2010).

<sup>116</sup> Of course, scholars have debated a host of alternative theories for consumer bankruptcy. See, e.g., Jason J. Kilborn, *Mercy, Rehabilitation, and Quid Pro Quo: A Radical Reassessment of Individual Bankruptcy*, 64 OHIO ST. L.J. 855 (2003); Sean C. Currie, *The Multiple Purposes of Bankruptcy: Restoring Bankruptcy's Social Insurance Function after BAPCPA*, 7 DEPAUL BUS. & COM. L.J. 241 (2009); Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L.

society should not deprive debtors of certain essentials that everyone needs to live day-to-day.<sup>117</sup> Second, there is a third-party interest and a public interest in letting debtors obtain a fresh start, so as to not become completely destitute.<sup>118</sup>

The U.S. bankruptcy code mirrors the Indian insolvency act in certain respects. Specifically, it provides that the following property of the debtor is exempt from recovery: (1) a homestead used as a residence; (2) one motor vehicle; (3) household goods, crops, animals; (4) jewelry; (5) tools of the trade; etc.<sup>119</sup> Notably, there is often a dollar limitation attached to these exemptions.<sup>120</sup> For example, in the United States, the federal homestead exemption covers the debtor's aggregate interest in the homestead of up to approximately \$21,625.<sup>121</sup> However, it is important to note that federal bankruptcy law permits states to opt-out of the federal exemptions and provide their own.<sup>122</sup> At least thirty-five states have done so, and many of these states provide much more generous homestead exemptions.<sup>123</sup>

Why do individual Americans tend to file for bankruptcy? Available data suggests that most consumers in America are likely to become insolvent or experience financial distress due to unexpected exogenous shocks, such as involuntary unemployment or sickness.<sup>124</sup> Moreover, the data indicates that many middle-class debtors are homeowners that use bankruptcy to attempt to hang on to their

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REV. 129, 129 (2005) (stating that consumer bankruptcy functions, at least in part, as a form of social insurance).

<sup>117</sup> See Susan Block-Lieb, *A Humanistic Vision of Bankruptcy Law*, 6 AM. BANKR. INST. L. REV. 471, 477 (1998) (emphasizing humanitarian considerations).

<sup>118</sup> See Rafael Efrat, *The Moral Appeal of Personal Bankruptcy*, 20 WHITTIER L. REV. 141, 141 (1998) (“The fresh start principle generally takes the form of forgiving the debtor part or all of the debts she incurred prior to her bankruptcy filing.”); Katherine Porter & Deborah Thorne, *The Failure of Bankruptcy's Fresh Start*, 92 CORNELL L. REV. 67, 68 (2006). The fresh start principle has deep roots in American jurisprudence. In 1934, the U.S. Supreme Court stated that bankruptcy “gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.” *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

<sup>119</sup> See 11 U.S.C. § 522 (2010).

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> See Richard M. Hynes, *Why (Consumer) Bankruptcy?*, 56 ALA. L. REV. 121, 129 (“Twenty-two states have exemptions that would allow them to exempt at least [fifty thousand dollars].”).

<sup>124</sup> See Feibelman, *India*, *supra* note 24, at 79.

homes.<sup>125</sup> This suggests that in America the homestead property exemption is a major incentive to file for bankruptcy. Indeed, a more generous property exemption may even encourage entrepreneurial activity.<sup>126</sup>

The Indian homestead exemption, on the other hand, does not provide the same incentive to file for bankruptcy that the American homestead exemption provides. The Indian insolvency scheme also provides a kind of homestead exemption, as it exempts the houses and related land of agriculturists, laborers, and domestic servants. However, because a large proportion of Indian debtors are not homeowners, this homestead exemption does not incentivize filing for bankruptcy to protect their home. Perhaps this insight helps to explain why Indians do not take advantage of their bankruptcy system.

*b. Discharge of Debts*

India's consumer bankruptcy law provides for the discharge of debts in some circumstances.<sup>127</sup> However, in a variety of circumstances discharge is not available.<sup>128</sup> Although some of these conditions for discharge are relatively objective, others are more subjective.<sup>129</sup> The latter permits a judge to exercise considerable discretion, and courts have the power to grant a conditional discharge.<sup>130</sup> Moreover, a number of debts are non-dischargeable, including debts to the government and debts involving fraud.<sup>131</sup>

Under the U.S. bankruptcy code, creditors may make two types of challenges to discharge. First, they may object to discharge of particular debts under Section 523 based on the nature of the debt.<sup>132</sup> Such debts include taxes, debts obtained by fraud, family support,

<sup>125</sup> See ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 114 (6th ed. 2009).

<sup>126</sup> See Wei Fan & Michelle J. White, *Personal Bankruptcy and the Level of Entrepreneurial Activity*, 46 J.L. & ECON. 543, 543–44 (2003) (arguing that higher levels of homestead exemption encourages entrepreneurial activity by providing “wealth insurance” that reduces risk for small business owners).

<sup>127</sup> See Feibelman, *India*, *supra* note 24, at 110 (“Where the debtor’s assets cannot satisfy his or her obligations, the debtor can apply for a discharge of the remaining obligations.”).

<sup>128</sup> *Id.* at 110–11.

<sup>129</sup> *Id.* (“For example, a debtor will not receive a discharge if the presiding court determines that the debtor ‘has brought on or contributed to his insolvency by rash or hazardous speculations or by unjustifiable extravagance in living or by gambling, or by culpable neglect of his business affairs.’”).

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> See 11 U.S.C. § 523 (2010).

student loans, and condominium fees.<sup>133</sup> Second, creditors may object to the discharge of all debts under Section 727 based on bad behavior by the debtor.<sup>134</sup> Such actions include the transfer of property with intent to hinder, delay, or defraud creditors; destruction or concealment of books or records; perjury, bribery, extortion, and other fraudulent acts; etc.<sup>135</sup>

The provisions in the Indian insolvency act relating to the discharge of debts are relatively similar to those in the U.S. bankruptcy code. Both have a mix of objective and subjective conditions for discharge that require an inquiry into the debtor's frame of mind. Although this taxes judicial resources, the United States consumer bankruptcy system is widely used by debtors, while the Indian system is not widely utilized. Therefore, there must be other factors that account for the inaccessibility of the Indian consumer bankruptcy system.

## 2. *In Practice*

Although practically no data exists on how the Indian insolvency system functions,<sup>136</sup> some evidence suggests that few Indians take advantage of it.<sup>137</sup> The disuse of the system, if true, is somewhat surprising because on paper, India's insolvency system provides a significant measure of protection and debt relief to consumer debtors.<sup>138</sup>

This scant available evidence is derived from published appellate court decisions, which offer an interesting window into the operation of India's insolvency system.<sup>139</sup> For example, in a case arising from the state of Andhra Pradesh, *Mohammed Abbas Ali v. Masood Bin Mohammed Al-Khaili*, the high court requested his clerks to report on

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<sup>133</sup> *Id.*

<sup>134</sup> *See* 11 U.S.C. § 727 (2010).

<sup>135</sup> *Id.*

<sup>136</sup> *See* Feibelman, *India*, *supra* note 24, at 111 (“[I]t is . . . extremely difficult to discern even the most general aspects of the operation of this scheme. There are no available data about insolvency cases in India—for example, no state-wide or country-wide data exists concerning how many cases are filed.”).

<sup>137</sup> *Id.* at 112. However, Professor Feibelman stated in an interview that based on his travels to rural India, he came away with an impression that there is a functional system, but it functions very slowly. He said that while there are things that we tend to think of as defects, the system may not be dysfunctional. There are a lot of cases that get decided, and many disputes are resolved.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at 114.

the number of pending insolvency petitions.<sup>140</sup> These clerks reported a total of 6,113 petitions pending in Andhra Pradesh, out of a population of 75.7 million in 2001.<sup>141</sup> Six thousand insolvency petitions is a small number per capita, especially considering that about a million households file for bankruptcy each year in the United States<sup>142</sup> out of a population of approximately 310 million. In other words, there are approximately 323 bankruptcy filings a year per 100,000 citizens in the United States, but only approximately 8 bankruptcy filings a year per 100,000 citizens in the state of Andhra Pradesh, a fortyfold difference.

### 3. *Why Do So Few Indians Take Advantage of Bankruptcy Protection?*

Why do so few Indians take advantage of the bankruptcy provisions on the books?<sup>143</sup> It seems that there are at least three categories of explanation: financial barriers to the poor, a perception that the system is ineffective, and cultural stigmas associated with bankruptcy. Analyzing what hurdles currently exist to making the Indian consumer bankruptcy system more accessible will help shape the discussion of what reforms are appropriate.

As an initial matter, the effectiveness of the current bankruptcy system should not simply be measured by the number of Indians that file for bankruptcy. For a consumer bankruptcy regime to be effective, “it should be viable enough to influence consumer financial transactions *ex ante* and to affect the relationships between creditors and debtors *ex post*, especially their motivations to renegotiate.”<sup>144</sup> It is often said in the U.S. that negotiations between creditor and debtor take place “in the shadow of bankruptcy.” Is the Indian consumer

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<sup>140</sup> *Id.* (citing Mohammed Abbas Ali v. Masood Bin Mohammed Al-Khaili and Anr., 2007 A.L.D. 1 (A.P.) 60).

<sup>141</sup> *Id.*

<sup>142</sup> See WARREN & WESTBROOK, *supra* note 125.

<sup>143</sup> In general, because there is so little data available, the author must resort to some degree of speculation. *But cf.* Feibelman, *India*, *supra* note 24, at 113–14 (“In fact, there are reasons to believe that the role of consumer insolvency in India’s society and economy is underestimated. Based on an informal review of the few dozen reported consumer insolvency-related opinions from the last decade available in Manupatra, a commercial legal database, it appears that a surprising number of consumer insolvency petitions are filed each year in India.”) (footnote omitted) (“[Certain data] suggests that a non-trivial number of individuals—debtors as well as creditors—view it to be in their interest to employ the regime. It may also reveal that the existing legal regime plays a more significant role in Indian society than is currently understood.”).

<sup>144</sup> *Id.* at 116.

bankruptcy regime sufficiently accessible and effective to shape the negotiating leverage between debtors and creditors? Even if Indians do not tend to take advantage of the consumer bankruptcy system in large numbers, it may still be useful to have it there in the background. Failing to take the ex ante effect of bankruptcy into account could understate the benefits it affords to consumers through enhanced leverage in negotiations with creditors, even if they do not end up filing for bankruptcy. That being said, it is not at all clear whether the current regime is effective enough to impact the motivations of creditors to renegotiate ex ante.<sup>145</sup>

*a. Financial Barriers to the Poor*

There is reason to believe that consumer bankruptcy will hardly ever be a viable option for the poor, as this is a universal problem.<sup>146</sup> For example, the process of filing for bankruptcy may be prohibitively expensive in India when you factor in the prospect of hiring an attorney, the cost of traveling, etc.<sup>147</sup> Moreover, as Professor Dickerson points out, in developing countries the poor tend not to utilize formal systems for conducting business and instead rely on customary norms.<sup>148</sup> The same set of reasons that discourage the rural

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<sup>145</sup> *Id.*

<sup>146</sup> For arguments about how bankruptcy fees discourage bankruptcy filing in the United States, see generally Rafael Efrat, *The Disadvantaged in Bankruptcy*, 19 BANKR. DEV. J. 71, 74 (2002) (suggesting that filing costs, coupled with the expense of hiring an attorney, may disproportionately discourage disadvantaged groups from filing bankruptcy); see also Richard E. Flint, *Bankruptcy Policy: Toward a Moral Justification for Financial Rehabilitation of the Consumer Debtor*, 48 WASH. & LEE L. REV. 15 (1991); Nathaniel C. Nichols, *The Poor Need Not Apply: Moralistic Barriers to Bankruptcy's Fresh Start*, 25 RUTGERS L.J. 329 (1994); Otis B. Grant, *Are the Indigent Too Poor for Bankruptcy? A Critical Legal Interpretation of the Theory of Fresh Start Within a Law and Economics Paradigm*, 33 U. TOL. L. REV. 773, 782–84 (2002). However, there are a lot of rules that are essentially debt relief, but do not require someone to file for bankruptcy; for example, generous property exemptions.

<sup>147</sup> In the United States, although hiring an attorney is generally a good idea, the bankruptcy code permits *pro se* filings in certain circumstances. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. § 418 (2005).

<sup>148</sup> See Dickerson, *Informal-Sector Entrepreneur*, *supra* note 27, at 208 (“At a 35,000 foot level, Sub-Saharan countries’ basic legal regimes applicable to commercial transactions are of a dual nature. For the foreigners and the elites, there is a version of a transplanted European system; and for the poor—but also for the elites when they wish to avail themselves of it—there is a quasi-traditional system. Inevitably, considerable hybridization occurs, and the boundary between the two principal regimes is blurry.”) (footnote omitted); Claire Moore Dickerson, *The Cameroonian Experience Under OHADA: Business Organizations in a Developing Economy*, 112 BUS. & SOC’Y REV. 191, 201 (2007) (noting that small businesses in OHADA countries tend to make decisions

poor from taking advantage of formal systems would presumably apply to the reluctance of rural Indians to take advantage of the bankruptcy regime.<sup>149</sup>

*b. Perception that the System Is Ineffective*

Another reason why so few Indians take advantage of consumer bankruptcy could be that the system does not work very efficiently, indicating to consumers that the costs outweigh the benefits.<sup>150</sup> A good place to start is looking at the practical effects of discharge in India. In the United States, one of the biggest negative consequences of filing for bankruptcy is the damage caused to a debtor's credit rating, which lasts for a number of years but is not permanent.<sup>151</sup> In India, "[i]t is not clear if individuals who receive a discharge can effectively obtain credit thereafter" because there is no available data.<sup>152</sup>

Moreover, the glacial pace of the Indian judicial system may discourage consumers from filing for bankruptcy.<sup>153</sup> Since insolvency cases move very slowly through the judicial system, debtors may believe that it is not worth their time, money, and effort to file for bankruptcy to protect their assets.<sup>154</sup> Additionally, if a case is filed, and the debtor dutifully waits as the case slowly unfolds, the debtor is still not assured of protection because the substantive provisions of

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based on local norms rather than OHADA legal rules); Claire Moore Dickerson, *Harmonizing Business Laws in Africa: OHADA Calls the Tune*, 44 COLUM. J. TRANSNAT'L L. 17 (2005) (arguing for increased use of general economic cooperative initiatives in Africa). Additional research would be useful in determining whether rural Indians tend to take advantage of formal system regarding enforcing contracts.

<sup>149</sup> See Dickerson, *Informal-Sector Entrepreneur*, *supra* note 27, at 220 (arguing that formal bankruptcy laws are not likely to help nano-entrepreneurs in the short term).

<sup>150</sup> See Feibelman, *India*, *supra* note 24, at 112 ("In fact, there are reasons to doubt that many debtors are inclined to utilize the regime or that they have reason to believe that it would be useful to do so. The consequences of being deemed an insolvent can be severe while the regime's potential benefits to debtors and creditors appear uncertain and may be slight in many instances.").

<sup>151</sup> See generally Katherine Porter, *Life After Debt: Understanding the Credit Restraint of Bankruptcy Debtors*, 18 AM. BANKR. INST. L. REV. 1 (2010).

<sup>152</sup> See Feibelman, *India*, *supra* note 24, at 111 (noting that although there may not be a formal credit rating system in rural India, there may be an informal one—for example, village money lenders certainly remember who failed to repay a debt).

<sup>153</sup> *Id.* at 113–14. For example, if it is generally known that court cases take years to work their way through the system, individuals may come to the conclusion that it is not worth their time to file for bankruptcy. However, as Professor Feibelman notes, "there are some indications that cases filed recently may be more likely to be resolved quicker than older cases, sometimes within a year or two." *Id.*

<sup>154</sup> *Id.* at 112.

India's consumer bankruptcy law often afford great discretion to judges, making "judicial outcomes . . . unpredictable."<sup>155</sup>

In what circumstances do Indians tend to brave these obstacles and file for bankruptcy? There is some indication that, when filed, voluntary petitions are often filed in India "to protect the debtor from incarceration or otherwise aggressive debt collection."<sup>156</sup> This indicates that among those that do file, many Indians file for bankruptcy only when their physical security is put at risk.<sup>157</sup>

*c. Cultural Norms*

Another factor in the low number of Indian bankruptcy filings might be cultural norms, such as the stigma associated with filing for bankruptcy.<sup>158</sup> In Indian culture, there is a deep shame associated with failing to repay one's debts, which is compounded by the intense peer pressure associated with the lending practices of microfinance firms.<sup>159</sup> This phenomenon is illustrated by the wave of farmer suicides that have swept across rural India. It is possible that the deep shame associated with failing to pay debts in Indian culture is similar to the shame associated with becoming bankrupt.<sup>160</sup> Assuming that

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<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 113.

<sup>157</sup> See Dickerson, *Informal-Sector Entrepreneur*, *supra* note 27, at 189 (noting that one major function of insolvency law is to provide physical security for the businessman's person and property).

<sup>158</sup> Rafael Efrat, *Bankruptcy Stigma: Plausible Causes for Shifting Norms*, 22 EMORY BANKR. DEV. J. 481, 483 (2006) [hereinafter Efrat, *Bankruptcy Stigma*] (As Professor Rafael Efrat notes, "[s]tigma is the social devaluation of a person who is deviant from or contrary to a social unit's norm.>").

<sup>159</sup> See *supra* note 56 and accompanying text.

<sup>160</sup> In the United States, there has been considerable debate about the extent that such a stigma has evolved over the years. See, e.g., Rafael Efrat, *The Evolution of Bankruptcy Stigma*, 7 THEOR. INQ. L. 365 (2006) (attempting to measure stigma by studying references to bankrupts in media portrayals, and finding insufficient evidence to conclude that changes in the perception of stigma is directed related to increased bankruptcy filings); Efrat, *Bankruptcy Stigma*, *supra* note 158, at 485 (discussing the decreasing social stigma of consumer bankruptcy and the shift away from the "traditional" view that disparages debtors as financially irresponsible); Elizabeth Warren, & Jay Lawrence Westbrook, *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213, 218 (2006) (observing that rising levels of debt is associated with financial distress); Gordon Bermant, *What's Stigma Got to Do with It?*, 22 AM. BANKR. INST. J. 22 (2003) (reviewing studies trying to connect increased individual bankruptcy filings with the decline in shame and stigma, and questioning the soundness of using certain proxies making this connection); 151 CONG. REC. S2421 (daily ed. Mar. 10, 2005) (statement of Sen. Durbin) ("People I have known who have gone through bankruptcy are not proudly announcing to their

some degree of stigma exists in Indian culture regarding filing for bankruptcy, this stigma might prevent debtors from taking advantage of bankruptcy protection, even if it were in their economic interests to do so. In other words, the shame associated with bankruptcy might be so great that it would negate the effectiveness of any reforms designed to make the consumer bankruptcy system more accessible.

Nevertheless, it is likely that cultural attitudes about debt and bankruptcy are not uniform throughout India, a nation of 1.18 billion people, four major religions, and over a dozen languages.<sup>161</sup> Even assuming that many subsets of Indian society have cultural beliefs that stigmatize debt and/or bankruptcy, these beliefs may not be uniform. Meaningful bankruptcy reforms could potentially be effective for a large minority of the country, like those living in urban areas.

### ***B. Specific Proposals for Strengthening Consumer Bankruptcy***

The form that proposals for strengthening consumer bankruptcy take is dependent on an assessment of the effectiveness of the current regime. Generally speaking, there may be economic, psychological, and cultural explanations for why Indians tend not to take advantage of the bankruptcy system. These barriers to greater accessibility of the consumer bankruptcy system could be addressed with properly targeted reforms.

Professor Feibelman has offered a set of general proposals for strengthening the consumer bankruptcy regime in India.<sup>162</sup> First, Indian policymakers could adopt procedural reforms that would make it easier for consumers to file for bankruptcy and therefore increase the negotiating leverage of debtors.<sup>163</sup> In particular, they could improve the administration of consumer bankruptcy cases by addressing the components of the current regime that tend to make the process slow and relatively unpredictable. For example, a number of

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friends: Well, I had a great day in bankruptcy court. These are people who are a little embarrassed, a little ashamed of what they had to go through.”).

<sup>161</sup> CIA WORLD FACTBOOK, India, <https://www.cia.gov/library/publications/the-world-factbook/geos/in.html> (last visited Oct. 12, 2011).

<sup>162</sup> See Feibelman, *India*, *supra* note 24, at 115–21 (“Assuming that India’s consumer insolvency regime is operational yet dysfunctional in many crucial respects, it is entirely possible that the regime could be markedly improved with carefully designed reforms. This Part does not argue that Indian policymakers should adopt any particular reform. Rather, it assumes that the role of consumer insolvency law in India can be enhanced, and it discusses some general approaches to reforming the regime that might help achieve this result.”).

<sup>163</sup> *Id.* at 118.

rules could be reformed to rein in judicial discretion.<sup>164</sup> Indeed, Professor Claire Moore Dickerson has observed that it is especially dangerous to grant judges wide discretion to apply legal standards in certain circumstances in developing countries—for example, when “judges are venal or incompetent, or that they have been merely co-opted by the government through blackmail by starvation.”<sup>165</sup> Therefore, improving the speed and predictability of India’s consumer bankruptcy regime might make it more appealing to both creditors and debtors.<sup>166</sup> Second, Indian policymakers could adopt substantive reforms that expand the availability of debt relief by, for example, enlarging the number of available property exemptions.<sup>167</sup>

### *C. Benefits of Strengthening Consumer Bankruptcy*

Strengthening the consumer bankruptcy system in India is promising for a variety of reasons. First, it may facilitate a more stable consumer finance market. Second, it is a good way to address the costs associated with expanding consumer finance. Third, it may help to save the microfinance industry in India by addressing the core grievance of the people, the imbalance of power that exists between debtors and creditors, while removing the impetus for misguided populist laws aimed at protecting the poor.

#### *1. Facilitating a More Stable Consumer Finance System*

Consumer bankruptcy law can benefit both debtors and creditors in a way that facilitates financial transactions.<sup>168</sup> For a debtor,

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<sup>164</sup> *Id.* at 116–17. Rules that enable judicial discretion could be replaced with rules that apply automatically, thus demanding less judicial energy. *Id.* at 116. For example, the rule that requires courts to determine whether a debtor is insolvent could be replaced with a presumption of insolvency. *Id.* at 116–17. Such reforms “would be consistent with some broad trends in consumer insolvency and bankruptcy regimes across the globe in recent decades.” *Id.* at 117.

<sup>165</sup> Claire Moore Dickerson, *Sex and Capital: What They Tell Us About Ourselves*, 79 ST. JOHN’S L. REV. 1161, 1175 (2005) (in the corporate governance context).

<sup>166</sup> See Feibelman, *India*, *supra* note 24, at 116. A more ambitious approach may include adopting a separate tribunal for consumer bankruptcy cases. *Id.* For a comparison to the approach taken in other countries to streamline their consumer bankruptcy system, see Jason J. Kilborn, *Out with the New, In with the Old: As Sweden Aggressively Streamlines Its Consumer Bankruptcy System, Have U.S. Reformers Fallen Off the Learning Curve?*, 80 AM. BANKR. L.J. 435 (2006).

<sup>167</sup> See Feibelman, *India*, *supra* note 24, at 116, 119–21 (“Expanding the availability of substantive protections and the scope of potential discharge of debts might also increase the beneficial impact of insolvency law on economic growth and development in India.”).

<sup>168</sup> *Id.* at 105.

bankruptcy regimes provide a way for insolvent debtors to seek an orderly restructuring of their obligations, affording the debtor a “fresh start” after his non-exempt assets are distributed.<sup>169</sup> For creditors, bankruptcy regimes solve the collective action problem that would exist in the absence of a bankruptcy mechanism, which harms creditors for at least two reasons.<sup>170</sup> First, it can make the collection from insolvent debtors unpredictable.<sup>171</sup> Second, in certain circumstances, it can reduce the creditor’s overall recovery, as would be the case when another creditor seizes the debtor’s valuable assets first.<sup>172</sup>

Moreover, having a robust system in place for discharging debts is superior to the kind of ad hoc rebellions against paying debts that are more likely to occur when there are few meaningful avenues for formal debt relief.<sup>173</sup> In Andhra Pradesh, a series of scandals with the microfinance industry triggered a rebellion against paying debts, causing the repayment rate to plummet from over 95% to 15%.<sup>174</sup> As a result, the microfinance industry was pushed to the brink of collapse, and its future prospects are uncertain.<sup>175</sup>

It seems reasonable to speculate that the absence of any meaningful avenue of legal debt relief played some role in exacerbating the scope of this crisis.<sup>176</sup> The existing regime, with formal debt relief out of reach for the ordinary Indian in Andhra Pradesh, became viewed as intolerable when various industry abuses came to light.<sup>177</sup> In other words, the status quo lost its legitimacy.<sup>178</sup>

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<sup>169</sup> *Id.* at 105–06.

<sup>170</sup> *Id.* at 105.

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> Although the boycotts that erupted in Andhra Pradesh against microfinance were not entirely spontaneous (at some point after the protests gained momentum politicians and activists seemed to have taken the reins) for the purposes of this discussion they should nonetheless be considered “ad hoc,” in the sense that the people’s anger coalesced rapidly into action, which the elites did not see coming. One could compare the uprisings in Egypt to oust former President Mubarak and how the Muslim brotherhood joined the movement as its momentum gained popular strength.

<sup>174</sup> See Buncombe, *supra* note 1; *Under Water*, *supra* note 1.

<sup>175</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>176</sup> Although this is a reasonable assumption, it is impossible to conclude with any certainty that, these ad hoc rebellions would not have occurred had the consumer bankruptcy regime been more widely accessible.

<sup>177</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>178</sup> To be sure, one may question whether this is nothing more than throwing a bone to the public. But any law that lacks legitimacy with the people rests on shaky foundations. In

Arguably, the long-term interests of the microfinance industry would be served by allowing a more predictable method of discharging debts. To some extent, this ad hoc rebellion is akin to a massive discharge all at once. A formal structure for discharging debts would benefit the microfinance industry over the long-term because it would be more predictable, and small losses could be more easily absorbed than one big shock.

## 2. *Addressing the Costs Associated with Expanding Consumer Finance*

Until recently, the elites' perception of the costs associated with expanding consumer finance to poor people in developing countries has been largely drowned out by a pro-microfinance ideology in media, political, and philanthropic circles.<sup>179</sup> Research indicates that microfinance does a lot of good, but that its overall benefits are more modest than is widely believed. It is far from a magic bullet, but it does work "for some people some of the time."<sup>180</sup> The costs associated with expanding consumer finance, long ignored, are now in the spotlight, and the close scrutiny it is receiving could instigate an overreaction.

Importantly, the expansion of consumer credit could generate costs and negative externalities for society.<sup>181</sup> For instance, consumers may borrow more than they can afford in view of their projected incomes for a variety of reasons. They may be overly optimistic about their expected incomes, they may be uninformed about business risks, or they may lack the discipline necessary to turn their start-up business into a thriving enterprise.<sup>182</sup> The resulting over-indebtedness can sink

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this light, it is entirely appropriate to take steps to address popular grievances in a way that promotes long-term growth.

<sup>179</sup> See *supra* note 63 and accompanying text. For a discussion of the lack of media coverage and public interest in the disclosure of corporate human rights abuses, see Dickerson, *Ozymandias*, *supra* note 56, at 1065.

<sup>180</sup> See *Under Water*, *supra* note 1; Subir Roy, *Lessons for Micro-Finance from 2010*, BUSINESS STANDARD, Jan. 5, 2011, 2011 WLNR 161959 ("[I]t should be clear to all that micro-finance on its own cannot remove poverty. It can at best make a dent in income poverty. A setback, be it a flood or drought or illness, can and does take a family back to destitution.").

<sup>181</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 79. Other types of costs associated with expanding consumption are an increased likelihood of harmful inflation and an erosion of the domestic savings rate. *Id.*

<sup>182</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 79. Other factors may include imperfect knowledge and pure luck. Another issue may be that the community in

consumers further into poverty.<sup>183</sup> In addition, the recent wave of suicides in India illustrates that there is a psychological dimension to financial distress.<sup>184</sup> Although some of those struggling with indebtedness have committed suicide, many more endure under crushing debt, which carries its own set of societal costs.

As the costs of expanding consumer finance have been ignored, so too have the inadequacies of the consumer bankruptcy system. Professor Feibelman has speculated that the dearth of secondary literature on consumer insolvency in India, either by academics or by the various national reports, “creates a strong impression that commentators, scholars, and policymakers in India do not believe that the regime is a significant aspect of Indian society or of its economy.”<sup>185</sup>

Bankruptcy’s role in facilitating development has not only been ignored in India; in fact, it has received scarce attention in the global debates over development policy.<sup>186</sup> This is curious, considering that there is a general consensus that corporate bankruptcy law serves to facilitate sustainable economic growth.<sup>187</sup> Downplaying the importance of consumer bankruptcy in this way is misplaced because a consumer bankruptcy system that allows for meaningful debt relief “can be an effective tool for reducing the social costs of consumer finance,” such as financial stress.<sup>188</sup>

In other words, it is at least arguable that consumer bankruptcy can provide a safety valve for financial distress.<sup>189</sup> First, bankruptcy protection encourages citizens to become entrepreneurs by cushioning the impact when they fail.<sup>190</sup> Second, bankruptcy provides a way to

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which an entrepreneur starts a business may not be able to support it if there isn’t enough cash flow/liquidity.

<sup>183</sup> See Jessica Schicks, *Microfinance Over-Indebtedness: Understanding Its Drivers and Challenging the Common Myths* 1 (CEB Working Paper No. 10/048, 2010), available at [http://www.rb-cms.nl/classes/FCKeditor/upload/65/File/overindebttness\\_cermi\\_2010.pdf](http://www.rb-cms.nl/classes/FCKeditor/upload/65/File/overindebttness_cermi_2010.pdf).

<sup>184</sup> *Id.* at 80.

<sup>185</sup> See Feibelman, *India*, *supra* note 24, at 112.

<sup>186</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 89.

<sup>187</sup> *Id.*

<sup>188</sup> *Id.* at 91.

<sup>189</sup> See Steven H. Kropp, *The Safety Valve Status of Consumer Bankruptcy Law: The Decline of Unions as a Partial Explanation for the Dramatic Increase in Consumer Bankruptcies*, 7 VA. J. SOC. POL’Y & L. 1, 4–5 (1999) (arguing that bankruptcy provides a way to address financial failures and promotes risk taking by acting as a “safety valve” that enhances social stability).

<sup>190</sup> *Id.*

handle financial distress in an organized way, adding an element of stability to the country's economic structure.<sup>191</sup>

Insofar as Indian legislators are concerned with the psychological distress associated with over-indebtedness, “[a]llowing debtors to discharge at least some obligations effectively insures them from some of the effects of financial distress.”<sup>192</sup> What's more, the availability of bankruptcy protection may ease some of the worries of those that do not actually file for bankruptcy. Such individuals know that bankruptcy protection is an option, and as a result, they may suffer less of an emotional toll from their financial troubles.

If expanding access to the consumer bankruptcy system were proven to promote economic growth, one might expect that a global consensus would emerge around this policy.<sup>193</sup> Specifically, it would be reasonable to expect developing economies to incorporate a robust consumer bankruptcy regime into their overall development strategy.<sup>194</sup> However, recent trends tell a different story.<sup>195</sup>

It seems that Indian policymakers have been hesitant to modernize their consumer bankruptcy regime, even though providing meaningful debt relief could carry many potential benefits.<sup>196</sup> India is not alone in its reluctance to increase the accessibility of consumer bankruptcy, for some of the largest and most rapidly developing countries have outdated consumer bankruptcy regimes.<sup>197</sup> What does this suggest about how policymakers in these countries view consumer bankruptcy?

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<sup>191</sup> *Id.* at 5.

<sup>192</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 92.

<sup>193</sup> *Id.* at 95–96. Also, one might expect the neo-liberal organizations, such as the World Bank, to be promoting this policy, but it does not appear that the international financial institutions are pushing developing countries to enhance their consumer bankruptcy regimes. *Id.* at 70. For a critique of the power of northern financial actors in establishing the cultural of international commerce, see Claire Moore Dickerson, *Class, Economics, and Social Rights: Culture and Trans-Border Effects: Northern Individualism Meets Third-Generation Human Rights*, 54 RUTGERS L. REV. 865, 867 (2002) (arguing that emphasizing the language of human rights discourse can temper the negative impact these actors have on vulnerable populations in the global south).

<sup>194</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 95–96. However, this is not necessarily the case to the extent that creditors encompass the elite in Indian society, and as such are willing to pursue policies that enrich themselves at the expense of the greater good.

<sup>195</sup> *Id.*

<sup>196</sup> *Id.* at 69.

<sup>197</sup> *Id.* In fact, some developing countries do not even have consumer bankruptcy regimes. *Id.*

One probable explanation is that policymakers are concerned that a “bankruptcy regime with meaningful debt relief would harm nascent credit markets more than help them.”<sup>198</sup> Indeed, expanding access to consumer bankruptcy may have some negative consequences. First, it could encourage poor consumers to borrow even more due to the insurance function of debt relief, which diminishes some of the risks of borrowing.<sup>199</sup> Second, if creditors believe that borrowers will become more unwilling to repay debts subject to discharge, they may refuse to lend to such borrowers.<sup>200</sup> As a result, available credit could be reduced overall or at least to some borrowers. Third, it will presumably lead to somewhat higher interest rates.<sup>201</sup> Fourth, leading policymakers may be subject to the influence of the elites, including the lender interests. It is unlikely that consumer advocates have enough power to counterbalance these powerful interest groups.<sup>202</sup> Even if an organized constituency existed to promote consumer interests, there may simply be a lack of social demand for these reforms.<sup>203</sup>

Finally, there may be a lack of resources to expand access to consumer bankruptcy. In particular, the judicial or administrative infrastructure necessary to carry out these reforms may not currently exist, and their creation may cost a significant amount of money.<sup>204</sup> For example, it may take substantial resources to expand the judiciary’s capacity to take more consumer bankruptcy cases. To the extent these costs are borne at the state level, it may be even more difficult to find these scarce resources.

### 3. *Helping to Save the Microfinance Industry in India*

Strengthening the consumer bankruptcy laws may help to save the microfinance industry in India by addressing the very problems that

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<sup>198</sup> *Id.*

<sup>199</sup> *Id.* at 94.

<sup>200</sup> *Id.* at 69.

<sup>201</sup> *Id.* at 92. *But cf. id.* at 93–94 (“Even if such relief reduces creditors’ insolvency-state returns from debtors who experience financial distress, however, it might improve their credit-granting decisions *ex ante*, reducing defaults and over-indebtedness in the first place. Exposing creditors to the possibility of discharge of obligations owed to them may give creditors additional incentives to gather reliable aggregate and borrower-specific information bearing on the probability of default. Lower-risk borrowers would in turn have incentives to provide information indicating that their actual risk profile justifies credit.”).

<sup>202</sup> *Id.* at 70.

<sup>203</sup> *Id.* (“Consumers and households are unlikely to clamor successfully for effective bankruptcy laws in the absence of widespread over-indebtedness.”).

<sup>204</sup> *Id.*

led to the debt rebellion. First, it may serve to correct the imbalance of power that exists between debtors and creditors. Second, it would presumably remove the impetus for misguided populist laws aimed at protecting the poor.

*a. Correct an Imbalance of Power Between Debtors and Creditors*

The outrage directed towards the microfinance industry took many forms, including charges that it was profiting on the backs of the poor, engaging in abusive practices, etc.<sup>205</sup> The core of these grievances against the microfinance industry dealt with the imbalance of power that exists between debtors and creditors. Interestingly, one commentator, while criticizing the Andhra Pradesh law, suggested that a better solution would be to enhance the “collective safety net for the poor.”<sup>206</sup> Indeed, one way to bolster the social safety net in India would be to strengthen the consumer bankruptcy law.

Reforming the consumer bankruptcy regime could serve to address the core grievances against the microfinance industry by correcting the imbalance of power that exists between debtor and creditor. In comparison to countries with robust consumer bankruptcy systems, Indian debtors appear to have less leverage in their dealings with creditors. For example, insofar as there is a widespread view that the bankruptcy system is not a serious option, the threat of filing for bankruptcy probably cannot compel the creditor to renegotiate the debt burden. Therefore, such reforms, like streamlining the consumer bankruptcy process, would have to be strong enough to lend credibility to a debtor’s threat of filing for bankruptcy.<sup>207</sup> Otherwise, debtors in India will always lack the leverage to force negotiations with their creditors, and future tragedy will be assured.

Reform of India’s consumer bankruptcy system could help shift public attitudes towards viewing it as part of the social safety net, while reducing the stigma associated with filing for bankruptcy. For example, there is some indication that Indian debtors view consumer bankruptcy as “a form of punishment or purely a debt-collection tool.”<sup>208</sup> However, there is an alternative way to view consumer bankruptcy protection. It can also be viewed as a populist tool, and

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<sup>205</sup> See Polgreen & Bajaj, *supra* note 13.

<sup>206</sup> See Jagannathan, *supra* note 18.

<sup>207</sup> See, e.g., Kilborn, *supra* note 105.

<sup>208</sup> See Feibelman, *India*, *supra* note 24, at 118 (suggesting that eliminating involuntary petitions could shift this viewpoint).

instituting reforms could help debtors see that consumer bankruptcy is in their interests.<sup>209</sup> In contrast, it seems that in the United States consumer bankruptcy is viewed as an integral part of the social safety net.<sup>210</sup> In India, as consumer finance has expanded rapidly, its costs have been often ignored, and many unfortunate people have fallen through the gap in India's social safety net, notably its lack of a robust consumer bankruptcy system.<sup>211</sup>

It seems that societal disappointment over these costs has come to a boil after so many years, and finally the top has blown off the microfinance industry. Ideally, consumer finance and consumer bankruptcy should work in harmony to ensure sustainable growth, but achieving this equilibrium requires tempering the costs associated with expanding consumer finance. Moreover, strengthening the consumer bankruptcy system could also address another apparent inequity in the system, the asymmetry between consumers and businesses. Specifically, it appears unjust to have a system where bankruptcy is available to businesses, including banks, but not to poor consumer borrowers.

*b. Remove Impetus for Bad Populist Laws Aimed at Protecting the Poor*

Strengthening the consumer bankruptcy system may also remove the impetus for misguided laws, such as capping interest rates, which would only serve to harm the very debtors they are meant to protect.<sup>212</sup> For example, if microlending is restricted, consumers may be forced to rely more on village loan sharks who abuse their position of power.<sup>213</sup> These laws would also harm the future of the microfinance industry in India by, among other things, slicing profit margins and reducing competition.<sup>214</sup> Insofar as the core grievances of the debt rebellions have stemmed from an imbalance of power between debtors and creditors, this concern could be addressed through reforming the consumer bankruptcy regime.<sup>215</sup> In other words, if policymakers address some of the underlying inequities in the system, specifically the imbalance of power between creditor and

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<sup>209</sup> *Id.*

<sup>210</sup> See *supra* note 107 and accompanying text (discussing the policy rationales of consumer bankruptcy).

<sup>211</sup> See *supra* notes 179–80 and accompanying text.

<sup>212</sup> See *supra* notes 88–96 and accompanying text.

<sup>213</sup> See *supra* note 94 and accompanying text.

<sup>214</sup> See *supra* note 93 and accompanying text.

<sup>215</sup> See *supra* notes 199–205 and accompanying text.

debtor, the need to promulgate laws restricting the business practices of microfinance firms will be greatly reduced.<sup>216</sup>

Finally, it is possible that increasing the accessibility of consumer bankruptcy could, over time, influence cultural attitudes towards debt in a way that would make these tragic farmer suicides less likely.<sup>217</sup> Microfinance companies have become successful by exploiting the shame that rural Indians feel towards debt. Although this makes for a very efficient business model, it also comes with significant social costs.<sup>218</sup> It is possible that if the consumer bankruptcy system were reformed in a way to make it more accessible, the stigma associated with filing for bankruptcy could be reduced over time. For example, policymakers could invest in financial education that paints debt relief in a positive light.<sup>219</sup>

To be sure, it is unlikely that policymakers could significantly alter deeply rooted cultural norms disfavoring debt and meaningful relief, but perhaps they could reduce enough resistance to make enhanced consumer bankruptcy protections worthwhile.<sup>220</sup> Moreover, the recent debt rebellions provide some evidence that there is social demand for debt relief in India as the rise of over-indebtedness makes citizens and policymakers more open to expanding consumer bankruptcy protections.<sup>221</sup> Before the populist revolts, there was a seemingly entrenched cultural belief regarding the shamefulness of failing to repay debts.<sup>222</sup> It seems that these revolts changed attitudes overnight, for repayments levels plummeted from over 95% to 15%.<sup>223</sup> At a minimum, the people no longer felt ashamed to repay these particular debts, perhaps due to community pressure being reversed. Before the

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<sup>216</sup> To be sure, it appears that strengthening the consumer bankruptcy system would not directly address the goals of microfinance: funneling money to the poor, alleviating poverty, etc. However, the social safety net function of consumer bankruptcy would help address the costs associated with expanding consumer finance markets.

<sup>217</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 103. Changing policies could serve to “increase the social demand for or reduce the social resistance to consumer bankruptcy law.” *Id.*

<sup>218</sup> See *supra* note 84 and accompanying text.

<sup>219</sup> See Feibelman, *Consumer Bankruptcy*, *supra* note 27, at 103. India is more fortunate than some developing countries in that it has a longstanding bankruptcy system. This makes it easier to “identify[] familiar forms of debt relief and build[] a bankruptcy regime upon those indigenous institutions.” *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* “This may help explain why recent reforms and adoptions have tended to occur in countries that have experienced such problems.” *Id.*

<sup>222</sup> See *supra* note 13 and accompanying text.

<sup>223</sup> See *supra* note 66 and accompanying text.

revolts, community pressure was strongly in favor of paying one's debts to the microfinance companies, after the revolts the pressure was strongly against paying these debts. It seems that community anger rooted in a sense of injustice was sufficient to change the context around cultural attitudes.

Perhaps consumer bankruptcy reforms could have a similar feedback effect to cultural attitudes towards failing to repay debts in general by reducing the deep shame that such a failure generates. In other words, codifying into law the notion that it is normatively acceptable to discharge your debts could have the effect of reducing the shame regarding debts that is widespread in Indian culture.

### CONCLUSION

It is time to seriously consider expanding consumer bankruptcy protections in India. The recent rebellion against microfinance in Andhra Pradesh is troubling because microfinance, though imperfect, is an essential means of lifting the rural poor out of poverty. The root of the people's grievances against the microfinance industry is broader than particular examples of abusive lending practices; at its core is a sense of injustice over an imbalance of power that exists between debtors and creditors. Strengthening the consumer bankruptcy system in India is an excellent way to address these grievances, while at the same time fostering the stable development of the consumer finance system.

The success of consumer bankruptcy reform could depend on whether it rides the sort of populist wave illustrated by the debt rebellions. If consumer bankruptcy reforms could be framed in a way that captures populist, anti-bank sentiment, then it could perhaps change the commonly held beliefs that stigmatize debt relief in bankruptcy. For example, to the extent a farmer is unable to pay his debts and believes "there's no way out for me," this belief could be modulated through a more liberalized consumer bankruptcy regime, showing the farmer "a way out." More importantly perhaps, the elites must be persuaded that it is in the country's best interests to strengthen the consumer bankruptcy system. This article has aimed to convince academics and policymakers to take up the cause of Indian consumer bankruptcy reform.