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## Credit and Human Welfare: Lessons from Microcredit in Developing Nations

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# Credit and Human Welfare: Lessons from Microcredit in Developing Nations

Alan M. White\*

## *Abstract*

*Deregulation of usury laws, in the United States and in developing nations, has permitted various forms of small loans to be made to the poor and the working class, sometimes at very high prices. In the case of credit, more is not always better. A human development approach to evaluating the welfare impacts of credit products for the poor asks these questions: does a credit product or program increase income or consumption, achieve savings through investment in capital goods, or smooth consumption and avert crises, all at a reasonable cost? Or does the credit on balance redistribute income away from the poor, without adequate offsetting benefits, or produce overindebtedness and declining borrower living standards?*

*The model of successful small-loan programs that may enhance the welfare of the poor is the work of the Grameen Bank in Bangladesh. Grameen Bank's microlending, savings, and insurance programs seem to have been effective in improving the lives of some Grameen borrowers. On the other hand, the experiences of South Africa and Bolivia with rapid expansion of microcredit were more problematic, resulting in crises of*

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*overindebtedness and, in the case of Bolivia, a social revolt by borrowers. Even after the crisis in Bolivia, however, some microlenders and their borrowers fared better. The experiences in these different contexts, as well as the United States' experience with payday lending, offer important insights into the benefits and risks of different credit products and programs for the poor. These insights can inform the next generation of consumer credit regulation, which should promote responsible lending based on full credit reporting, insurance, workouts to protect against and mitigate defaults, continual repayment of principal, differentiation based on credit use, and simple and transparent pricing.*

*Table of Contents*

I. Introduction .....	1095
II. The Welfare Economics of Small-Loan Credit .....	1098
A. The Inadequacy of Revealed Preferences .....	1099
B. Rethinking the Consumer Welfare Benefits and Harms of Credit.....	1106
C. The Human Development Approach to Welfare Economics .....	1110
III. Lending to the Poor in the Developing World—The Grameen Bank Entrepreneurial Model .....	1113
IV. Failures of Microcredit: The Bolivian and South African Experiences.....	1121
A. Bolivia .....	1121
B. South Africa.....	1125
V. The United States Experience—Payday Lending and Incoherent Usury Laws.....	1128
VI. The Role of Law and Regulation in Fostering Beneficial Credit for the Poor.....	1133
VII. Conclusion.....	1138

*I. Introduction*

How do we know when access to credit improves or harms consumer welfare? Can legal rules improve the aggregate welfare effects of small loans? The poor need credit and have always borrowed. At the same time, credit, especially in the form of small loans and credit cards, has led to national crises for developing countries and increased poverty and exclusion for overindebted individuals in developed nations. Lending to the poor has always posed a moral dilemma.<sup>1</sup> Legal rules, particularly usury and bankruptcy laws, have struggled to find a balance between preventing exploitation while permitting and encouraging responsible credit access. Despite decades, even centuries, of legal experimentation, the story of credit for the poor remains a tale of feast or famine—overindebtedness and exploitation coexist with vast unmet needs for credit.<sup>2</sup> While bankruptcy and debt-relief systems play a role in mediating this duality of credit and debt,<sup>3</sup> regulators struggle with how to and even whether to regulate credit markets *ex ante*, to encourage the benefits the unregulated market fails to achieve, and to mitigate the harms the unregulated market causes. In the United States, the new Consumer Financial Protection Bureau has been tasked with rationalizing our system of credit regulation, relying on research and cost-benefit analysis.<sup>4</sup>

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1. See *Exodus* 22:25 (“If you lend money to any of my people with you who is poor, you shall not be to him as a creditor and you shall not exact interest from him.”); *QHURAN, Al-Baqarah* 2:275–80 (condemning to hell those who engage in usury against the poor).

2. See generally *CREDIT MARKETS FOR THE POOR* (Patrick Bolton & Howard Rosenthal eds., 2005).

3. See Adam Feibelman, *Consumer Bankruptcy as Development Policy*, 39 *SETON HALL L. REV.* 63, 68 (2009) (arguing that consumer bankruptcy can work to promote growth and development).

4. See Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 1031–1032, 124 Stat. 1376, 2005–07 (governing unfair, deceptive, or abusive practices and disclosure to consumers of the costs, benefits, and risks associated with financial products and services); see also Arthur E. Wilmarth, *The Dodd–Frank Act’s Expansion of State Authority to Protect Consumers of Financial Services*, 36 *J. CORP. L.* 893, 921 (2011) (explaining the Director of the Consumer Financial Protection Bureau’s powers to regulate disclosure of the costs, benefits, and risks of financial products and services).

Extensive empirical research literature has developed around the welfare impacts of microlending in the developing world.<sup>5</sup> Similar literature has also emerged debating the benefits and harms of payday and “fringe” lending in the United States.<sup>6</sup> While payday lending and microenterprise credit are conceptually distinct, they can serve as product substitutes, and, more importantly, similar issues arise in attempts to weigh their costs and benefits. The experiences of different nations with microloans to the poor and the extensive research on both consumer and microenterprise lending can offer insights for regulators seeking to craft a fair and effective regulatory structure for small-loan credit. The welfare impacts of microlending are clearly mixed, but existing research offers some empirical insights about loan

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5. See, e.g., BEATRIZ ARMENDARIZ DE AGHION & JONATHAN MORDUCH, THE ECONOMICS OF MICROFINANCE 199–229 (2005); Jonathan Morduch, *The Microfinance Promise*, 37 J. ECON. LITERATURE 1569 (1999); John Weiss & Heather Montgomery, *Great Expectations: Microfinance and Poverty Reduction in Latin America and Asia* (ADB Inst. Discussion Paper No. 15, 2004). For links to numerous studies, see the Microcredit Summit Campaign Commissioned Papers, Microcredit Summit Campaign, [http://www.microcreditsummit.org/commissioned\\_papers](http://www.microcreditsummit.org/commissioned_papers) (last visited Apr. 8, 2012) (on file with the Washington and Lee Law Review).

6. See, e.g., John P. Caskey, *Payday Lending: New Research and the Big Question* (Fed. Reserve Bank of Phila., Working Paper No. 10-32, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1696019](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1696019); Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ L. REV. 563 (2010); Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589 (2000); Iain Ramsay, *The Alternative Consumer Credit Market and Financial Sector: Regulatory Issues and Approaches*, 35 CANADIAN BUS. L.J. 325 (2001); Michael A. Stegman & Robert Faris, *Payday Lending: A Business Model That Encourages Chronic Borrowing*, 17 ECON. DEV. Q. 8 (2003); Scott E. Carrell & Jonathan Zinman, *In Harm's Way? Payday Loan Access and Military Personnel Performance* (Fed. Reserve Bank of Phila., Working Paper No. 08-18, Aug. 1, 2008), available at [http://www.dartmouth.edu/~jzinman/Papers/PayDay\\_AirForce\\_aug08.pdf](http://www.dartmouth.edu/~jzinman/Papers/PayDay_AirForce_aug08.pdf); Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* (FDIC Ctr. for Fin. Res. Working Paper No. 2005–09, 2005), available at [http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP\\_2005-09\\_Flannery\\_Samolyk.pdf](http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf); Leslie Parrish & Uriah King, Ctr. for Responsible Lending, *Phantom Demand: Short-Term Due Date Generates Need for Repeat Payday Loans, Accounting for 76% of Total Volume* (July 9, 2009), <http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-short-term-due-date-generates-need-for-repeat-payday-loans-accounting-for-76-of-total-volume.html> (last visited Apr. 8, 2012) (on file with the Washington and Lee Law Review).

characteristics that are more or less likely to result in net borrower benefits.

In the United States, the Community Reinvestment Act,<sup>7</sup> and the community economic development movement more broadly,<sup>8</sup> promote lending to low-income individuals and in low-income communities as a positive, and even essential, tool for improving the welfare of the poor. On the other hand, consumer and civil rights advocates decry the debt treadmill created by payday lenders<sup>9</sup> who make small loans to low- and moderate-income borrowers and predatory mortgage lending that strips wealth from low-income and minority families.<sup>10</sup> Congress and the states have also passed laws restricting high-cost mortgage and consumer loan pricing and terms because of the perceived harmful effects on consumer welfare.<sup>11</sup>

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7. 12 U.S.C. § 2901 (2006); see also Richard D. Marsico, *Enforcing the Community Reinvestment Act: An Advocate's Guide to Making the CRA Work for Communities*, 27 N.Y.L. SCH. J. HUM. RTS. 129, 129 (July 2001) (providing a guide to community investment advocates for using the Consumer Reinvestment Act to increase lending in their neighborhoods).

8. See JULIA ANN PARZEN & MICHAEL HALL KIESCHNICK, *CREDIT WHERE IT'S DUE: DEVELOPMENT BANKING FOR COMMUNITIES* 10–27 (1992) (explaining the importance of access to credit to community economic development); Susan R. Jones, *Current Issues in the Changing Roles and Practices of Community Economic Development Lawyers*, 2002 WIS. L. REV. 437, 468 (noting that changes in the community economic development field have expanded the role of public interest lawyers, increasing the need for advanced legal services).

9. Parrish & King, *supra* note 6, at 2 (noting that a majority of payday borrowers must take out a new loan soon after repaying the prior loan because the repayment left them insufficient funds); Stegman & Faris, *supra* note 6, at 19 (noting the “explosive growth of payday lending as a source of short-term consumer credit in low- and moderate-income (LMI) communities”).

10. See DANIEL IMMERGLUCK, *FORECLOSED: HIGH-RISK LENDING, DEREGULATION AND THE UNDERMINING OF AMERICA'S MORTGAGE MARKET* 133–54 (2009) (discussing the costs of high-risk lending to low-income borrowers); Debbie Gruenstein Bocian et al., Center for Responsible Lending, *Foreclosures by Race and Ethnicity: The Demographics of a Crisis* (2010), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-s-by-race-and-ethnicity.pdf> (arguing that the public sector's failure with respect to the 2008 subprime mortgage collapse “was its inability or unwillingness to adequately address predatory lending practices, not in its support of lending to historically underserved communities”).

11. See, e.g., Homeownership Equity Protection Act of 1994 (HOEPA), 15 U.S.C.A. § 1639 (2010) (setting federal standards for mortgages, including disclosure requirements and limitations on, for example, balloon payments, negative amortization, and the extension of credit without regard to the consumer's ability to pay); North Carolina Predatory Lending Law, N.C. GEN.

Very small loans, or microcredit, and the experience of developing nations in promoting and then regulating microcredit, offer important lessons in the ways credit can either alleviate or exacerbate poverty. In the developing world, microcredit has been hailed as a key tool for alleviating poverty, and the microcredit industry has grown dramatically in the past twenty years. The successes and failures of widely varying models and legal regimes for microcredit and microfinance can inform credit regulation and oversight in both developed and developing nations. In Part II of this Article, I consider the utilitarian and equity concerns that should motivate credit policy, using a human development framework. A defensible theory of welfare economics is an essential foundation for any coherent utilitarian evaluation of credit laws. In Parts III and IV, I review the recent microcredit experiences of Bangladesh, South Africa, and Bolivia and the evidence of effects on borrower welfare. In Part V, I survey the debate in the United States concerning regulation of payday loans and the incoherent legal response to dealing with payday lending to date. Finally, I propose some principles for future credit regulation and areas for further research, drawing on the theoretical framework of human development welfare economics and the empirical lessons learned from the United States' and developing nations' experiences with small loans to the poor and working class.

## *II. The Welfare Economics of Small-Loan Credit*

Much of the disagreement between researchers who conclude that microcredit and payday lending is either beneficial or harmful is a result of asking different questions. Advocates of regulation tend to focus on spiraling debt, the costs of debt default, and high interest and fees (compared to other types of loans), treating these as welfare harms, and they also cite more

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STAT. 24-1.1E (2011) (placing restrictions and limitations on high-cost home loans); *see also* LEAH A. PLUNKETT ET AL., NAT'L CONSUMER L. CTR., SMALL DOLLAR LOAN PRODUCTS SCORECARD—UPDATED (2010), *available at* [http://www.consumerfed.org/elements/www.consumerfed.org/file/Updated\\_Scorecard.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/Updated_Scorecard.pdf) (surveying state laws restricting payday loans and similar products and documenting and scoring each state's actions concerning small loan products); *infra* text accompanying notes 151–78.

direct welfare losses, such as psychological harm and social exclusion resulting from excessive debt.<sup>12</sup> Advocates of the free market, on the other hand, measure access to credit as an end in itself, and they invoke substitution effects, i.e., the argument that restricting one form of credit will merely drive borrowers to other, less beneficial forms.<sup>13</sup> These regulation opponents often assume that reduced credit access reduces welfare, although in some cases they attempt to measure welfare losses directly, such as unemployment or subjective assessment of financial well-being.<sup>14</sup> A comprehensive approach to credit regulation requires a comprehensive and sound theory of welfare maximization, or at least of net welfare improvement, and therefore a careful account of all the categories of welfare benefits and harms that credit and debt produce.

#### A. *The Inadequacy of Revealed Preferences*

By conventional measures, microcredit in the developing world has been a tremendous success.<sup>15</sup> By the end of 2009, microlenders reported having reached 190 million individuals, 68% of whom were among the poorest (the \$1 per day World Bank

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12. See Martin, *supra* note 6, at 570–78 (concentrating primarily on payday lending’s high interest rates, high fees, and the so-called “debt trap,” the situation that arises when a borrower must take out repeated loans because the repayment of prior loans leaves them with inadequate funds); Parrish & King, *supra* note 6, at 4 (finding that the “debt trap” causes borrowers, over the entire industry, to pay \$3.5 billion annually in extra fees); Stegman & Farris, *supra* note 6, at 8–9 (noting that payday lenders “charge fees that, although moderate in absolute terms, translate into extremely high and profitable compound interest rates” and that “the incidence of repeat borrowing at additional fees by individual borrowers has grown to epidemic proportions”).

13. Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap 3* (Federal Reserve Bank of Phila. Working Paper No. 08-32, 2008), available at <http://www.philadelphiafed.org/research-and-data/publications/working-papers/2008/wp08-32.pdf> (finding that a significant reduction in the availability of payday loans in Oregon resulted in former borrowers shifting to inferior substitutes).

14. See *id.* (stating that “employment status is a useful proxy for (financial) well-being here because unemployment is likely to be involuntary” and noting that “subjective assessments help address the issue that financial condition may be difficult to infer from objective choices and outcomes”).

15. For a review of the literature on microcredit, see DE AGHION & MORDUCH, *supra* note 5, at 12–17.

extreme poverty threshold) and 82% of whom were women.<sup>16</sup> Viewed in terms of “efficiency,” i.e., the number and volume of voluntary transactions, it seems that microcredit has been a boon to the welfare of lenders and borrowers in poor countries. This has been the case not only in Bangladesh, where the Grameen Bank pioneered microcredit as we know it, but all over south Asia, Latin America, and even Africa.<sup>17</sup> Similarly, in the United States, the growth of payday lending and related categories of small loans to lower-income workers has been called “explosive.”<sup>18</sup> While microlending, narrowly defined, is a product separate and distinct from payday lending, i.e., small, short-term consumer loans to wage earners, in deregulated environments the two products can easily become substitutes, and they exhibit numerous similarities in their observed welfare harms and benefits.<sup>19</sup>

If we rely on the revealed preference measure of consumer welfare, then any credit expansion by definition improves consumer welfare.<sup>20</sup> Revealed preference theory posits that consumers express preferences through market purchases, including the purchase of a loan.<sup>21</sup> If borrowing is a transaction that reveals the borrower’s preferences, then any voluntary loan or credit transaction could be thought to enhance welfare, if welfare is utility and utility consists of revealed preferences.<sup>22</sup>

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16. SAM DALEY-HARRIS, MICROCREDIT SUMMIT CAMPAIGN, STATE OF THE MICROCREDIT SUMMIT CAMPAIGN REPORT 2011 3, *available at* [http://www.microcreditsummit.org/pubs/reports/socr/2011/SOCR\\_2011\\_EN\\_web.pdf](http://www.microcreditsummit.org/pubs/reports/socr/2011/SOCR_2011_EN_web.pdf).

17. *Id.* at 59–68 (listing all verified microfinance institutions by region and providing data on number of clients, percentage of clients among the world’s poorest, and percentage of female clients).

18. See Stegman & Faris, *supra* note 6, at 8.

19. See Muhammad Sayeedul Haque & Masahiro Yamao, *Can Microcredit Alleviate Rural Poverty? A Case Study of Bangladesh*, 36 WORLD ACAD. SCI. ENG. & TECH. 648, 655 (2009).

20. See e.g., Marc Anthony Fusaro & Richard E. Ericson, *The Welfare Economics of “Bounce Protection” Programs*, 33 J. CONSUMER POL’Y 55, 55 (2010) (arguing that bounce protection fees at an effective 1,900% interest rate enhance consumer welfare based on revealed preference analysis).

21. Paul Samuelson, *A Note on the Pure Theory of Consumers’ Behaviour*, 5 ECONOMICA 61, 61 (1938) (describing revealed preference theory of utility measurement in the seminal article on the subject).

22. See Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 322 (1977) (showing

Thus, any regulation that constrains voluntary credit transactions would reduce consumer welfare. On the other hand, a more robust approach to welfare economics recognizes that borrowers can suffer net harm from voluntary transactions, as when borrowers' income, consumption, and other measures of well-being decline as a result of getting a loan. Moreover, from a macroeconomic point of view, aggregate increases in consumer borrowing, and corresponding declines in savings, jeopardize future output growth and, hence, aggregate welfare.<sup>23</sup>

The notion that if you buy something, it must make you better off, has obvious limitations as a utilitarian norm for evaluating credit for the poor.<sup>24</sup> Among the many flaws with revealed preference theory, several undermine its usefulness when considering credit regulation.

The first flaw is the problem of income distribution. Preferences are revealed through purchasing, and income and assets limit purchasing. Income is limited in any economy with involuntary unemployment and underemployment. For consumption goods, this means a market allocation through revealed preferences will favor luxury goods, and a social welfare function based on revealed preferences will inadequately supply basic needs to the poor.

Credit is a peculiar type of market good, and because of its peculiarity, the poor will tend to purchase it in excess. Credit is not a consumption good; it is a device to trade present consumption for future consumption. The welfare gain of borrowing must be distinguished from welfare gains from consumption that borrowing makes possible. The purchase made with a loan will soon be offset by the later forgone purchases prevented when the loan must be repaid.

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that, in a simplified model, engaging in an action provides a revealed preference, which must be chosen because it provides greater utility).

23. See Aldo Barba & Massimo Pivetti, *Rising Household Debt: Its Causes and Macroeconomic Implications—A Long-Period Analysis*, 33 *CAMBRIDGE J. ECON.* 113, 118 (2009) (noting that “a characteristic feature of the long-run analysis of household debt is that, being output as potential, consumer credit impinges on production as it affects the amount of saving channelled into investment”).

24. See AMARTYA SEN, *DEVELOPMENT AS FREEDOM* 76–81 (1999).

Consider the borrower with a \$1,000 monthly income who borrows \$200 with a promise to repay \$280 a month later. The borrower's consumption over two months will be \$1,200 in month one, but only \$720 in month two, or \$1,920. Without the loan the borrower would have consumed \$2,000 of goods and services. Is the income-constrained borrower really expressing a preference for that reduced consumption over two months, or is she simply responding in the present to immediate needs? The question is not whether the \$200 expended produced a welfare gain in the short run; it is whether advancing the use of the \$200 by thirty days produced a large enough benefit to offset the \$80 cost in the long run.

The "preference" of the poor for borrowing is driven by chronic income shortfalls, a preference they would not reveal if they had adequate income-earning opportunities.<sup>25</sup> Thus the poor can use credit in welfare-enhancing ways but also out of desperate and immediate need for money with which to reveal their basic preference to eat. This is particularly true when the borrower considers the possibility of not repaying, and the consequences of not repaying the borrowed money in the later time period are uncertain (or irrationally discounted by the borrower). In other words, the borrower may have incorrect information or beliefs about the need to curtail future consumption as the trade-off for current consumption that borrowing makes possible.

The second flaw with revealed preference as a proxy for welfare is that preferences are unstable and inconsistent. Revealed preference theory assumes fixed and stable preferences, which real people, rich and poor alike, do not exhibit.<sup>26</sup> A theoretical rational consumer will trade off future consumption for present consumption (i.e., borrow) only based on a careful calculation discounting future consumption at some reasonable

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25. See Lois Lupica, *The Consumer Debt Crisis and the Reinforcement of Class Position*, 40 LOY. U. CHI. L.J. 557, 593–94 (2009) (noting that "borrowers who are driven by need, however, know that payday lenders are exploiting them, that credit cards are a trap, and that rent-to-own stores are a rip-off, but in the face of such dire need, the price of credit and the effects of indebtedness become irrelevant").

26. See Ramsay, *supra* note 6, at 371 (showing that individuals tend to have time-inconsistent preferences and poorly calculate the probabilities of uncertain future events).

discount rate. A human being will discount the future to something close to zero, especially when hungry children are in the house. The same borrower will experience severe distress when the consequences of the borrowing decision are met and there is no money for food after the loan comes due.<sup>27</sup> To say that such a borrower has revealed her preferences over both time periods is a shallow measure of utility indeed. It is only because the consumer in the present has the decision power that she usurps the preferences of herself as consumer in the future. In fact, if asked, the consumer might express a preference for self-restraint devices (like low credit-card limits) because she is aware of time-inconsistent preferences and self-control problems.<sup>28</sup> Moreover, the overconfidence bias leads borrowers to assume a much greater disposable income to repay loans in the future than is likely to be available.<sup>29</sup> This overconfidence combines with the rationalizing function, by which the borrower mitigates the mental stress of knowing she is borrowing money she cannot repay, to justify borrowing decisions that do not maximize welfare in the long term.<sup>30</sup> Amartya Sen and Jon Elster have also pointed out that preferences adapt to the circumstances of the

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27. See Brian Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Q.J. ECON. 517, 550 (2011) (finding that increased access to payday borrowing leads to difficulties in paying for essential goods and services including rent, utilities, and medical care).

28. See Kurt Eggert, *Lashed to the Mast and Crying for Help: How Self-Limitation of Autonomy Can Protect Elders from Predatory Lending*, 36 LOY. L.A. L. REV. 693, 736 (2003) (arguing that a rational individual may place self-imposed limitations on their available choices to prevent the temptation to select an option that would be harmful in the long term); Angela Littwin, *Beyond Usury: A Study of Credit Card Use and Preference Among Low-Income Consumers*, 86 TEX. L. REV. 451, 479–88 (2008) (discussing several policy measures that would increase consumers' ability to impose limits on their temptation to abuse credit cards, including allowing consumers to opt out of credit card offers and granting consumers the ability to cap their credit limit).

29. See Lauren Willis, *Against Financial Literacy Education*, 94 IOWA L. REV. 197, 235 (2008) (explaining that, due to inaccurate predictions of future employment and income, borrowers will often secure unaffordable loans); Cass Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249, 251 (2006) (arguing that excessively optimistic borrowers will tend to make welfare-reducing choices because they do not sufficiently consider problems associated with borrowing).

30. See Willis, *supra* note 29, at 235 (noting that “consumers can avoid fear and anxiety when contemplating objectively unpleasant facts of life by perceiving personal risk overoptimistically”).

consumer, so that for example, poor people learn to be satisfied with conditions that seem objectively intolerable and leave them far short of truly satisfying basic human needs for shelter, security, health, and education.<sup>31</sup>

A third and related flaw with revealed preferences as a tool to measure the welfare effects of consumer credit is that preferences can be manipulated. Consumer behavioral biases and abbreviated reasoning are well understood and exploited by sellers of credit.<sup>32</sup> Lenders shape borrower preferences.<sup>33</sup> Thus, consumers can be and are persuaded to enter credit transactions that reduce their consumption in the present and future, do not result in investment or other gains, and simply transfer their limited resources to lenders and investors.<sup>34</sup> Preferences that have been manipulated and exploited by lenders cannot reasonably be equated with a borrower's welfare or utility. Income inequality, instability and adaptability of preferences, and lender exploitation lead poor borrowers into crises of overindebtedness, or at least into chronic distress of carrying interest payment burdens that further diminish their already

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31. See generally JON ELSTER, *SOUR GRAPES: STUDIES IN THE SUBVERSION OF RATIONALITY* (1983); AMARTYA SEN, *RESOURCES, VALUES AND DEVELOPMENT* (1984).

32. See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 46 (2008) (explaining that because borrowers were overly optimistic concerning the probability of future borrowing, they focused on the annual fee, which would be paid regardless of borrowing, instead of the interest rate, and, as a result, lenders lower the annual fee and increase the interest rate); Jason Kilborn, *Behavioral Economics, Overindebtedness and Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions*, 22 EMORY BANKR. DEV. J. 13, 16 (2005) (noting that, after the "liberalization" of consumer credit regulations in the 1980s, the resulting competition pressured lenders to market and structure their products to exploit their customers' psychological biases); Alan M. White, *Behavior and Contract*, 27 LAW & INEQ. 135, 150 (2009) (finding that, armed with the knowledge of consumers' biases, "marketers engage in various strategies to increase sales by exploiting consumer search costs, obfuscation, identity group marketing, focusing on salient features, identifying with consumers' subjective goals, and other strategies").

33. See Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 730 (2005) (arguing that lenders manipulate the borrower's reference points, framing the possible outcomes, which influences the borrower's choices).

34. See Lauren Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 785–87 (2006) (discussing the effects of lender framing on consumer choices).

inadequate purchasing power. These readily observable consequences raise concerns, not only about consumer welfare, but also about the distributional effects of credit regulation or nonregulation<sup>35</sup> and the external costs of overindebtedness.<sup>36</sup> The dilemma for credit regulation, therefore, is to take account of the fact that voluntary credit transactions can be harmful to borrowers and to the broader society, while still acknowledging the various ways in which credit and debt can enhance consumer welfare in both the short and long term.

Empirical studies that attempt to measure the welfare effects of microcredit on the poor have reached mixed conclusions. In several countries, like South Africa and Bolivia, liberalized microlending has led to serious overindebtedness and further impoverished the people it was intended to help.<sup>37</sup> Even in Bangladesh, the success story of Grameen Bank has been clouded by evidence of extremely aggressive debt collection and even domestic violence resulting from the lending program, and the ability of microloans to raise individuals from poverty on a lasting basis is still controversial.<sup>38</sup> On the other hand, some studies have asked the right question and found that microlending has resulted in improvements in borrowers' income, consumption stability, and other measures of well-being.<sup>39</sup>

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35. See Edward C. Glaeser & José Scheinkman, *Neither a Borrower nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws*, 41 J.L. & ECON. 1, 3 (1998) (arguing that usury laws restricting interest rates help redistribute income from rich to poor); Iain Ramsay, *Consumer Credit Law, Distributive Justice and the Welfare State*, 15 OXFORD J. LEGAL STUDS. 177, 178 (1995) (arguing that “the primary questions in relation to consumer credit regulation are distributional, and are linked to the achievement of values such as security, autonomy, and equality of access to credit markets”).

36. See Javier Bianchi, *Credit Externalities: Macroeconomic Effects and Policy Implications*, 100 AM. ECON. REV. 398, 398 (2010) (finding that excessive borrowing can substantially increase the number and severity of financial crises).

37. See *infra* notes 118–66 and accompanying text.

38. See Rashmi Dyal-Chand, *Reflections in a Distant Mirror: Why the West Has Misperceived the Grameen Bank's Vision of Microcredit*, 41 STAN. J. INT'L L. 217, 293–94 (2005); see also Haque & Yamao, *supra* note 19, at 655 (cataloging the failures of the microcredit institutions to adequately alleviate rural poverty).

39. See Richard Rosenberg, Consultative Group to Assist the Poor, *Does Microcredit Really Help Poor People?* (2010), available at <http://www.cgap.org/gm/document-1.9.41443/fn59.pdf> (finding that, while microcredit may not alleviate poverty, it prevents threats to the poor's minimum

*B. Rethinking the Consumer Welfare Benefits and Harms of Credit*

These observations raise an essential first question: by what measure (other than revealed preferences) are we to evaluate the benefits and harms of credit extended to the poor? Credit might improve consumer welfare in several ways.<sup>40</sup> Enterprise loans that permit borrowers to invest in income-producing assets or activities and then to earn a return that exceeds the cost of the credit offer the easiest example.<sup>41</sup> An important and related second benefit of small loans is to preserve employment. A low-wage worker might borrow a small sum to repair a car, buy a uniform, or deal with a short-term emergency to preserve her ability to go to work.<sup>42</sup>

When money is borrowed for consumption rather than entrepreneurship, permanent welfare is increased if the money is used to purchase a durable good, like a car or washing machine, that provides the consumer with a present-value savings compared to the alternative, such as periodic payments for mass transit or taxis or using a laundromat.<sup>43</sup> A second consumer-welfare improvement results when a loan helps the consumer avoid a cost, such as a penalty for failing to meet an existing financial obligation.<sup>44</sup> Third, some consumer and small business borrowing is used simply to repay other debt that is maturing or bears a higher interest rate, resulting in cash-flow savings. Finally, a consumer might simply borrow against future income to smooth consumption, i.e., to provide dinner for the week before

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consumption level).

40. See Feibelman, *supra* note 3, at 75–78 (discussing a number of ways that consumer credit can promote growth and development).

41. See DE AGHION & MORDUCH, *supra* note 5, at 25–26 (reporting on the effect of introducing microcredit into a new market). *But see* Haque & Yamao, *supra* note 19, at 655 (finding that loans from microfinance institutions in Bangladesh were largely used for purposes other than those stated, including buying food and paying off prior loans).

42. See Dean Karlan & Jonathan Zinman, *Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts*, 23 REV. OF FIN. STUDS. 433, 453 (2009).

43. See Edward C. Lawrence & Gregory Elliehausen, *A Comparative Analysis of Payday Loan Customers*, 26 CONTEMP. ECON. POL'Y 299, 302 (2008).

44. *Id.*

payday.<sup>45</sup> The smoothing of consumption does not reduce poverty in the long run, but the other uses of credit could do so by increasing income or reducing expenses. Consumption smoothing does provide a welfare benefit, albeit more difficult to quantify and weigh against the interest cost.<sup>46</sup> A simple example is the household that borrows to continue purchasing essential medicines or a healthy diet for a diabetic and thus avoids costly medical emergencies.<sup>47</sup> More challenging is the tradeoff between simply being hungry for a few days and reducing the weekly food budget by the cost of loan interest.

Whether any of these welfare improvements actually occur should be considered an empirically testable hypothesis, rather than an assumption accepted on faith. Each category of possible benefits could be the subject of empirical measurement for a particular credit product in a particular market.

Consumer credit also causes obvious and not-so-obvious harms to consumers. First, of course, are the interest and fees, i.e., the cost of the credit itself. To be sure, the cost of credit in the welfare-enhancing examples discussed above may be less than the consumer's welfare benefit. In other words, the idealized rational consumer will only borrow money at interest if the consumer's benefit from the loan exceeds the interest and other costs. Nevertheless, any fair welfare analysis of a credit product must weigh the cost of credit against its benefits. The higher the costs, the less likely there will be a positive net benefit, an obvious proposition but one that underlies the intuitive rationale for usury ceilings. Microcredit interest rates range from 20% to 30% per annum but can sometimes be much higher.<sup>48</sup> Payday

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45. See Barba & Pivetti, *supra* note 23, at 119; Melzer, *supra* note 27, at 518.

46. For one attempt to model the welfare benefits of credit access to smooth consumption, see Kartik B. Athreya, *Credit Access, Labor Supply, and Consumer Welfare*, 94 *ECON. Q.* 17 (2008).

47. The ability to borrow in order to resolve emergencies has been identified by poor borrowers themselves as a key welfare benefit of credit access and one justifying the use of high-cost loans on a short-term basis. See Littwin, *supra* note 28 (reporting the results of in-depth interviews with low-income women).

48. Richard Rosenberg et. al., Consultative Group to Assist the Poor, *The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates?* 5 (2009), available at <http://www.cgap.org/p/site/c/template.rc/1.9.9534/>.

loan rates in the United States are typically between 200% and 500% per annum.<sup>49</sup>

In the real world, consumers often miscalculate, or, for various other reasons, borrow in a situation that does not increase their welfare.<sup>50</sup> Lenders are motivated to obfuscate the total cost of credit through complex pricing so that borrowers underestimate borrowing costs.<sup>51</sup> For the poor especially, credit can simply aggravate a bad cash-flow situation, adding interest costs to an existing monthly shortfall.<sup>52</sup> This can result in consumers being worse off than had they not borrowed.

The second major category of credit harms encompasses those that flow from debt distress and default. Overindebted consumers can be pushed into default and bankruptcy by repeated borrowing, even in small amounts,<sup>53</sup> and suffer additional costs, such as the health effects of debt-related stress,<sup>54</sup>

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49. Will Dobie & Paige Marta Skiba, *Information Asymmetries in Consumer Credit Markets: Evidence from Two Payday Lending Firms* 6 (Vanderbilt Law and Economics Research Paper No. 11-05, 2011) (noting that a typical two week payday loan carries a 15% to 18% finance charge).

50. This can be due to various behavioral factors. Consumers may suffer from self-control problems and “choose” short-term welfare gains even when they understand the long-term costs far outweigh the gains. See Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided “Reform” of Bankruptcy Law*, 84 TEX. L. REV. 1481, 1543–44 (2006) (stating that “the impulse for immediate gratification is often irresistible, notwithstanding the long-term consequences of such action”). Borrowers also may systematically underestimate the cost of borrowing or be overconfident about how rapidly they will repay. *Id.* at 1540–41 (noting that, due to overconfidence bias, “borrowers are more likely to underestimate than overestimate the risks associated with uncertainty”).

51. See Willis, *supra* note 34, at 727–28 (arguing that in the subprime mortgage market, pricing is complicated and nontransparent, creating an information asymmetry that lenders exploit).

52. See Stegman & Faris, *supra* note 6, at 19.

53. See Melzer, *supra* note 27 (finding that payday loan access increases delinquencies on other debts and postponement of health care); Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy* 1 (Oct. 20, 2010) (unpublished manuscript) (finding that access to payday loans increases bankruptcy rates) (on file with the Washington and Lee Law Review).

54. See Karlan & Zinman, *supra* note 42, at 461 (finding stress-related mental health effects from overindebtedness); Jeannine Aversa, *AP Impact: Debt Hurts Your Body, Too*, USA TODAY, June 9, 2008 (finding that “[w]hen people are dealing with mountains of debt, they’re much more likely to report health problems”).

and other social and external costs.<sup>55</sup> Overindebtedness reduces welfare not only when borrowers default on their payments, but also when they resort to reducing consumption, selling assets, or borrowing repeatedly to avoid payment default.<sup>56</sup> Debt default results not only in direct economic costs from impaired credit scores, repossession of collateral, and added collection fees, but also in a myriad of health impairments and other negative effects on the borrower's well-being.<sup>57</sup>

The U.S. military recently concluded that high-cost credit was particularly detrimental to the welfare of enlisted soldiers,<sup>58</sup> and one experimental study found that payday borrowing measurably reduced job performance among Air Force personnel.<sup>59</sup> In contrast, a study done in cooperation with a South African microlender found positive consumer welfare effects of expanding access to consumer credit, even at rates in excess of 100% annual percentage rate (APR).<sup>60</sup> The study measured income, consumption, physical and mental health, and credit scores several months after the four-month loans were due to be

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55. See Catarina Frade & Claudia Abreu Lopes, *Overindebtedness and Financial Stress: A Comparative Study in Europe*, in CONSUMER CREDIT, DEBT AND BANKRUPTCY: COMPARATIVE AND INTERNATIONAL PERSPECTIVES 249, 249 (William Whitford, Johanna Niemi-Kiesilainen, & Iain Ramsay eds., 2009) (noting that "overindebtedness . . . may potentially lead to social, financial, and market exclusion" and "[i]n extreme cases, divorce, mental disorders, homelessness or even suicide"); Therese Wilson, *Responsible Lending or Restrictive Lending Practices? Balancing Concerns Regarding Over-Indebtedness with Addressing Financial Exclusion*, in THE FUTURE OF CONSUMER CREDIT REGULATION 91, 95 (Michelle Kelly-Louw, James P. Nehf & Peter Rott eds., 2008) (stating that "consumers who find themselves over-indebted may suffer stress, depression, anxiety; become violent, suicidal, or homicidal; and face barriers to access to further credit and barriers to work").

56. Adrian González & Claudio González-Vega, *Overindebtedness in the Bolivian Microfinance Sector, 1997–2001 (Sobreendeudamiento en Las Microfinanzas Bolivianas, 1997–2001)* (Sept. 2003), available at <http://ssrn.com/abstract=1413005>.

57. See Katherine Porter, *The Damage of Debt*, 69 WASH. & LEE L. REV. 981 (2012) (cataloging a wide variety of harms caused by debt distress).

58. DEPARTMENT OF DEFENSE, REPORT ON PREDATORY LENDING PRACTICES DIRECTED AT MEMBERS OF THE ARMED FORCES AND THEIR DEPENDENTS (2006), available at [http://www.defense.gov/pubs/pdfs/report\\_to\\_congress\\_final.pdf](http://www.defense.gov/pubs/pdfs/report_to_congress_final.pdf) (describing loss of security clearances, divorces, repossessions, disciplinary action, and discharges resulting from overindebtedness).

59. See Carrell & Zinman, *supra* note 6, at 3.

60. Karlan & Zinman, *supra* note 42, at 461.

repaid and compared the outcomes with a control group who were denied credit but had similar credit characteristics.<sup>61</sup> Some increase in stress was found among the experimental group of borrowers with increased credit access.<sup>62</sup>

A defensible social welfare function for credit regulation needs to compare utility and disutility consequences of borrowing for individuals, or at least to take seriously the existence of positive and negative welfare effects and the fact that revealed preferences provide an impoverished means to measure those effects.

### *C. The Human Development Approach to Welfare Economics*

How should the welfare impact of lending to the poor be evaluated, and what goals should credit regulation pursue? Recognizing the inadequacy of gross domestic product (GDP) as a measure of human welfare, the human development movement has proposed a more sophisticated set of measures for the aggregate welfare of societies. These ideas have been embodied in the United Nations' annual Human Development Report and Human Development Index (HDI),<sup>63</sup> as well as the work of Amartya Sen<sup>64</sup> and Martha Nussbaum.<sup>65</sup> Rather than using average GDP as a measure of a nation's well-being, the HDI combines measures of health, education, and income, but with an emphasis on the income of people below the median.<sup>66</sup> The intent of such welfare measures is twofold: the HDI addresses distribution of wealth and income, recognizing that there is a diminishing marginal utility to income for an individual, and income improvement means more to the poor than to the rich. In other words, for a fixed level of income and assets, aggregate

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61. *Id.* at 449–55 (explaining the results of the study).

62. *Id.* at 461.

63. See MUHBAB AL HAQ, REFLECTIONS ON HUMAN DEVELOPMENT 46–66 (1995).

64. See, e.g., SEN, *supra* note 24; AMARTYA SEN, CHOICE, WELFARE AND MEASUREMENT (1982).

65. See, e.g., MARTHA NUSSBAUM, CREATING CAPABILITIES: THE HUMAN DEVELOPMENT APPROACH 44 (2010).

66. See AL HAQ, *supra* note 63, at 49–50.

utility will be greater if the poor have a larger (or less unequal) share of income and assets. The HDI also, and just as importantly, treats income as a means to the end of enhancing the capabilities, choices, and opportunities open to all people, and not as an end in itself, by measuring outcomes like health and literacy.<sup>67</sup> To improve aggregate welfare measured in this way, policies need to improve the health, education, and other capabilities of the population, as well as the incomes and consumption levels of the poor preferentially. In other words, income and GDP are not direct measures of human welfare. Instead, welfare can and should be measured by looking at consumption of basic needs (food and shelter), health, education, and the freedom to participate in civil society, and at the distribution of those benefits across society.

Credit markets seem to be an excellent place to apply the human development framework. Martha Nussbaum describes access to credit as a “fertile capability,” using the example of an Indian woman who was enabled “to protect her bodily integrity (not returning to her abusive husband), to have employment options, to participate in politics, to have a sense of emotional well-being, to form valuable affiliations, and to enjoy enhanced self-respect.”<sup>68</sup> She rightly focuses not simply on the wealth and consumption effects of credit, but on those monetary measures as means to the real ends, including the capacity of all people to live healthy, safe lives and to develop their intellectual, emotional, political, and associative capabilities.<sup>69</sup> On the other hand, if we recognize that in the case of consumer credit, more is not necessarily better, then a legal regime for creation and

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67. See *id.*; AMARTYA SEN, RATIONALITY AND FREEDOM 8 n.8 (2002) (distinguishing between the HDI and previous measures which did not focus on “human development” indicators); see also NUSSBAUM, *supra* note 65, at 59 (noting that the HDI “heavily weight[s] items (longevity, education) not typically emphasized in development rankings”). See generally Kerry Rittich, *The Future of Law and Development: Second Generation Reforms and the Incorporation of the Social*, 26 MICH. J. INT’L L. 199 (2004) (describing the move among international development institutions toward human development and social outcome measures rather than measures of economic growth for its own sake).

68. NUSSBAUM, *supra* note 65, at 44.

69. *Id.* at 33–34 (introducing the “central capabilities” that a political order should secure to its citizens, including bodily health, emotional well-being, and free association).

cancellation of consumer debt need not and should not be based on the premise that regulation should aim to maximize the volume of consumer lending to the poor. Instead, a partly utilitarian, partly egalitarian approach to credit regulation based on a human development framework would seek to stimulate the availability of welfare-enhancing credit forms, while minimizing the volume of harmful and damaging forms of credit, if those forms can be described and distinguished. Credit improves welfare if the borrower's earning capacity, housing, health, education, and/or consumption levels are permanently improved as a result of borrowing. Even the stabilizing effect of consumption smoothing can and should be recognized as a welfare benefit, but consumption smoothing is obviously more problematic to measure and compare to the cost of borrowing.

The higher the interest rate prevailing, of course, the less likely that poor borrowers are achieving net welfare benefits, but this will also depend on the amount of credit, its duration, and the use to which it is put. To summarize, a human development approach to distinguishing beneficial credit from harmful credit requires several elements. First, we need a reasonable estimate of improvements in income, consumption levels, health, education, and other indicators of well-being made possible by borrowing; second, and more challenging, we need a means to quantify the welfare benefits of consumption smoothing over time when there is no permanent increase in income or other measures of welfare; and, third, we need a comparison of those welfare benefits to the interest and other costs of the loan, as well as the risk-adjusted harms that result from debt distress and default for those who cannot repay their loans.

Studies of microlending in the developing world have in fact attempted to measure not only the raw volume of lending but also its contribution to long-term reduction of poverty (i.e., improvement of the assets and consumption patterns of the poor), and the conclusions are decidedly mixed.<sup>70</sup> Studies of small-loan lending in the United States have considered welfare impacts on individual borrowers but not on the poor preferentially. Credit that improves the income of the poor or permits long-term cost

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70. See, e.g., DE AGHION & MORDUCH, *supra* note 5; Rosenberg, *supra* note 39.

savings ought to be favored, while credit that exploits self-control problems and does not enhance welfare but simply transfers income from the poor to lenders and investors ought to be disfavored. The results of recently expanded credit access for the poor in different nations around the world may be instructive in this endeavor.

*III. Lending to the Poor in the Developing World—The Grameen Bank Entrepreneurial Model*

The paradigmatic success story for microcredit as a means to improve the welfare of the poor has been the Grameen Bank in Bangladesh. Muhammad Yunus, winner of the 2006 Nobel Peace Prize, founded Grameen Bank in 1976.<sup>71</sup> Dr. Yunus hit on the idea of microloans when he and his students interviewed poor women in a village near his university.<sup>72</sup> They told him that moneylenders lent them money at high rates, then sold them bamboo to make stools, and at the end of the day purchased the finished stools for resale, leaving the women with a tiny profit.<sup>73</sup> If only they had the money to buy their own bamboo each day, the women could make a much better living.<sup>74</sup> Dr. Yunus was surprised at the miniscule amounts they were borrowing and repaying each day, and he decided to make them a loan from his own pocket.<sup>75</sup>

Under the guidance of Dr. Yunus, the Grameen Bank developed a unique lending method that found innovative solutions for some of the information and moral hazard issues that previously had prevented lending to the rural poor.<sup>76</sup> Grameen Bank's basic loan does not require any collateral, and although loans are made to groups of five borrowers (nearly all

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71. MUHAMMAD YUNUS, *BANKER TO THE POOR: MICROLENDING AND THE BATTLE AGAINST WORLD POVERTY* 45 (1999).

72. *Id.* at 47–55.

73. *Id.* at 49–50 (recounting the story of a particular interview and the subsequent formation of the idea of microlending).

74. *Id.* at 51.

75. *Id.* at 54.

76. See Joseph E. Stiglitz, *Peer Monitoring and Credit Markets*, 4 *WORLD BANK ECON. REV.* 351, 353 (1990) (calling the Grameen Bank “a model of success”).

women), only the individual borrower is responsible for repayment.<sup>77</sup> However, if a loan is not repaid on time, no new loans are made to any group members.<sup>78</sup> Because payments are collected in public, personal honor and humiliation play an important role in addition to the economic incentive of access to future credit.<sup>79</sup> Repayment rates are reportedly 90%.<sup>80</sup>

No written contracts are used, nor is the legal system used in any way to enforce loan repayment.<sup>81</sup> The interest rate is 10% add-on, equivalent to about 20% APR.<sup>82</sup> Although the original intent was to fund small enterprises, Grameen Bank loans are used for education, consumption, housing, and other purposes not related to income-generating activities.<sup>83</sup>

For the early years of its growth, Grameen Bank relied on grants and below-market-rate loans to fund its expensive operations.<sup>84</sup> It now claims to be funded entirely from deposits of its members and not to have relied on grants or outside loans since 1998.<sup>85</sup> The frequent and personal contact between Grameen staff and its borrowers, together with the small loan

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77. YUNUS, *supra* note 71, at 67.

78. *Id.*

79. Rashmi Dyal-Chand, *Human Worth as Collateral*, 38 RUTGERS L.J. 793, 822 (2007).

80. Grameen Bank, *Grameen Bank Monthly Update in US\$: November, 2011*, [http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=453&Itemid=527](http://www.grameen-info.org/index.php?option=com_content&task=view&id=453&Itemid=527) (last visited Apr. 8, 2012) (on file with the Washington and Lee Law Review).

81. Grameen Bank, *Grameen Bank at a Glance*, [http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=26&Itemid=0](http://www.grameen-info.org/index.php?option=com_content&task=view&id=26&Itemid=0) (last visited Apr. 8, 2012) (on file with the Washington and Lee Law Review).

82. See Jonathan Morduch, *The Role of Subsidies in Microfinance: Evidence from the Grameen Bank*, 60 J. DEV. ECON. 229, 243 (1999).

83. See DARYL COLLINS, ET AL., PORTFOLIOS OF THE POOR: HOW THE WORLD'S POOR LIVE ON \$2 A DAY 164 (2009) (noting that, despite Grameen Bank's intent that the money be spent on "productive investment," microloans can be successfully used for consumption smoothing); Haque & Yamao, *supra* note 19, at 649–50 (finding that 33% of borrowers used microloans for consumption purposes).

84. See Morduch, *supra* note 82, at 236.

85. *Grameen Bank at a Glance*, *supra* note 81. Grameen Bank audited financial statements are available at <http://www.grameen-info.org>. Grameen provides life insurance to its borrowers at no additional charge; it has recently started to earn some income from ancillary businesses, for example a cell phone service that employs village dwellers as "telephone ladies." *Id.*

sizes, make reaching break-even status, while charging relatively low interest rates, a continuing challenge.<sup>86</sup>

Apart from the group lending model, Grameen's loan program uses a variety of other features to ensure successful repayment:

- Progressive increases in loan size: initial loans are small, and borrowers (and fellow group members) who successfully repay their loans become eligible for larger loans.<sup>87</sup>
- Intensive staffing: Grameen operates through a vast network of branches, and the loan officers in the branches visit their clients at least once weekly.<sup>88</sup> During these visits, new loans are disbursed and payments are collected, all in public view.<sup>89</sup> Although one study found that repayment rates did not drop measurably when borrowers paid less frequently than weekly,<sup>90</sup> it still seems intuitively clear that the constant staff-borrower contact is one likely factor in Grameen's success. It also, however, imposes salary costs that limit the potential for profitability and growth.
- The Sixteen Decisions: Grameen Bank requires that each of its borrowers memorize and recite sixteen behavioral commitments intended to encourage her personal development and progress out of poverty.<sup>91</sup> The Decisions (so-called because they were developed from a bottom-up borrower consultation process) include such behaviors as not having too many children, growing vegetables, and repairing and upgrading houses. Although loans are not conditioned

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86. See Morduch, *supra* note 82, at 230 (explaining the difficulties in pursuing Grameen Bank's mission despite high per-transaction costs).

87. See *Grameen Bank at a Glance*, *supra* note 81.

88. See *id.*

89. See *id.*

90. Erica Field & Rohini Pande, *Repayment Frequency and Default in Microfinance, Evidence from India*, 6 J. EURO. ECON. ASS'N 501, 508 (2008).

91. YUNUS, *supra* note 71, at 135–37; Dyal-Chand, *supra* note 38, at 227, nn.46, 47.

on compliance, the bank does monitor success of its branches in achieving these goals and thus links loan repayment with progress out of poverty in the minds of its customers.<sup>92</sup> There is some research supporting the effectiveness of the Sixteen Decisions. Women who take Grameen microloans reduce their fertility and increase their participation in politics and civil society.<sup>93</sup>

- Loans are always amortizing. Every weekly payment must cover the interest due and reduce the principal balance.<sup>94</sup> This contrasts with the typical payday loan product in the United States, which permits borrowers to pay interest only without reducing their debt.<sup>95</sup>
- Payment defaults are always worked out if possible. Loan officers who are faced with a missed payment immediately inquire into the circumstances and arrange revised payment schedules if at all possible.<sup>96</sup>
- Groups lose access to credit when payments from any member are not made on time.<sup>97</sup>
- Insurance schemes: through a combination of linked savings accounts, life insurance, emergency loans, and other tools, Grameen strives to minimize loan defaults

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92. See DAVID BORNSTEIN, *THE PRICE OF A DREAM: THE STORY OF THE GRAMEEN BANK* 95 (2005) (describing the Sixteen Decisions as “the bank’s social development manifesto”); YUNUS, *supra* note 71, at 137, 202 (describing the development of the Sixteen Decisions as a way to encourage social improvement).

93. See Md. Abul Basher, *Empowerment of Microcredit Participants and Its Spillover Effects: Evidence from the Grameen Bank of Bangladesh*, 40 J. DEVELOPING AREAS 173, 173–83 (2007) [hereinafter Basher, *Empowerment*], available at <http://ssrn.com/abstract=983363> (arguing that “the Grameen Bank transforms its participants from a passive recipient of credit to a well responsive and active agent in economic and non-economic aspects of life”).

94. See BORNSTEIN, *supra* note 92, at 44–50.

95. Martin, *supra* note 6, at 564.

96. See BORNSTEIN, *supra* note 92, at 170–73 (describing Grameen’s loan adjustment practices); YUNUS, *supra* note 71, at 68–71 (noting Grameen’s high repayment rates).

97. BORNSTEIN, *supra* note 92, at 20, 45.

caused by predictable crises in the lives of its poor borrowers.<sup>98</sup>

Bangladesh experiences frequent floods and other disasters. As a result, Grameen borrowers have frequently lost their homes and their businesses and have not been able to repay their loans.<sup>99</sup> Grameen responds by mobilizing additional capital and extending emergency loans while not canceling any of the prior debt.<sup>100</sup> From these experiences Grameen has learned that insurance schemes are essential to protect its borrowers and their loans against foreseeable risks faced by the poor in a country like Bangladesh.<sup>101</sup>

The Grameen program is known for its focus on women. Grameen Bank loans initially were made equally to men and women, but the bank eventually concluded that women were better “fighters against poverty” and more likely to use money to improve their family’s situation rather than for unproductive purposes.<sup>102</sup> On the other hand, Aminur Rahman reports that women often were coerced into borrowing by husbands or male relatives and may have faced greater violence, or at least been disempowered, by becoming Grameen Bank borrowers.<sup>103</sup>

Grameen claims that 98% of its borrowers repay their loans, but the real nonpayment rate is probably closer to 10% or higher.<sup>104</sup> Grameen Bank’s calculation compares the loans not repaid after one year (recall that they are due in six months or less) to the volume of loans outstanding.<sup>105</sup> The denominator in this fraction is not comparable to the numerator because of the Bank’s rapid growth in loan volume, i.e., loans made in the current year always exceed loans made two years earlier, whereas it would be more meaningful to compare loans now in

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98. YUNUS, *supra* note 71, at 137–40.

99. *Id.* at 138–40.

100. *Id.*

101. *Id.*

102. *Id.* at 71–72; Dyal-Chand, *supra* note 38, at 228 n.51, 261–62.

103. See AMINUR RAHMAN, WOMEN AND MICROCREDIT IN RURAL BANGLADESH: ANTHROPOLOGICAL STUDY OF THE RHETORIC AND REALITIES OF GRAMEEN BANK LENDING 120–26 (1999) (analyzing rates of violence against women in connection with their participation as Grameen borrowers).

104. Morduch, *supra* note 82, at 231–35.

105. *Id.*

default to all loans originated at the same time, i.e., a year ago.<sup>106</sup> Moreover, the borrowers reported as repaying their loans include many who are late in paying but have arranged some alternative schedule or emergency loan with Grameen to prevent complete default.<sup>107</sup> Nevertheless, the percentage of borrowers who repay loans without difficulty is in the vicinity of 90%.<sup>108</sup> On the other hand, one survey of Bangladeshi microfinance borrowers from multiple lenders, including Grameen Bank, found that only 51% of poor borrowers made weekly payments on time and found significant incidence of borrowers selling property or going to moneylenders to make microfinance payments.<sup>109</sup>

There is considerable controversy about the effectiveness of Grameen Bank, both on its own terms and in comparison to other antipoverty strategies,<sup>110</sup> and it is not my purpose to engage that debate. Several studies have shown that Grameen borrowers do succeed in developing microenterprises, raising their families' incomes out of extreme poverty and becoming empowered in numerous other ways.<sup>111</sup> These studies, as well as their critics,

106. *Id.*

107. *Id.*

108. *Id.*

109. Haque & Yamao, *supra* note 19, at 12–13, 16.

110. *See id.* at 17–18 (indicating that the majority of surveyed members of microfinance institutions felt that their involvement had not had a positive impact on their lives); Basher, *Empowerment*, *supra* note 93, at 180–82 (concluding that participation empowers members to take a more active role in society and results in positive societal changes); Dyal-Chand, *supra* note 38, at 221 (arguing that the “key features of the [Grameen Bank] model fail to eliminate the informational and other problems that contribute to market failure in poor communities, arguably leaving the poor with even fewer resources to sell their products or services”); M. Kabir Hassan, *The Microfinance Revolution and the Grameen Bank Experience in Bangladesh*, 11 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 205, 258 (2002) (noting that “[t]he jury is still out regarding the overall viability of microfinance organizations”); Rafiqul Bhuyan Rafiq, Shahnaz Abdullah & Hamid Ahmadi, *Women Empowerment and Credit Control: An Empirical Analysis on Credit Recipients of Grameen Bank in Bangladesh*, 5 ICFAI J. FIN. ECON. 21 (2007); Mark Schreiner, *A Cost-Effectiveness Analysis of the Grameen Bank of Bangladesh*, 21 DEV. POL’Y REV. 357, 369–73 (2003) (finding that the Grameen Bank was cost-effective and that it had positive impacts on various aspects of its members’ lives).

111. *See* SHAHIDUR R. KHANDKER, FIGHTING POVERTY WITH MICROCREDIT: EXPERIENCE IN BANGLADESH 51–54 (1998) (finding increases in income, household production, and employment associated with involvement with Grameen); Basher, *Empowerment*, *supra* note 93, at 173–75, 180–82 (“Grameen

are asking the right questions: what is the effect of loans on the borrowers' consumption, health, and other indicators of well-being?

Critics of the microcredit movement, such as Thomas Dichter, dispute the welfare improvement claims made for Grameen Bank.<sup>112</sup> They argue that microcredit does little but replace existing informal credit arrangements to fund subsistence activity, activity with little or no prospect of growth. The overall impact of Grameen on the poverty rate in Bangladesh remains disappointingly marginal.<sup>113</sup> Entrepreneurs face inherent limits in markets and in the capacity of their country to create growth. Microloans mostly just smooth consumption and may have a limited role in unleashing productive capacity.<sup>114</sup> Dichter also argues that, as more microcredit lenders have entered the field, the quality of the lending has deteriorated, a phenomenon he calls self-pollution.<sup>115</sup> The cases of Bolivia and South Africa, discussed below, certainly support this view.

Professor Rashmi Dyal-Chand has argued that Grameen Bank's microlending model imposes Western and male-oriented values on Third World women and imposes a one-size-fits-all

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Bank also helps its participants to graduate from a passive recipient of credit to an active agent of economic and social process.”).

112. See Thomas Dichter, *Hype and Hope: The Worrisome State of the Microcredit Movement*, CGAP Microfinance Gateway (Mar. 24, 2006), <http://www.microfinancegateway.org/p/site/m/template.rc/1.26.9051/> (last visited Mar. 1, 2012) (“[T]he hoped for poverty reduction impact of microcredit remains elusive.”) (on file with the Washington and Lee Law Review).

113. See Md. Abul Basher, *Towards Understanding the Mismatch Between Micro and Macro Level Effects of Microcredit: Causes and Imperatives*, 27 BANGL. DEV. STUD. 137, 144 (2001) (finding a “very meager rate of annual poverty reduction”); Sarah Gibb, *Microfinance's Impact on Education, Poverty, and Empowerment: A Case Study from the Bolivian Altiplano* 20–23 (Institute for Advanced Development Studies, Working Paper No. 04/2008), available at [http://www.inesad.edu.bo/pdf/wp04\\_2008.pdf](http://www.inesad.edu.bo/pdf/wp04_2008.pdf) (finding that microloans mostly supported marginal informal economy activity and did little to improve education or women's empowerment).

114. See Dichter, *supra* note 112 (noting that while microcredit often helps the poor “smooth consumption over periods of cyclical or unexpected crises . . . this is not what the majority of microcredit enthusiasts claim it can do—function as capital aimed at increasing the returns to a business activity”).

115. See *id.* (“As more and more operators have got involved, the quality of microcredit operations has deteriorated just as the serious veteran players have reached the point of perfecting their lending techniques. Microcredit is on the verge of becoming a self-polluting industry.”).

development model on widely varying cultural groups.<sup>116</sup> The overreliance on the idea of universal values embedded in microlending, she argues, will lead to repeated failures when microcredit is used as a development strategy in different contexts, including the United States and the developed countries.<sup>117</sup> While Professor Dyal-Chand is quite right to caution us about making cross-cultural generalizations regarding microcredit, certain features of successful and unsuccessful microlending programs can be readily identified and compared and can be instructive in thinking about credit regulation generally.

Scholars on both sides of the debate would probably concede that some forms of microlending do improve the welfare of borrowers but that empirical study is critical to evaluating the real welfare costs and benefits of any microlending program. At this point, the evidence of net welfare improvements is mixed at best. Some advocates of microcredit have conceded that it does not consistently produce permanent income improvements and poverty reduction and have asserted instead the more problematic consumption-smoothing benefits.<sup>118</sup>

Clearly, the loan product offered by Grameen Bank differs in almost every respect from the payday loan product offered in the United States. In fact, their only common feature is that the loans are small. Before considering how legal regimes might incorporate the lessons of microlending by Grameen Bank, it is instructive to consider the failures of microcredit in other developing nations.

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116. See Dyal-Chand, *supra* note 38, at 289–94 (“The Bank does not simply adopt the Bangladeshi male perspective. It compounds the problem by superimposing on and through the model a more Western perspective about women’s rights, needs, and liberation.”).

117. *Id.* at 303–06.

118. See Rosenberg, *supra* note 39, at 2–6 (“Whether or not financial services lift people *out of* poverty, they are vital tools in helping them to *cope* with poverty.”).

*IV. Failures of Microcredit: The Bolivian and South African Experiences*

*A. Bolivia*

Bolivia is a relatively poor country, particularly compared to its South American neighbors.<sup>119</sup> After an economic crisis in the early 1980s featuring 24,000% inflation,<sup>120</sup> a new government turned to market liberalization and microcredit as a strategy for both poverty alleviation and economic growth.<sup>121</sup> The microcredit boom in Bolivia eventually fell victim to its own success. Between 1998 and 2004 Bolivia was plunged into another serious economic and political crisis, exacerbated by widespread distress and default brought on by its consumer lending sector.<sup>122</sup> National associations of debtors were formed, holding demonstrations and demanding that the government intervene and cancel small-loan debts.<sup>123</sup> The Bolivian experience offers an instructive counterpoint to the successes of microcredit in Bangladesh and elsewhere.

Bolivia had suffered a serious crisis of hyperinflation in 1985, leading to a complete loss of confidence in the traditional banking sector.<sup>124</sup> At the same time, thousands of workers lost jobs in mining and in government service as a result of restructuring promoted by the International Monetary Fund.<sup>125</sup> The center-right government promoted microcredit, and it expanded rapidly.<sup>126</sup> Nongovernmental organizations (NGOs) like Prodem

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119. See UNITED NATIONS DEV. PROGRAMME, HUMAN DEVELOPMENT REPORT 2007/2008, at 231 tbl.1 (ranking Bolivia 117th in the world on the 2005 U.N. Human Development Index). In 2005, Bolivia had a per capita GDP of \$2,819. *Id.*

120. ELISABETH RHYNE, MAINSTREAMING MICROFINANCE: HOW LENDING TO THE POOR BEGAN, GREW, AND CAME OF AGE IN BOLIVIA 36–37 (2001); Jason Mitchell, *Bolivia—Shaken But Still Standing*, FIN. TIMES, July 1, 2004.

121. RHYNE, *supra* note 120, at 38–42.

122. *Id.* at 144–51; Reynaldo Marconi & Paul Mosley, *Bolivia During the Global Crisis 1998–2004: Towards a ‘Macroeconomics of Microfinance,’* 18 J. INT’L DEV. 237, 238–39 (2006).

123. RHYNE, *supra* note 120, at 144–47; Marconi & Mosley, *supra* note 122, at 246 n.12.

124. RHYNE, *supra* note 120, at 36.

125. *Id.* at 42.

126. *Id.* at 38–42.

(the precursor to BancoSol) and ProMujer followed a microcredit model not unlike that of Grameen Bank, including outreach to the rural poor and lending to groups.<sup>127</sup> However, with much of Bolivia's poor concentrated in urban centers, the first microcredit lenders grew more rapidly in the cities and quickly became profitable. The initial rapid growth of microlending in Bolivia contributed to a measurable reduction in poverty.<sup>128</sup>

The government relaxed its banking regulations, allowing nonbank finance companies to begin accepting deposits and making small loans. The amounts of "small" loans rapidly escalated; consumer lending for durables, such as washing machines, began to be emphasized over microenterprise lending; and new competitors took progressively less care to evaluate borrowers' repayment ability.<sup>129</sup> Profit-oriented consumer loan companies from other Latin American countries entered the Bolivian market and began competing with more socially oriented NGO microlenders.<sup>130</sup> From the borrowers' perspective, the products of the two sectors were interchangeable, and many borrowers fell into a debt trap, "bicycling" their loans by borrowing from one lender to pay another.<sup>131</sup> One study found that payment defaults were highest for Bolivian borrowers who went to both microfinance lenders and consumer lenders (39%), compared with those borrowing solely from consumer lenders (19%), and were lowest for microfinance lenders (11%) and NGO lenders (6%).<sup>132</sup>

After the 1998 onset of the crisis, Bolivia's GDP growth fell from 5% to 1%, and the bottom fell out of the retail and service sectors on which many microloan borrowers depended for their

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127. *Id.* at 55–72, 82–91.

128. Paul Mosley, *Microfinance and Poverty in Bolivia*, 7–8 37 J. DEV. STUD., no. 4, Apr. 2001 at 101, 127.

129. Herbert Muller, *Las microfinanzas reguladas en Bolivia [Regulated Microfinances in Bolivia]*, 10 *Tinkazos* 71, 71–82 (2007), [http://www.scielo.org.bo/scielo.php?script=sci\\_pdf&pid=S1990-74512007000100005&lng=en&nrm=iss&tlng=es](http://www.scielo.org.bo/scielo.php?script=sci_pdf&pid=S1990-74512007000100005&lng=en&nrm=iss&tlng=es) (last visited Apr. 8, 2012) (on file with the Washington and Lee Law Review).

130. See RHYNE, *supra* note 120, at 141–44 (describing these consumer lenders and comparing their methods to those of microlenders within Bolivia).

131. *Id.* at 144–45.

132. González & González-Vega, *supra* note 56, at 63 tbl.XIII.2.

economic activity.<sup>133</sup> Loan defaults mounted rapidly and borrower distress led to the organizing of a social movement. Between 1998 and 2002, several thousand borrowers formed various debtors' associations and demanded forgiveness of debts.<sup>134</sup> Many of the protestors had borrowed from a single microlending institution (Bolivia has many) called Acceso, which was shut down shortly thereafter.<sup>135</sup> Failure of this institution was attributed to its grossly inadequate underwriting.<sup>136</sup>

In response to the social movements demanding debt relief, the Bolivian government implemented measures in 1999 and 2001 to postpone payments on microloans.<sup>137</sup> A number of the consumer lenders eventually collapsed.<sup>138</sup> However, not all microlenders in Bolivia did poorly during the crisis. Several key characteristics distinguished the microlenders that failed during the Bolivian crisis from those that continued to grow and to maintain low levels of payment defaults. Among these were:

- low loan amounts and limits;
- a “village banking” model, in which some interest is set aside for emergency loans to borrowing group members as a form of default insurance;
- an integrated program of services that help ensure borrower loyalty, including training, advice, health services, and political education;
- maintaining a careful screening process to ensure borrower repayment ability.<sup>139</sup>

The strongest players in the Bolivian microsector, including BancoSol, continue to operate profitably and provide credit to the poor.<sup>140</sup>

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133. Marconi & Mosley, *supra* note 122, at 250–51.

134. RHYNE, *supra* note 120, at 144–47; Marconi & Mosley, *supra* note 122, at 246–47.

135. Valerie Rozycki, *Lessons for Success from Microfinance Networks in Bolivia* 25 (2003) (unpublished B.A. dissertation, Stanford University).

136. *Id.*

137. Marconi & Mosley, *supra* note 122, at 241.

138. RHYNE, *supra* note 120, at 147–48.

139. Marconi & Mosley, *supra* note 122, at 244–46.

140. *Id.* at 241–46.

The Bolivian regulators, Superintendency of Banks and Financial Institutions (SBEF) and the Financial System Supervision Authority (ASFI), responded to the overindebtedness crisis with a range of regulatory measures. First, a system of credit reporting was established to permit microfinance lenders to obtain information about borrowers' other outstanding loans, with a view to responsible lending.<sup>141</sup> Second, debt service was limited to 30% of salary for employees.<sup>142</sup> Third, ASFI now mandates disclosure of loan terms, including interest rate, whether it is fixed or variable, itemization of fees, and so forth, similar to the U.S. Truth in Lending Act scheme.<sup>143</sup> Finally, ASFI requires every financial institution to provide a Service for Response to Client Claims (Servicio de Atención de Reclamos de Clientes) to receive and monitor borrower and customer complaints.<sup>144</sup>

The Bolivian lenders that concentrated on larger, more profitable consumer loans to employees fared the worst, while socially oriented lenders that focused on microloans for capital investment appear to have survived the Bolivian crisis in better condition.<sup>145</sup> Proponents of microfinance lending argue that its success depends on lenders differentiating loans for investment from loans for consumption.<sup>146</sup> The Bolivian regulator defines microcredit as “a loan to a borrower—either an individual, a business, or a group of individuals—for the purpose of financing small-scale production, trade, or provision of services and where the assessment of repayment capacity of the borrower is based on the revenues generated by these activities.”<sup>147</sup> On the other hand,

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141. Autoridad de Supervisión del Sistema Financiero (ASFI), *La Regulación y Supervisión de las Entidades, Microfinancieras en Bolivia* [Regulation and Supervision of Microfinance Entities in Bolivia] 5 (July 6, 2010), [http://www.asfi.gob.bo/Portals/0/Documentos/Reg\\_y\\_Sup\\_de\\_EMFs.pdf](http://www.asfi.gob.bo/Portals/0/Documentos/Reg_y_Sup_de_EMFs.pdf) [hereinafter AFSI]; JACQUES TRIGO LOUBIÈRE, PATRICIA LEE DEVANEY & ELISABETH RHYNE, *SUPERVISING AND REGULATING MICROFINANCE IN THE CONTEXT OF FINANCIAL SECTOR LIBERALIZATION: LESSONS FROM BOLIVIA, COLOMBIA AND MEXICO* 35 (2004), available at <http://ssrn.com/abstract=776905>.

142. ASFI, *supra* note 141, at 14.

143. *Id.*

144. *Id.*

145. Marconi & Mosley, *supra* note 122, at 257–58.

146. LOUBIÈRE ET AL., *supra* note 141, at 15.

147. *Id.* at 36.

critics argue that a majority of microloan borrowers do not use the funds for their stated purposes.<sup>148</sup>

It is not clear at this point whether the regulatory measures (credit reporting, explicit debt-to-income ratio caps, and disclosure) have prevented or will prevent overindebtedness and future debt crises. Bolivia still faces an overabundance of consumer credit with high default rates on the one hand and a shortage of small-loan financing for microenterprises on the other.<sup>149</sup>

### *B. South Africa*

Shortly before the end of the Apartheid regime in 1994, the South African government sought ways to attack the most pressing problems of the black majority, including housing and poverty. Microcredit was embraced as one tool to combat entrenched poverty.<sup>150</sup> A prior first step had been the Usury Act Exemption of 1992, which removed legal limits on interest rates for small loans, defined as less than 6,000 rand (about \$1,000) and for terms of no more than thirty-six months.<sup>151</sup> The removal of rate ceilings was not accompanied at first by any government effort to fund NGOs to provide credit to the poor at reasonable cost, nor was any consumer protection regulation initially put in place.

What developed in the mid-1990s was a rapid growth of thirty-day loan products, similar to the U.S. payday loan market, and extremely high rates.<sup>152</sup> Large banks quickly came to

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148. Haque & Yamao, *supra* note 19, at 12.

149. Muller, *supra* note 129, at 71–82.

150. PATRICK MEAGHER ET AL., MICROFINANCE REGULATION IN SEVEN COUNTRIES: A COMPARATIVE STUDY 63–64 (2006), available at <http://www.microfinancegateway.org/gm/document-1.9.24382/26.pdf>.

151. Reza Daniels, *Consumer Indebtedness Among Urban South African Households: A Descriptive Overview 2* (Development Policy Research Unit, University of Cape Town, DPRU Working Paper No. 01/55, 2001), available at <http://econpapers.repec.org/scripts/redir.pf?u=http%3A%2F%2Fwww.dpru.uct.ac.za%2Fsites%2Fdefault%2Ffiles%2Fsites%2Fdefault%2Ffiles%2FDPRU%2520WP01-055.pdf;h=repec:ctw:wpaper:01055>.

152. See NATIONAL CREDIT REGULATOR, PRICING OF AND ACCESS TO CONSUMER CREDIT: A REVIEW OF THE IMPACT OF THE NATIONAL CREDIT ACT ONE YEAR AFTER ITS IMPLEMENTATION 5 (2009) (showing short-term loan rates averaging 313%

dominate the rapidly growing sector.<sup>153</sup> Most small loans were not made to entrepreneurs but to wage earners, based on the lender's ability to have access to the borrower's bank account and salary.<sup>154</sup> Thus, the lifting of usury ceilings, a necessary condition to microlending in the Grameen Bank model, did not by itself result in Grameen-style microenterprise lending. Instead, a large and profitable consumer lending sector arose, leading to widespread complaints about a lack of consumer understanding, excessive charges, and irresponsible lending leading to overindebtedness.<sup>155</sup> Harsh collection measures were used. For example, many borrowers gave lenders bank cards and PIN numbers and were faced with seizure of their entire incomes to service accumulated debt, making them unable to provide for their basic needs.<sup>156</sup>

The resulting debt crisis led to the enactment of the 2005 National Credit Act.<sup>157</sup> The purpose of the new law was to:

[P]romote and advance the social and economic welfare of South Africans . . . by:

- (a) promoting the development of a credit market that is accessible to all South Africans, and in particular to those who have historically been unable to access credit under sustainable market conditions;
- (b) ensuring consistent treatment of different credit products and different credit providers:

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APR in 2002 and declining to 93% by 2008).

153. ECIAFRICA, THE EVOLUTION OF THE SOUTH AFRICAN MICROFINANCE SECTOR FROM 1992 TO 2004: THE ROLE OF THE MICROFINANCE REGULATORY COUNCIL 7–8, 21–22 (2005), available at <http://www.microfinancegateway.org/p/site/m/template.rc/1.9.25161>.

154. *Id.* at 27–28.

155. *Id.*; Cédric Ludwig, *Trade Unions and Financial Inclusion: The Case of South Africa* 15–27 (Int'l Labour Org., Working Paper No. 51, 2008), available at [http://www.ilo.org/employment/Whatwedo/Publications/WCMS\\_106330/lang-en/index.htm](http://www.ilo.org/employment/Whatwedo/Publications/WCMS_106330/lang-en/index.htm); Polly Mashigo, *The Debt Spiral in the Poor Households in South Africa*, 2 INT'L INDIGENOUS J. OF ENTREPRENEURSHIP, ADVANCEMENT, STRATEGY & EDUC. 1, 13–15 (2006), available at [www.indigenousjournal.com/IIJEASVolIIIss1Mashigo.pdf](http://www.indigenousjournal.com/IIJEASVolIIIss1Mashigo.pdf).

156. Michelle Kelly-Louw, *Prevention of Overindebtedness and Mechanisms for Resolving Overindebtedness of South African Consumers*, in CONSUMER CREDIT, DEBT AND BANKRUPTCY: COMPARATIVE AND INTERNATIONAL PERSPECTIVES 175, 176 (Johanna Niemi et al. eds., 2009).

157. National Credit Act 34 of 2005 (S. Afr.).

(c) promoting responsibility in the credit market by—

(i) encouraging responsible borrowing, avoidance of over-indebtedness and fulfilment of financial obligations by consumers; and

(ii) discouraging reckless credit granting by credit providers and contractual default by consumers . . . .<sup>158</sup>

South Africa's National Credit Act prohibits lenders from entering into any "reckless credit agreement" with consumers.<sup>159</sup> A reckless credit agreement means either that the consumer does not understand the risks, costs, and obligations under the agreement or that the credit results in the consumer being overindebted.<sup>160</sup> Overindebted consumers may seek relief from reckless credit by first consulting a debt advice agency and then applying for court-ordered cancellation or restructuring of the reckless credit.<sup>161</sup> The enactment of the National Credit Act does not seem to have had a dramatic impact on loan approval rates, which have declined somewhat, or on overall indebtedness, but it is perhaps too soon to tell.<sup>162</sup>

Despite the enactment of the National Credit Act, South African consumers continue to suffer from high levels of debt stress. The National Credit Regulator reported in March 2010 that only 54% of active credit consumers were current in their payments.<sup>163</sup> Efforts to deal with overindebtedness through credit counseling and repayment plans have had little success to date.<sup>164</sup> The current picture of small-loan credit in South Africa remains one of excess supply of consumer loans to salary earners with widespread overindebtedness on one hand and a continuing

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158. *Id.* § 3.

159. *Id.* § 81(3).

160. *Id.* §§ 80(1), 81(2).

161. Kelly-Louw, *supra* note 156, at 190–91.

162. FEASIBILITY LTD., CREDIT EXTENSION TO HOUSEHOLDS: REPORT FOR THE NATIONAL CREDIT REGULATOR 4 (2006), available at <http://www.ncr.org.za/pdfs/Public%20Report.pdf>.

163. NATIONAL CREDIT REGULATOR, CREDIT BUREAU MONITOR 1 (Mar. 2010).

164. Melanie Roestoff et al., *The Debt Counselling Process—Closing the Loopholes in the National Credit Act 34 of 2005*, 12 POTCHEFSTROOM ELECTRONIC L.J. 246, 247–48 (2009), available at <http://ssrn.com/abstract=1555214>.

dearth of credit for microenterprises on the other.<sup>165</sup> While interest rates have declined and collection abuses have been reduced, it appears, on balance, that small-loan credit has not increased the welfare of South Africa's poor during the post-Apartheid period.<sup>166</sup>

*V. The United States Experience—Payday Lending and  
Incoherent Usury Laws*

The problematic welfare effects of small loans and credit cards in the United States on the poor have been written about at length.<sup>167</sup> One of the most controversial developments of the 1990s was the phenomenal growth of payday loan companies, which largely displaced pawnbrokers and finance companies as lenders to low- and moderate-income workers.<sup>168</sup> Payday lenders provide loans in small amounts (\$500 or less) for short periods, typically two weeks, at annual interest rates sometimes exceeding 500%.<sup>169</sup>

The policy debate surrounding payday lending in the United States has revolved around two issues: the high price of payday loans and the debt trap problem, where borrowers continually renew loans because of an apparent inability to repay them.<sup>170</sup> The price and debt trap issues are, of course, linked, because the high annual rates have less impact when borrowers repay loans in two weeks or a month, but the costs are more likely to outweigh the welfare benefits when borrowers pay only the interest and postpone payment on the principal for longer

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165. FINMARK TRUST & THE CENTRE FOR MICROFINANCE, UNIVERSITY OF PRETORIA, A REVIEW OF THE SOUTH AFRICAN MICROFINANCE SECTOR, 2009: SUCCESSES, CHALLENGES, AND POLICY ISSUES 15–35 (Barbara Calvin & Gerhard Coetzee eds., 2010), available at <http://web.up.ac.za/sitefiles/file/1/3841/MF%20Review%202009%20-%2021%20July%202010%20FINAL.pdf>.

166. *Id.*

167. *See supra* note 6.

168. John P. Caskey, *Fringe Banking and the Rise of Payday Lending*, in CREDIT MARKETS FOR THE POOR 17, 17–20 (Patrick Bolton & Howard Rosenthal eds., 2005).

169. *Id.* at 18.

170. *See id.* at 20–21; Michael S. Barr, *An Inclusive, Progressive National Savings and Financial Services Policy*, 1 HARV. L. & POL'Y REV. 161, 161–84 (2007).

periods. Theoretically, even borrowers repeatedly using payday loans might obtain net welfare gains. The empirical evidence, however, suggests otherwise: payday borrowers systematically underestimate both the costs of borrowing and their likelihood of falling into the debt trap.<sup>171</sup>

Defenders of payday lending, on the other hand, challenge the industry critics' claims that the product harms borrowers. Jim Hawkins, for example, contends that debt distress is not a likely result of payday loans and other small-loan products because the amount borrowed is limited and because lenders verify applicants' credit scores and outstanding debt (although his description of product terms and lender practices is more anecdotal than empirical).<sup>172</sup> One study found that greater access to payday lenders for borrowers affected by natural disasters led to a reduction in bad welfare outcomes, as measured by foreclosures and property-theft crimes.<sup>173</sup> In other words, emergency borrowing can help avoid shocks that increase expenses or reduce income. Another study compared borrowers in two neighboring states, one with legal restrictions on payday lending, and found that access to payday loans may increase employment or job retention and perceived economic well-being.<sup>174</sup> None of these studies attempts to compare the cost of payday loans with these welfare benefits. Studies finding either benefits or harms of payday lending have tended to isolate one or two borrower impacts for study<sup>175</sup> rather than attempting a true,

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171. Marianne Bertrand & Adair Morse, *Information Disclosure, Cognitive Biases and Payday Borrowing* 16–18 (Univ. of Chicago Booth Sch. of Bus., Working Paper No. 10-01, Oct. 2009), available at <http://ssrn.com/abstract=1532213>; Parrish & King, *supra* note 6, at 15–16; Stegman & Faris, *supra* note 6, at 13.

172. Jim Hawkins, *Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress*, 86 IND. L. J. 1361, 1376–1401 (2011).

173. Adair Morse, *Payday Lenders: Heroes or Villains?* 3 (Univ. of Chicago Booth Sch. of Bus., Working Paper, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1344397](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344397).

174. Zinman, *supra* note 13, at 13–15.

175. Bart J. Wilson et al., *An Experimental Analysis of the Demand for Payday Loans*, B.E.J. ECON. ANALYSIS & POL'Y (2010) John Y. Campbell et al., *The Regulation of Consumer Financial Products: An Introductory Essay with Four Case Studies* 27–33 (Harvard Univ. John F. Kennedy Sch. of Gov't, Faculty Research Working Paper No. RWP 10-40, 2010), available at <http://ssrn.com/abstract=1649647>.

complete cost–benefit analysis that would determine aggregate welfare impact.

At present the United States’ legal framework regulating small-loan lending is entirely incoherent. Usury limits vary from state to state.<sup>176</sup> Some state laws are displaced by federal law or other states’ laws through “rate exportation”; small-loan regulation varies depending on the amount, purpose, duration, and collateral of the loan, and the license or charter of the lender; and no state or federal agency has articulated a set of principles for differentiating beneficial from harmful credit products.<sup>177</sup> Interest rates are capped and uncapped in a schizophrenic manner as regulators struggle with the competing claims of lending industry and consumer advocates.

Usury laws in the United States consist of at least four layers. The first, general usury ceiling, dating from the Statute of Anne, typically limits interest rates broadly to low levels such as 5% or 6%.<sup>178</sup> The second layer consists of the small-loan laws adopted between 1916 and 1930.<sup>179</sup> Small-loan acts were prompted by calls for reform from the Russell Sage Foundation and others seeking to legalize and regulate the underground loansharking and salary-lending industry.<sup>180</sup> These acts typically require lenders to be licensed, limit loan amounts and terms, and set rate caps at 24% to 36% per annum.<sup>181</sup>

The third set of laws was adopted in the states beginning in the 1980s to permit higher cost lending to low- and moderate-income consumers. Laws authorizing rent-to-own transactions, payday loans, and other fringe lending either removed all rate ceilings or adopted very high levels of finance charges as the new norm.<sup>182</sup> These laws, like the small-loan laws a half a century earlier, recognized the existence of strong consumer demand for

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176. Campbell et al., *supra* note 175, at 31; Michael Stegman, *Payday Lending*, 21 J. ECON. PERSP. 169, 176–78 (2007).

177. See Bar-Gill & Warren, *supra* note 32, at 79–97.

178. CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET 77 (2004).

179. *Id.* at 94–95; Drysdale & Keest, *supra* note 6, at 621.

180. PETERSON, *supra* note 178, at 95.

181. ELIZABETH RENUART & KATHLEEN E. KEEST, THE COST OF CREDIT: REGULATION, PREEMPTION, AND INDUSTRY ABUSES 29–30 (4th ed. 2009).

182. *Id.* at 348–49.

high-cost credit products and either removed all regulatory impediments or sought to restrict only the perceived abuses at the margin of “fringe” lending.<sup>183</sup>

Finally, the fourth layer consists of federal preemption, in both the removal and partial reimposition of usury limits. Small-loan interest rates and terms are deregulated by federal preemption in two ways. First, federally chartered banks and thrifts are free from most state usury and credit laws.<sup>184</sup> Second, the federally chartered institutions may take advantage of the United States Supreme Court’s decision in *Marquette National Savings Bank of Minneapolis v. First of Omaha Service Corp.*,<sup>185</sup> which permits a national bank to comply with the law of its home state while doing business in other states, in essence “exporting” the usury laws of one state to others. However, for reputational and safety and soundness reasons, federal regulators eventually persuaded banks to exit the payday lending business by 2005.<sup>186</sup> Congress also reimposed usury limits for some consumers in the Talent-Nelson Military Lending Act of 2006, limiting interest charged to members of the armed forces and their families to 36%.<sup>187</sup> Although the statute was worded very broadly, Defense Department regulations limited the reach of Talent–Nelson to a discrete set of loan products, specifically payday loans, car title loans, and tax refund anticipation loans.<sup>188</sup>

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183. *Id.*; Mary Spector, *Payday Loans: Unintended Consequences of American Efforts to Tame the Beast*, in *THE FUTURE OF CONSUMER CREDIT REGULATION: CREATIVE APPROACHES TO EMERGING PROBLEMS* 107, 115–17 (Michelle Kelly-Louw et al. eds., 2008).

184. RENUART & KEEST, *supra* note 181, at 70–112.

185. *Marquette Nat’l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299, 301 (1978) (holding “the National Bank Act, Rev. Stat. § 5197, as amended, 12 U.S.C. § 85, authorizes a national bank based in one state to charge its out-of-state credit-card customers an interest rate on unpaid balances allowed by its home state, when that rate is greater than that permitted by the state of the bank’s nonresident customers” (citation omitted)).

186. RENUART & KEEST, *supra* note 181, at 150–53; FDIC, FIL-14-2005, PAYDAY LENDING PROGRAMS: REVISED EXAMINATION GUIDELINES (Mar. 1, 2005), available at <http://www.fdic.gov/news/news/financial/2005/fil1405.html>.

187. Military Lending Act of 2006, Pub. L. No 109-364, Sec. 670, 120 Stat. 2266 (codified at 10 U.S.C. § 987).

188. 32 C.F.R. pt. 232 (2012); Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, 72 Fed. Reg. 50,580, 50,585 (Aug. 31, 2007); see also Comments of National Consumer Law Center et al. Regarding Limitations on Terms of Consumer Credit Extended to Service

We can summarize U.S. regulation of payday lending as follows. States first decided to allow small-loan lending at rates around 36% in the 1930s, decided higher rates were needed to facilitate payday lending in the 1990s, and were then preempted as to both federally chartered lenders that could charge unlimited rates and to military families by the federal government's conclusion that credit at rates above 36% APR to soldiers did more harm than good. Most recently, Congress reaffirmed our national ambivalence about regulating consumer credit by establishing a new Consumer Financial Protection Bureau (CFPB) with the power to prohibit abusive practices while, at the same time, expressly forbidding the CFPB to enact usury limits, whatever that might mean.<sup>189</sup>

Those states and regulators that chose not to limit interest rates or that set very high ceilings have sought to mitigate harmful effects of payday loans in other ways. Some states impose repayment term limits but encounter practical difficulties in enforcing such limits.<sup>190</sup> In a market with many competitors, consumers can evade a single lender's prudential rules limiting debt amount or period outstanding by borrowing from multiple lenders. The Federal Deposit Insurance Corporation (FDIC) tried to mitigate the debt trap in its 2005 guidance for federally insured banks partnering with payday lenders.<sup>191</sup> The guidance stated that "[w]hen a customer has used payday loans more than three months in the past twelve months, institutions should offer the customer, or refer the customer to, an alternative longer-term credit product that more appropriately suits the customer's needs."<sup>192</sup> Consumer advocates criticized both the FDIC guidance and the more aggressive state restrictions on excessive renewals

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Members and Dependents, 71 Fed. Reg. 70,512, 70,512 (proposed Dec. 5, 2006), available at <http://www.responsiblelending.org/payday-lending/policy-legislation/regulators/MLA-DOD-FINAL-2-5-07-A.pdf>.

189. Consumer Financial Protection Act of 2010 § 1027(o), Title X of Restoring American Financial Stability Act of 2010, Pub. L. No. 111-203 (codified at 12 U.S.C. § 5517).

190. Florida, for example, established a credit reporting database for payday borrowers and restricted "rollovers," i.e., new loans to repay old loans, while imposing a sixty-day "grace period" for repayment for troubled borrowers. Spector, *supra* note 183, at 116.

191. See FDIC, *supra* note 186.

192. *Id.*

and overborrowing as insufficient to prevent the serious borrower harm caused by payday loans.<sup>193</sup> Small-loan regulation will persist in its incoherence until (1) there is some agreement on the norms to be applied, (2) we agree what costs and benefits to measure, if cost–benefit analysis is the norm, and (3) adequate empirical study of the costs and benefits has been completed.

#### *VI. The Role of Law and Regulation in Fostering Beneficial Credit for the Poor*

The microcredit experience of the past twenty years in developing nations demonstrates that “mechanisms matter,”<sup>194</sup> i.e., the success and the benefits to the borrowers of small loans depends on credit product design as well as the uses to which the credit is put. The experiences in Bangladesh, South Africa, and Boliva, among others, also show that deregulation is a necessary but not sufficient condition for welfare-improving credit for the poor. In fact, the result of unregulated markets, as shown by the examples of South Africa and Bolivia, is quite the opposite. Credit products that do not amortize, that are not appropriately limited in amount, and that provide no insurance against income shocks may tend to drive out more welfare-enhancing products.

The empirical evidence shows that unrestricted lending and borrowing leads rather predictably to debt overhang and traps the poor in a cycle of borrowing to service past debt. Moreover, payment of interest, especially above-market interest, has negative distributional consequences, transferring income away from the poor. Beneficial microcredit and small-loan credit have observable and distinguishing characteristics, and the challenge for the law is to devise credit regulation schemes that will foster credit with these characteristics while minimizing the boom-bust cycle of overindebtedness and the tendency of bad credit to drive out good credit.

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193. *Hearing Before the Ohio S. Comm. on Fin. & Fin. Insts.*, 127th Sess. 5–7 (Ohio) (statement of Uriah King, Legislative Associate, Center for Responsible Lending), available at <http://www.responsiblelending.org/payday-lending/policy-legislation/states/king-ohio-payday-testimony-05072008.pdf>.

194. Morduch, *supra* note 5, at 1572.

To foster welfare-enhancing credit, regulation needs to address the risks faced by low-income workers and entrepreneurs: the risk of overborrowing and the risk of catastrophic events that lead to default. Overborrowing risk may be mitigated through credit-product design (e.g., requiring amortization) and requirements for lenders to assess repayment ability properly. Default risk and the costs it imposes on borrowers could be mitigated by the development of suitable credit insurance products.

The Grameen Bank's success has not been dependent on a rule of law model; while the bank has a legal charter, the terms of its loans to borrowers and the means for enforcing repayment are largely extra-legal. Its success has been due in part to somewhat unique circumstances in Bangladesh that have prevented market entry by less socially directed banks and lenders. Nevertheless, credit regulation should be informed by several key aspects of the Grameen Bank model that contrast with the forms of lending to the poor that led to failure in South Africa and Bolivia, among others.

First, the Grameen model implicitly incorporates several key principles of responsible lending to protect against the risk of overborrowing. Loan amounts start small, with repayment required over a relatively short time period and, more importantly, always with amortization of principal. Loan amounts increase only as long as payment is made. In a study of low-income credit card borrowers in the United States, participants identified mandatory amortization over a fixed time period and the ability to choose a credit limit as desirable features of credit products from the standpoint of their own desire for self-control measures.<sup>195</sup>

Second, insurance against the various disasters that predictably befall the poor is critical to the Grameen model. This feature can be mimicked through regulation encouraging or mandating linked savings programs or fairly priced life and disability insurance.<sup>196</sup> Unfortunately, credit insurance products in the United States have been plagued by excessive cost and

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195. See Littwin, *supra* note 28, at 485–88.

196. See MICHAEL A. STEGMAN, SAVINGS FOR THE POOR: THE HIDDEN BENEFITS OF ELECTRONIC BANKING 121–51 (1999).

very low loss ratios because of various market failures.<sup>197</sup> Another form of insurance is the Grameen Bank's policy of always renegotiating and modifying repayment terms, while still mandating continual repayment of principal and interest, when borrowers get into difficulty. Regulation could require reasonable workout terms for low-income borrowers, as the Federal Housing Administration (FHA) mortgage loan program now does for at-risk home loan borrowers in the United States.<sup>198</sup> The 2005 FDIC guidance for payday lending included a requirement that lenders assist borrowers who were unable to begin principal repayment within a given time period by offering an installment payment plan at a reduced interest rate.<sup>199</sup>

Indeed, many of the emergency needs that prompt the poor to borrow in the first place would be better met with reasonably priced savings or insurance products. The microfinance movement explicitly recognizes this by promoting not only microloans for the poor but also the more comprehensive provision of financial services.

Thus, the small-loan programs most likely to improve the welfare of the poor have the following characteristics:

- Responsible lending based on credit reporting: Loan amounts are limited based on repayment ability, and repayment ability is carefully assessed at initial loan and renewal stages. Borrowers in repayment difficulty have reduced access to additional credit. Credit reporting is comprehensive so that any lender should know the amount and terms of outstanding debt a potential borrower is already carrying. While borrowers have legitimate privacy concerns about credit reporting, there is no effective way to prevent overindebtedness without comprehensive credit reports.

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197. See RENUART & KEEST, *supra* note 181, at 369–76.

198. *Loan Modifications: Are Mortgage Servicers Assisting Borrowers with Unaffordable Mortgages? Hearing Before the Subcomm. on Hous. and Cmty. Opportunity of the H. Comm. on Fin. Servs.*, 111th Cong. 4–6 (2009) (statement of Vance T. Morris, Director for Single Family Asset Management, U.S. Department of Housing and Urban Development).

199. See FDIC, *supra* note 186.

- Insurance and default mitigation: Borrowers are forced to insure against default-triggering events through, for example, emergency loan pools. The Grameen Bank lending model requires borrowers to set aside a small portion of loan proceeds for an emergency fund to provide for repayment or additional loans when group members face default due to unexpected events.<sup>200</sup> Many other insurance mechanisms are possible, but the need for insuring poor borrowers against unexpected events triggering default is evident.<sup>201</sup>
- Mandatory but flexible principal repayment: Loans are always amortizing; that is, however small the payment, it is designed to repay interest and principal within a reasonable time period, and balloon or negative amortizing payments are not allowed. Most microfinance institutions have preferred to require frequent periodic (typically weekly) payments. One study has shown that such frequent payment schedules are not necessary to ensure low default rates among poor borrowers, and indeed costs can be effectively reduced with a monthly payment schedule without increasing the risk of nonpayment.<sup>202</sup> On the other hand, regular and frequent contact between loan officers and borrowers is a common feature of microlending that increases repayment rates and limits overborrowing. Nevertheless, considering successful microcredit programs with the debt trap experienced by U.S. payday borrowers, one can see

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200. Morduch, *supra* note 5, at 1585–86.

201. As Iain Ramsay has pointed out, another approach is to adjust contract rules, to treat unemployment and similar events that prevent loan repayment as force majeure and excuse nonpayment, i.e., deprive creditors of legal enforcement of debts, thus requiring lenders to insure against these events. See Ramsay, *supra* note 35, at 195.

202. Erica Field & Rohini Pande, *Repayment Frequency and Default in Microfinance: Evidence from India*, 6 J. EUR. ECON. ASS'N 501, 503, 507 (2008), available at [http://www.hks.harvard.edu/fs/rpande/papers/repayfreqjea\\_1107.pdf](http://www.hks.harvard.edu/fs/rpande/papers/repayfreqjea_1107.pdf).

the utility of limiting repayment periods and requiring principal amortization.

- Product differentiation based on use: While no microcredit or consumer loan program can prevent borrowers from squandering their loan proceeds or compel them to make income-producing investments, the fact remains that the use to which loan proceeds are put will often determine whether the borrower will be better or worse off as a result of the loan. In the Grameen Bank model and similarly inspired microcredit programs, some borrower training or counseling is provided, and the use of the borrowed funds is somewhat constrained or guided, with preference for either entrepreneurial investing to produce income or acquisition of capital goods such as housing or durable goods. Loans for emergencies are offered, but loans for chronic consumption shortfalls are discouraged or denied. Direct regulation of how loan funds are used is neither likely nor desirable. On the other hand, credit regulation can and should make distinctions among credit products recognizing the differing consumer welfare impact of, for example, loans for housing or business creation compared with loans for short-term consumption needs. Borrowers use some U.S. payday loans for emergencies, but most are used to pay living expenses or other debts.<sup>203</sup> United States consumer protection and usury laws already differentiate to some degree between business-purpose and consumer loans, usually by excluding the former from consumer protection law coverage.<sup>204</sup>

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203. Martin, *supra* note 6, at 608–09; Brian K. Bucks et al., *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, FED. RES. BULL., Feb. 2009, at A45.

204. See, e.g., Truth in Lending Act, 15 U.S.C. § 1603(1) (2007); see also Laurence M. Katz, Comment, *Usury Laws and the Corporate Exception*, 23 MD. L. REV. 51, 51–66 (1962) (detailing the history and reasons for a corporation's inability to seek relief under the usury laws).

- Reasonable and transparent pricing: Grameen Bank established its interest rate (20% per annum) based on social, rather than profit, criteria.<sup>205</sup> For small-loan credit to benefit the poor, interest rates and fees must remain below the likely welfare gains borrowers obtain by borrowing. In a regulated and competitive market, the regulator's role will be not to dictate or limit pricing but to limit complexity, maximize clarity in advertising and contract forms, and monitor market pricing to respond to rent-seeking and exploitation. In markets where pricing exceeds likely welfare benefits, regulation should stigmatize the products as risky and promote better alternatives.

### VII. Conclusion

Once we observe that more small-loan credit is not necessarily better, i.e., that indefinite expansion of loan volumes does not obviously improve the individual or aggregate welfare of borrowers (or lenders, for that matter), the task of the regulator becomes clear. First, we need a set of tools with which to evaluate the benefits and harms of small-loan lending, including the choices and opportunities such loans potentially offer, as well as the deprivation and misery that repayment and default can impose. To that end, I propose borrowing from the human development approach. Existing research offers some promising, albeit partial, measurements of credit benefits, such as investment in income-producing activity, consumption smoothing, and protection from emergency shocks to income and consumption. As for the costs and harm side of the equation, a credit regulator can begin to provide important measures by conducting periodic empirical and comprehensive surveys of interest rates, as well as all other charges and fees and other terms of small-loan credit, as the South African regulator has done.<sup>206</sup> To complete the picture on the costs

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205. Morduch, *supra* note 82, at 245.

206. See, e.g., PENELOPE HAWKINS, FEASIBILITY LTD., PRICING OF AND ACCESS TO CONSUMER CREDIT: A REVIEW OF THE IMPACT OF THE NATIONAL CREDIT ACT ONE YEAR AFTER ITS IMPLEMENTATION (2009), available at <http://www.ncr.org.za/publications/Pricing%20and%20Access%20Summary%20Cover%20June%202009.pdf>.

side, considerably more research is needed to measure and weigh the variety of harms caused by debt default and distress and the rate at which default or other bad outcomes occur for given credit products and markets.<sup>207</sup>

Second, we need to consider the range of potential interventions, including both *ex ante* regulation but also *ex post* debt relief measures like bankruptcy, which are beyond the scope of this Article. Regulatory strategies certainly must consider displacement and substitution effects, i.e., the risk that reducing the supply of harmful credit may cause borrowers to turn to even worse products. This quick survey of the experiences of different nations with small-loan credit is not intended to propose definitive conclusions. Nevertheless, some *ex ante* credit regulation strategies appear promising, including the broadest possible use of credit reporting with responsible lending rules that limit excess borrowing and reduce the risk of defaults, the provision of insurance or repayment relief in the event of catastrophe, and the requirement to always amortize principal in order to prevent debt spiraling. Obviously, a fact-based regulatory plan will include continuing measurement of the benefits and harms of small loans as they are actually taken up in real markets by real borrowers.

The approach of the 1930s small-loan laws in the United States was to link a liberalized usury regime for small loans to consumer protections, including caps on loan amounts, and restrictions on problematic terms such as balloon payments in order to ensure that the resulting credit was beneficial. This schema may simply need to be updated in recognition of what has been learned through improved empirical research in deregulated markets in the United States and around the world. The next generation of credit laws and regulations needs to recognize and encourage the loan product design features that deliver genuine welfare improvements for lower-income borrowers while discouraging rent-seeking exploitation, debt spiraling, and further impoverishment.

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207. See Caskey, *supra* note 168, at 36–37 (suggesting the use of randomized experiments and ethnographic studies of individual consumers to better understand welfare effects of payday lending); Porter, *supra* note 57, at 56–61 (describing various “dimensions for future empirical research”).