

LAW, INSTITUTIONS AND ECONOMIC DEVELOPMENT: EXAMINING THE DEVELOPMENT OF THE HOME MORTGAGE MARKET IN INDIA – CAN TWO WRONGS MAKE A RIGHT?

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Abstract

There is a vast literature examining the interactions between law, institutions and economic development, but it only occasionally examines *how* actual markets in emerging economies have developed and transitioned to relying on legal institutions. This paper addresses that question by examining the puzzling growth of the formal home mortgage market in India from the mid 1990s onwards. Enforcing a mortgage and foreclosing on property in the Indian courts were, until very recently, lengthy affairs with a typical case taking between 15 to 20 years to resolve. These delays, along with other factors, made writing mortgages unattractive for banks and led to a trivial home mortgage market until the mid 1990s. However, from about 1994 to 2003, and before any mortgage law related changes took effect, the home mortgage market in India grew quite impressively. This paper examines what led to this growth and finds that, amongst other things, banks in India relied on “dysfunctions” in the criminal justice system to help overcome dysfunctions in the civil justice system for enforcing mortgages. Quite simply, perhaps two “wrongs” might make a “right”? In particular, in house departments at banks relied on a provision that criminalized “bounced” checks along with the predictability and regularity of extortion by the police to enhance their ability to obtain payments for mortgages and other kinds of debts (e.g., car loans, student loans). Although this aided the growth of the home mortgage market, it also resulted in substantial negative collateral effects by enhancing corruption and worsening adjudicative delays in India. Indeed, the “bounced” check strategy came to represent one of the largest areas of litigation in India. However, once the mortgage market started growing the banks pushed for law changes around 2003 that facilitated the continued expansion of the market, but reduced the need to rely on the “bounced” check strategy, which was becoming costly for banks. This account of the development of the home mortgage market in India not only tracks the incentives faced by the players and highlights the improvisational aspects of this market’s growth, but also has implications for a number of areas of research. This includes insights on the interactions between law, institutions and economic development; how institutional change or transition might arise in some contexts; and the role of private ordering, and key players like in-house lawyers, in market development. These insights in turn facilitate the emergence of a richer and more textured approach for exploring the interactions between law, institutions and economic development.

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I. INTRODUCTION

The interactions between law, institutions, and economic development have garnered a great deal of research interest over the last few decades. A central question in this literature is what comes first – better law and institutions or greater economic growth? Some scholars argue that better law and institutions facilitate economic growth in many ways, with a number of studies highlighting the law’s role in protecting property rights and enforcing contractual obligations.¹ Others argue that causation runs in the opposite direction (from development to law) with greater economic growth creating the impetus and political support for enacting laws and better institutions.² This debate, however, has generally involved only limited examination of *how* the development of actual markets takes place. Yet, the process of development is of great importance because, in many instances, this is where apparently well-designed reform efforts fail. Moreover, emerging markets have often experienced

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¹ See North and Thomas (1973), North (1981, 1989a, 1989b, 1990, 1991, 1994, 2005), Acemoglu (2004, 2008), Acemoglu and Robinson (2012), Acemoglu, Johnson and Robinson (2002), Ang (2016).

² See Lipset (1959), Inglehart and Welzel (2005).

growth before reforms were enacted or fully implemented. This suggests that greater understanding of the process of development and the role of the law is important in developing richer and more nuanced theoretical frameworks and policy prescriptions. In addition, understanding how development occurs is important in exploring how institutions and markets *transition* from one state of affairs to another and what may facilitate or impede that process.³ Further, examining the process of development may provide important insights on the roles of key players, and private ordering more generally, in the growth and emergence of markets.⁴ This paper explores these issues by examining the development of the formal home mortgage market (HMM) in India during a key transitional period from about 1994 to 2003.

The analysis suggests that the development of this market was more complicated and improvisational than either of the standard law and development accounts noted above indicate, but still reflected the incentives the players faced. The formal HMM in India languished for many years because of a cocktail of problems ranging from inadequate financing for the housing sector, issues with land titles, challenges in making credit risk assessments, and difficulties in enforcing mortgages and foreclosing on property in India. Indeed, enforcing a mortgage could typically take around 15 to 20 years in the slow moving Indian judicial system. This would have substantially reduced the attractiveness of a mortgage for a bank or other lender. In spite of this decades long malaise, and few legal changes addressing mortgage enforcement or land titles, the HMM in India started to grow in the mid 1990s. Indeed, legal changes arose, or became effective, only in the mid 2000s when the HMM had already increased, conservatively, by around 1000% (albeit from a small base). Although the HMM continued to grow after the law reforms in the mid 2000s, that still leaves the early growth of the HMM (from about 1994 to 2003) in need of greater explanation. That is the starting point for my inquiry.

However, because there is little extant data on what steps were taken by banks and lenders, I conduct a series of semi-structured interviews with legal officers and collection officers in the home loans (or home finance) groups at the major Indian banks during the relevant time period (1994 to 2003). This provides

³ See, e.g., Greif (2012), Greif and Laitan (2004), Ang (2016), Wallis (2005); Milhaupt and Pistor (2008); Acemoglu, Egorov and Sonin (2012).

⁴ See, e.g., Ellickson (1991), Bernstein (1992), Greif (1989, 1993, 2006), Feldman (2006), McAdams (1997), McMillan and Woodruff (2000), Milhaupt and West (2000), Richman (2004, 2016).

us with a better understanding of how and why these players became more comfortable entering the HMM. The key interview findings are that although there were important market changes (e.g., more young urban professionals seeking housing loans), the in-house departments of mortgage lenders increasingly utilized a strategy that relied on some criminal law provisions to enhance the likelihood that borrowers would pay.

In particular, lenders would regularly require that, at the beginning of the mortgage, borrowers sign post-dated checks for all the mortgage payments over the life of the mortgage and give them to the lender. If the borrower failed to honor any of those checks, then that would amount to a “bounced” check, which in 1988 became a criminal offense via Section 138 of the Negotiable Instruments Act 1881. Lenders would then take steps to initiate a criminal case. Of course, even these cases would take some time to wind their way through the Indian Judicial system (and the perceived likelihood of conviction was low), but they could be used to impose a series of costs on borrowers including harassment, inconvenience, and an increased likelihood of having to pay extortion or bribes to police officers. This made defaulting on a home mortgage loan less attractive. Thus, lenders relied on dysfunctions in the Indian criminal justice system to address problems (weak mortgage enforcement) related to dysfunctions in the Indian civil justice system. Simply put, perhaps two wrongs made a right.

Although the HMM grew, reliance on the Section 138 “bounced” check strategy generated substantial collateral effects. In particular, at their peak, the number of Section 138 cases (which included check bouncing for mortgages and other kinds of debts) represented around 15% of *all litigation* (civil and criminal) in the Indian courts. It seemed like Section 138 had become the primary method of debt collection in the formal sector. This astonishing number of cases significantly contributed to the delays in the Indian judicial system and served to further worsen police corruption.

However, this was not the final scene in the growth of the HMM. By the early 2000s there were moves afoot to enact new laws that made it easier for secured creditors (such as mortgage lenders) to enforce their mortgages and foreclose on property in a timely matter. Although these laws were hardly global “best practices”, they were supported by banks and other lenders and came into effect around 2003. This raises the question of why lenders would lobby for a new law if use of Section 138 was sufficient to obtain their ends. Interviews indicated that lenders found Section 138 useful at the beginning of the

growth in the HMM, but as the market grew reliance on Section 138 presented some problems. In particular, the staggering number of Section 138 cases led to (i) increased judicial delays which affected banks in their other litigation, (ii) intense pressure within in-house and collections departments which were unable to keep up with these suits and their other increasing compliance obligations, and (iii) increasing concerns that police were starting to demand payments from lenders (i.e., banks) to initiate and pursue such cases. This last point would have raised additional corruption concerns for Indian and Foreign lenders, which were subject to both Indian and foreign anti-corruption laws (e.g., the Foreign Corrupt Practice Act 1977). The combined effect of these concerns and the need to scale up the market seemed important in leading to the push for these new laws.

With these new laws there was less need for secured lenders to rely on Section 138. Indeed, as the HMM has continued to grow we now witness bank general counsels in India calling for the de-criminalization of Section 138. This is quite an intriguing development, which underscores the transitory nature of the reliance on Section 138. As new laws were enacted the key players started moving away from Section 138 so much so that now they would prefer to have it de-criminalized so that the delays it causes in the general judicial system (which affects these lenders too) can be reduced.⁵

The remarkable use and then turnaround on Section 138 raises a number of fascinating issues – many of which are discussed in the paper. In this Introduction I focus on just a few.

First, the HMM in India provides an example of how development actually occurs. This research details the improvisational nature of the early development of the HMM in India and how that was followed by more formal legal changes. This suggests that there may be multiple stages in the developmental process – first, an early growth phase where players improvise by relying on existing tools and structures (or informal norms) to attempt to obtain growth and then, if the first stage appears successful, moves to change towards more formal structures to enable greater growth. One reason for this is that in the early growth phases there may be considerable uncertainty about whether the market will grow, what laws might work best, what enforcement structures are appropriate, whether people will comply and at what cost. This uncertainty may

⁵ This has elements of the argument in Greif (2006) about certain systems sowing the seeds of their own destruction.

result in legislators, regulators, and others being unwilling to invest the time and resources to create or implement such structures. Thus, involved parties may find they need to rely on existing tools used in interesting ways. If the market does grow then one can imagine that legislators and others might consider it worthwhile to explore what types of laws and institutions may be useful in helping the market to grow further and invest in creating and implementing them.⁶

This resembles how speculative economic and political ventures tend to develop – early stages are improvisational and appear to involve a great deal of “muddling” through, but once there is some measure of success (or “proof of concept”) then people may become inclined to invest to scale up and grow further.⁷ This also suggests the process of development requires more on-going vigilance than appears to have been discussed in the literature thus far. Indeed, this presents a more back-and-forth or iterative vision of the interaction between law and development. In light of this, it would be valuable to explore other settings where markets appear to have grown and how that happened as that may provide us with greater information about managing the crucial transitional phases in development.

Second, the development of the HMM provides an example of lawyers (the in-house departments at lenders) facilitating the growth of a market. The important role of in-house counsel illustrates how these “transaction cost engineers” can play a critical role in market development.⁸ Although this is interesting by itself, it also opens up a window to examine what the development of the HMM may tell us about private ordering. Much of the private ordering literature examines markets or situations where close-knit communities, social norms and reputational mechanisms are important, such as whaling,⁹ property

⁶ The multi-step development process has analogs in the development experiences of other countries and at different times in history. See Milhaupt and Pistor (2008) discussing examples in the US, Germany, Russia, South Korea, China, and Japan, Ang (2016) discussing examples in China, Greif (1993) discussing examples in medieval Mediterranean trade, and Wallis (2005) discussing examples in the 19th Century United States.

⁷ For works exploring incremental reform, “muddling” through, and informational cascades see, e.g., Acemoglu and Jackson (2015), Sunstein (2014), Lindblom (1959), Bikhchandani, Hirshleifer and Welch (1992). For research on institutional and political change see Acemoglu, Egorov and Sonin (2012).

⁸ This phrase comes from Gilson (1984).

⁹ See Ellickson (1989).

disputes,¹⁰ diamond markets,¹¹ and organized crime.¹² This has then led to the debate often being framed as a choice between markets driven by norms versus those driven by rule of law.¹³ The HMM in India provides an example that seems to sit somewhere along a continuum between these two extremes. It represents an example of a market developing due to a form of private ordering that relies on an inappropriately (or poorly) functioning state player (the police) without the typical close-knit communities witnessed in the private ordering literature. It represents a hybrid that is likely to be all too common in many emerging economies and provides us with a way to examine when different points on the continuum between reliance on norms and reliance on rule of law may prove important to understanding, and spurring, market development.

The paper begins in Part II by describing the evolution of the HMM in India until 1994 and focuses on what factors hampered its growth. Part III explores the development of the HMM between 1994 and 2003 through a series of semi-structured interviews with participants in the banks and lending agencies during this critical time period. In particular, this Part examines the increase in housing demand and the use of the Section 138 “bounced” check strategy to enhance the likelihood of payment. Part IV explores the development of the HMM after 2003 by focusing on the new laws enacted and made effective around 2003. These new laws did not require reliance on Section 138, but still benefited the HMM. In particular, this Part examines why lenders began to support new laws when the Section 138 approach seemed to be working and why the 2003 reforms came when they did. Part V discusses the implications that this case study may provide for a number of areas of scholarly inquiry. Part VI concludes.

II. THE DEVELOPMENT OF THE FORMAL HOME MORTGAGE MARKET IN INDIA UNTIL 1994

The formal HMM in India is now a star performer registering a growth rate of roughly 15% to 20% per year over the last few years (Pandey and Shah (2014), Thakur and Antony (2012), Mohanty (2013), National Housing Bank (NHB) (2013)). Indeed, the HMM has grown spectacularly since 1994 with India’s mortgage-to-GDP ratio now sitting around 10% - which reflects a rise of

¹⁰ See Ellickson (1986, 1991).

¹¹ See Bernstein (1992), Richman (2016).

¹² See, e.g., Gambetta (1993, 2009), Milhaupt and West (2000).

¹³ See Davis and Trebilcock (2008).

over 2000% (NHB (2013), Tiwari (2012)). Although still quite small by global standards and focused primarily on urban environments,¹⁴ the HMM's stunning rise has made it the envy of most other banking and financial products (Pandey and Shah (2014), Thakur and Antony (2012), NHB (2013)).

However, this was not always the case. As recently as the early 1990s the formal HMM was largely moribund and had been for decades (registering a mortgage-to-GDP ratio of somewhere between 0.33% to 0.50%)(NHB (2013)).¹⁵ Indeed, the most recent treatise on Mortgage Law in India is, *still*, from 1877 (Ghosh (1877)). To understand how this turnaround occurred it is important to explore why the HMM was so weak in the first place and what steps had been taken to try to improve it.

Although there has been a persistent shortage of housing stock in India since its Independence in 1947 (Joshi (2006)), the anemic state of the HMM was largely due to difficulties in obtaining home loan financing. In light of this, and the well-known concerns that arise when people do not have housing, policy reform efforts have been targeted at trying to increase the amount of available financing (NHB (2013)).

In particular, the Government of India created entities in the 1970s which were tasked with supporting the housing sector. The Housing and Urban Development Corporation (HUDCO) was to assist lower income households in obtaining financing to purchase a home and the Housing Development Finance Corporation (HDFC) was to assist moderate to higher income households in purchasing a home. Although these entities had some moderate success in raising financing, the HMM barely grew until the early 1990s (Tiwari (2012), NHB (2013)). During this time, lenders were reluctant to provide financing for purchasing a home and when they did they would frequently charge very high interest rates (above 17% per annum) and would rarely provide a loan for more

¹⁴ The mortgage to GDP ratios of other countries are substantially higher with the US near 65%, Western Europe in the 45%-50%, range and East Asia ranging from about 20% to 30% (NHB (2013), Tiwari (2012)).

¹⁵ With such a low level of penetration the housing stock in India is substantially underprovided and leads to a host of well-documented problems. In light of this, encouraging the housing market is an issue on which the Government, development agencies and banks have been attempting to make progress. These percentages of course reflect only formal financing for homes and not the role of informal finance. *See* Joshi (2006). For general discussions on growth in India see Basu and Maertens (2007), Kochhar, Kumar, Rajan, Subramanian and Tokatlidis (2006), Kotwal, Ramaswami, and Wadhwa (2011).

than 33% of the total value of the home (Tiwari (2012), Interview Respondents (IR) # 3, 6, 7). Thus, if a typical home cost 1,000,000 Indian Rupees (INR) the lender would probably provide up to INR 330,000 at a very high interest rate and a short repayment schedule with the borrower having to arrange for the other INR 670,000 either from personal savings or from family, friends or other informal sources. This situation, unsurprisingly, led to little growth in the formal HMM and a typical age for a borrower being in their 50s (an age when people might have accumulated larger savings).¹⁶

There were a number of reasons for lenders' reluctance, but the primary ones related to difficulties in enforcing mortgages and challenges in assessing credit risk. First, if a borrower defaulted then enforcing a mortgage in a timely manner (i.e., obtaining the property subject to a mortgage) was a lengthy process. This was due, in part, to the delays in the Indian civil justice system and to problems associated with land titling in India. These concerns left lenders with little effective legal recourse. Second, credit risk assessment was very difficult prior to the mid 2000s because there were no credit rating agencies and information about individuals' income and net worth was opaque.

Although these issues are explored in the next few sections, it is noteworthy that these twin concerns did not necessarily impede the informal credit markets in India in the same way. Informal credit is well known in India and generally relies on the lender being intimately familiar with the borrower and his (and his family's) financial position (Timberg and Aiyar (1984), Munshi (2010)). This aids in assessing credit risk. Moreover, this proximity also provides the lender with ways to shame and otherwise sanction the borrower for failure to pay. However, this level of familiarity works to also limit the scope of informal

¹⁶ These low amounts of loans relative to the value of the property (usually called low "loan-to-value" ratios) would have made the HMM unattractive to borrowers too. It probably appeared simpler to just save a little more rather than work with a bank or mortgage lender.

It is also noteworthy that tenants were quite protected in India (for a recent discussion see Besley, Leight, Pande, and Rao (2016)) so that tenants might be able to afford to wait to save enough money for purchasing a home on their own given that the chance of eviction or significant rent increases were low. This situation may be changing soon as the Government of India has proposed substantial reforms to the Tenancy laws (Das Gupta (2015)). Further, the prevalence of large multi-generational housing at this time would have reduced the immediate need to seek out your own home.

credit markets so that they tend to be very local and thus limit the amount of credit available (Timberg and Aiyar (1984), Munshi (2010)).¹⁷

A. *Delays in Enforcing Mortgages in Indian Courts.*

It is well known that the Indian judicial system is plagued with delays, but those delays seem especially pronounced in cases involving property or contracts and mortgages involve both (Khanna (2016)).¹⁸ A lender from the formal sector would have had to enforce a mortgage at this time by relying primarily on Section 69 of the Transfer of Property Act 1882 (ToP). Although this section allowed for the sale of property (in case of default) without court intervention, it was severely limited by its own terms (Mulla (1985)). For example, if either the lender or the borrower were a “Hindu, Muhammadan or Buddhist [or a member of any other race, sect, tribe or class from time to time specified in this behalf by [the State Government], in the Official Gazette]” then Section 69 would not be available. This excludes well over 95% of the Indian public from using Section 69.¹⁹

If Section 69 of the ToP was not available, then lenders had to go through the court system to obtain a court order to foreclose on the property, seize it and sell it. Given the problems with land titling and ownership in India (discussed below) and the general delays in litigation this meant many lenders could expect lengthy delays in enforcing a mortgage against a defaulting borrower.

Land titling was challenging because even though land law varies state by state in India, most states do not have a binding land registry system (Anant and Mitra (1998), Banerjee and Ayer (2005)). Thus, in many instances the way that a person proves she owns a parcel of land is by showing a deed with her name as the owner on it. If a dispute should arise the court is to determine whether that deed is valid (Sinha (2009), Anant and Mitra (1998)). Some of these deeds may

¹⁷ Fisman, Paravisini, and Vig (2016) discuss the role of cultural proximity even in the formal lending sector.

¹⁸ There are many Law Commission of India reports discussing the delays and concerns raised by them (No. 14, 79, 124, 230 and 245 to name just a few).

¹⁹ It appears that Section 69 of the ToP may be of benefit to people of British (or non-Indian) origin, the British Crown as lender, or people purchasing property in the British presidencies or affiliated parts of the Subcontinent. This seems to underscore the fact that the ToP was legislation enacted during the colonial era.

Alternatively, to rely on this provision the mortgagee (the lender) had to be the Government or the property had to be in certain cities only.

date from quite some time ago (e.g., during the British Raj) and sometimes there may not be a deed. Without a deed the courts may have to rely on receipts for payment of taxes or dues that typically accompany being a property holder as proof of ownership. Worse yet, even if there was a deed it may not provide much detail on the boundaries of the property because substantial parts of India are not precisely surveyed (Sinha (2009)). All these concerns would serve to lengthen adjudication in an already delay-ridden system.

Further, other factors related to ownership claims in India would have exacerbated these effects. For example, under Indian law people can hold property for the benefit of their joint family (the Hindu Undivided Family (HUF)), which bears some similarities to a joint tenancy.²⁰ Holding property in this manner is fairly common given the ubiquity of multi-generational households in many parts of India during this period. This is problematic because, for example, to alienate land held by a HUF may require obtaining the approval of all those entitled to inherit or operate the land. Given weak land records this provides an opportunity for people to claim an interest in land based on an alleged (though often undocumented) inheritance claim or based on oral statements (or promises) made between members of an extended family. When a purchaser buys land in such a situation there is a risk that the transaction will be challenged by a person who claims (i) the property was really held on behalf of a HUF (or grew out of HUF assets), (ii) that he is a member of the HUF, and (iii) that his approval for the transaction was allegedly not obtained thereby making the transaction invalid.²¹ These concerns would also plague someone who

²⁰ See Orenstein and Micklin (1966-67), Seth and Gandhi (1984). Another type of ownership structure that causes problems is the “*benami*” transaction which is a transaction where one person (say X) pays the consideration for some property, but that property is listed in another person’s name (say Y) without an intent to benefit Y. This was commonly done to evade taxes, park unaccounted for money, evade creditors, avoid discovery for other reasons (e.g., political perception) or sometimes just because of superstition. This was not an uncommon method of holding land (Banerjee and Ayer (2005)) prior to 2003 (the period of interest for this paper). “*Benami*” transactions were officially prohibited with the enactment of The *Benami* Transactions (Prohibition) Act 1988, but its operation was stalled due to procedural issues and weaknesses in the drafting of the Act. In 2011 the Government of India proposed another Bill (the *Benami* Transactions (Prohibition) Bill, 2011) to address these issues. Information on compliance with the 1988 Act or with the general drive to remove *benami* transactions is either not available or incomplete.

²¹ Studies also indicate that family business structures in India can serve other beneficial purposes (e.g., reducing the risk of bankruptcy because families will support firms that are failing in their business group to avoid the stigma of bankruptcy). See Khanna and Yifeh (2007). This

believes they have a security interest in the land as a result of a mortgage because enforcing the mortgage will involve transferring the land and addressing these sorts of claims.²²

These types of issues led to it taking around 15 to 20 years to foreclose on a property and, given that the typical mortgage might be for 20 years, this would have made it unattractive for lenders to rely on mortgages (Tiwari (2012), IR # 2,4-9, 11). Moreover, even if you were exceptionally patient and willing to wait until a favorable judgment you might be rewarded with the property, but still be left bearing a fairly hefty charge for court fees (a fee charged for using the court to enforce some of your rights) which tended to increase with the amount claimed.²³

One might respond that as long as the courts eventually enforced the mortgage and allowed the lender some appropriate interest then lenders should have been willing to enter the fray. Although possible in theory, this did not eventuate in reality for a number of reasons.²⁴

First, such lengthy delays meant that lenders had funds tied up in the property for a very long time making them unavailable for other potentially profitable purposes.²⁵ The longer the delay the larger this cost. Of course, this might have been ameliorated to some extent if the Indian courts granted “pre-judgment” interest (interest from the date the suit was filed not from when it was adjudicated). Although Indian courts have the power to allow for such pre-judgment interest, it is rarely granted.²⁶

does not always require the presence of a HUF. Moreover, HUFs in the land context are often not family businesses where the concerns of reputation might act as a countervailing consideration.

²² One might wonder why there has not been a movement to address these concerns. In fact, multiple attempts have been made to clarify title (and some are on-going), but implementation has been challenging and often there are market intermediaries who may find the current state of “confusion” important to their business model. *See* Mamidi (2013) on certain market intermediaries in Indian land markets. *See* also Section 44 of the Transfer of Property Act 1882 for additional rules regarding transfers of co-owned land.

²³ *See* The Court Fees Act 1870.

²⁴ The reasons listed below are part of a larger project examining the problems raised by delays in India’s justice system (Khanna 2016).

²⁵ *Cf.* Bernstein (1992), Richman (2016), Feldman (2006).

²⁶ For criminal or non-monetary sanctions, this is more difficult to address. A 10 year jail term that could have been granted in 2020 may carry a different impact if granted in 2040 to the defendant, victim and the state.

Second, delays in adjudication tend to weaken the accuracy of decision-making (Khanna (2016), Kaplow (1994)). Delays may lead to evidence becoming stale or witnesses forgetting details, which tends to reduce the accuracy of decision-making. This is particularly problematic in property disputes where issues of inheritance (often unwritten) and boundaries (often un-surveyed) arise and the primary evidence is witness testimony. As accuracy declines the lenders who are trying to secure property subject to a mortgage are less likely to obtain the property. This reduces the deterrent effect of the law and can be expected to increase the amount of defaults.

Third, the delays (and resultant decline in accuracy) add uncertainty and make it more difficult to come up with appropriate estimates of the expected value of bringing a civil suit (e.g., predicting the probability of success is more difficult).²⁷ This means that it becomes more complicated to price the risk of lending as the outcome range is expanding.

B. Credit Risk Assessments

Another key problem was that assessing credit risk was very difficult at this time (Tiwari (2012)). The core reasons for this were that (i) many individuals and businesses had opaque financial statements due to the presence of a large informal sector, the preponderance of family businesses, and efforts to avoid paying high taxes, and (ii) there were no credit rating agencies.

Many Indians had very opaque finances. Given high tax rates for much of Post-Independence India's history it is not altogether surprising that individuals and businesses would try to hide income from the authorities to avoid having it

²⁷ The lower probability of conviction in criminal matters is noticeable in India as studies have found a conviction rate of around 30% to 35% as compared to the US, UK or Japan where conviction rates hover above 90% (NHB (2013), Tiwari (2012), Tiwari and Debata (2008)). Khanna (2016) argues that the lower probability of conviction can become a breeding ground for corruption because one can imagine police bringing cases to extort money from individuals and then dropping them once the police are paid without raising great suspicion. If the conviction rate was higher then cases that are initiated but do not result in a conviction are more likely to attract closer scrutiny than when conviction rates are low. Moreover, bribing police officers and prosecutors to drop meritorious cases is more likely when conviction rates are lower for essentially the same reason as extortion is more likely. The added problem of corruption is often overlooked when discussing some of the problems caused by delays. Indeed, corruption is often only thought of as being a cause of the delays rather than also a result of them (see Aida (2009), Rehn, et al (2011)). Corruption and delays likely interact in complicated ways with each other. See Khanna 2016.

taxed.²⁸ This would have made it more difficult for banks to estimate someone's assets and collateral. This was compounded by the fact that much of the Indian economy was in the informal sector where document trails and transparency were less common and less cost-justified (RBI (2013), Mohanty (2013)). Finally, the dominance of family business in India would have added an additional layer of opacity. This is because people in a family business are often concerned about attempts to break up (or partition) the family business (usually by other family members to obtain their "share"), which is often one more factor that leads them to devise convoluted and difficult-to-follow ownership structures (Khanna and Yafeh (2007), Gopalan, Nanda and Seru (2005), IR #2, 3, 5, 8, 10). If ownership structures are difficult to understand for family members (who presumably know something about each other) then they are likely to be difficult to fathom for outsiders like lenders.

Finally, the absence of a credit rating market during this time would have only worsened these problems. These agencies were not present because the law at this time required the permission of the borrower to aggregate credit information in the manner necessary for a credit rating agency (Tiwari (2012)). Such permission was not likely to be forthcoming if the borrower was trying to obfuscate ownership of assets to avoid taxes or make the break up of a family business more difficult. Combining these factors would have made credit risk assessments for large lenders quite difficult.

In light of these concerns, it is hardly surprising that banks did not grant many mortgages. Moreover, even when banks did occasionally grant mortgages their in-house and collections departments were reduced to relying on subtle ways to pressure borrowers into paying. Interviews suggested that once a borrower had not paid a regular installment the lender's staff would start a process of trying to first ascertain the likely cause of the failure to pay and then work towards a negotiated outcome (IR # 2, 3, 6). Lenders would frequently remind borrowers of the social opprobrium and shame that might accompany a default and how it might harm their social standing which would be relevant for other business transactions and social engagements, such as arranged marriages (IR # 2, 3, 6, 11). Moreover, it was common practice that lenders would not grant a mortgage unless the borrower could obtain a personal guarantor for the loan (IR # 2, 3, 4). Although such guarantors were unlikely to have to pay on such a personal guarantee even if the borrower defaulted (because of delays in the court system), the pressure such guarantors could bring (because they knew the

²⁸ See Jain (1987) and Anant and Mitra (1998).

borrower) was substantial (IR # 2, 3, 4). In particular, the guarantor could, because of her close relationship with the borrower, inform the lender about better ways to pressurize the borrower into paying (IR # 2, 3, 4). However, respondents all indicated that these costly and often unreliable methods further discouraged them from aggressively targeting the mortgage market.²⁹

III. EARLY STAGES OF GROWTH IN THE HOME MORTGAGE MARKET (1994 – 2003)

In spite of these many weaknesses, the formal HMM in India began to grow at an impressive rate from 1994 to 2003, without major reforms to the mortgage laws or secured credit laws. During this period the mortgage-to-GDP ratio increased from around 0.33% or 0.5% to 3% or so – about a ten-fold increase (albeit from a low base) (NHB (2013), Joshi (2006), Tiwari (2012)). This actually underestimates the growth because India's GDP also grew during this time. In addition, the amount of loaned funds provided as a percentage of the home value increased dramatically to around 80% of home value (compared to about 33% prior to 1994) (Tiwari (2012), IR# 3-7, 9, 11). This impressive growth without mortgage law reforms begs the question: why did growth occur in these years?

One of the important changes that impacted the mortgage market was India's decision to begin a more focused Liberalization effort in 1991 following a balance of payments crisis (Krueger (2002), Kochhar, Kumar, Rajan, Subramanian and Tokatlidis (2006)). The economic changes unleashed by Liberalization propelled a number of people to move into urban India. This had multiple effects on the home finance market.

First, the influx of people led to dramatic increases in home prices making home purchases a more attractive market for lenders. Second, the people who were moving to the urban environments were primarily younger people working in salaried positions with corporate and public sector entities (Tiwari (2012), NHB (2012), IR # 1 – 11). This meant that their finances were more transparent than the cohort of individuals prior to Liberalization. Further, many of these individuals were not active members of family businesses and because they were salaried individuals there was less scope for them to be receiving unaccounted for money. This in turn led them to be more willing to provide accurate information on their financial situation (NHB (2013), IR # 1 – 11) thereby

²⁹ Banks might have considered relying on organized crime to enforce mortgages. None of the respondents indicated that this was common. Further discussion of this is found at *infra* note 42.

making credit risk assessment easier.³⁰ Third, compared to non-urban areas, land titling in urban environments was by and large better. This is a relative statement – there were (and are) many issues with land titles in urban environments, but they appear to present fewer problems than the rural environment (Banerjee and Ayer (2005)).³¹ Fourth, Liberalization involved lightening restrictions on foreign investment in India, including into the housing and home finance market, as well as permitting domestic banks to use more of their funds for home lending (Tiwari 2012, Mohanty (2013), NHB (2013)). This led to more capital being available for the home financing market (although this did not necessarily mean it would be used).

The combination of these factors made the home mortgage market more attractive, but did not, by itself, make it easier to ensure payment of mortgages. The Government of India did enact a new general debt recovery law (the Recovery of Debts Due to Banks and Financial Institutions Act 1993 – the “1993 Act”) that applied to all debts and which envisioned relying on newly formed Debt Recovery Tribunals (DRTs) to speed up collections, relative to the courts, by streamlining and reducing some legal procedures. However, this law ran into a number of Constitutional challenges and its full implementation was delayed until the early 2000s.³²

Thus, in the mid 1990s lenders were faced with a home mortgage market that was palpably ready for substantial growth, but did not have an effective

³⁰ After Liberalization began economic growth started to blossom with more and more people leaving the villages and moving into the cities (Tiwari (2012), NHB (2013)). This urbanization often meant that families were separated and that they became smaller leading to a need for more (and smaller) homes. In addition, the urban areas often were congested leading to another constraint on large families being able to move in. Thus, post-Liberalization there was an increase in younger urban professionals with smaller families seeking housing. This led to a large increase in demand for housing in the cities.

³¹ In addition to titling issues, land in India often has use restrictions – frequently land owned by a farmer can only be used for agricultural purposes unless its purpose can be converted (a lengthy and difficult process) or there may be land ceilings. See Banerjee (1999).

³² Among some of the key arguments that led the Delhi High Court (which is one level below the apex Supreme Court, as all High Courts are) to declare the 1993 Act unconstitutional were that it did not allow for a counter-claim and that it harmed the independence of the judiciary by restricting the jurisdiction of the civil courts and vesting it in the DRTs. See *Delhi High Court Bar Association v. Union of India & Anr*, AIR1995, Delhi 232. After nearly 7 years (2002) the Supreme Court of India heard the appeal, but by that time the Government had made substantial amendments to the 1993 Act that addressed the key Constitutional concerns raised in the Delhi High Court. The Supreme Court thus upheld the 1993 Act in 2002. See *Union of India & Anr v. Delhi High Court Bar Association*; AIR 2002 SC 1479.

mechanism for enforcing mortgages given the delays with the 1993 Act. This might have stymied the growth of the HMM, but in-house departments at lenders became quite creative. In particular, respondents suggested that lenders found a way to credibly threaten borrowers with negative consequences if they failed to pay even with a weak civil justice system.

This began with lenders exercising some care in selecting borrowers (e.g., relying on more transparent finances) and offering them a mortgage for a 20 year term with monthly payments. Lenders would then require the new borrower to sign post-dated checks for all monthly mortgage payments and give them to the lender on the day the mortgage was approved (i.e., 240 checks in this example because there are 12 monthly payments per year times 20 years). If the borrower's check(s) did not clear when presented then the lender could initiate a claim under Section 138 of the Negotiable Instruments Act 1881 (i.e., for "bounced" checks), which was added in 1988 and carried with it a one year prison sentence.³³ The criminalization of "bounced" checks was not, however, the result of lobbying by the home finance industry, but rather the result of deep and long-standing concerns that individuals were issuing (and "bouncing") checks, which predated Liberalization by many years (Law Commission of India (LCI) Report No. 11 (1958)).³⁴

Interview respondents consistently indicated that this Section 138 "bounced" check strategy started being utilized at a much faster pace in the mid 1990s because there appeared few alternatives to enhancing the likelihood of repayment (IR# 1-11).³⁵ However, these same respondents did not think it likely

³³ In 1988 the Government of India enacted The Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988, which inserted a new Chapter XVII into the 1881 Act comprising Sections 138 to 142 including the one year criminal penalty for "bouncing" a check. The criminalization of this was intended to bolster confidence in the check system (LCI (1958)). In 2002 the Indian Parliament further strengthened the bounced check penalty to 2 years in prison if convicted. *See* Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002 (55 of 2002).

³⁴ Delong (2003) argues that India's economic growth began to improve around the early 1980s which was before Liberalization in 1991 began. Nonetheless, the concern with bounced checks pre-dates this too because the first discussion of attempting to address bounced checks stems from the late 1950s. *See* LCI (1958). The concern was that these individuals appeared confident that payee would face lengthy delays (judicial and others) in coming after the payor for failure to pay. In response, the law was amended in 1988 to criminalize bounced checks on concerns that the check writing system was under increasing stress.

³⁵ The respondents were not sure when exactly Section 138 started being used in the context of home mortgages (perhaps that will remain shrouded in the mists of time) but most

that the borrower would be convicted or that a criminal adjudication decision would happen quickly (IR # 1-11). This is borne out by the extant data indicating that conviction rates were quite low (as is common in criminal matters in India) and criminal cases – while moving faster than civil cases – would still regularly take 5 or more years to be resolved (National Crime Records Bureau (NCRB)(2013)). In light of this, a natural question arose as to why in-house departments thought the threat of a distant low probability conviction would motivate borrowers to pay when borrowers stood to gain large amounts of money as house prices raced upwards?³⁶

Respondents indicated that for some borrowers even this distant low probability outcome would be sufficient to induce payment (perhaps due to a fear of spending any time in jail and stigma concerns), but for the majority the *process* of going through the criminal justice system was so costly that it would induce many to pay (IR # 1-11). Elements of the process that seemed to have this effect were the inconvenience associated with having to appear in court (or more likely to seek delays of the case to stretch it out to 5 years) and the embarrassment and social stigma that might attach if people thought you were not paying your debts (IR # 1 – 11). However, further discussion with the respondents made it clear that an important cost was the cost associated with dealing with the police.

When a criminal matter is commenced in India the police are often involved (e.g., serving an initial summons or warrant)³⁷ and interacting with the police as the matter progresses is fairly common (e.g., later summons or warrants informing the borrower about the next hearing date).³⁸ These interactions with the police carry costs both in terms of delay (e.g., getting to work late because of being served a summons at home), embarrassment (e.g., being served at work by a uniformed officer) and the costs associated with paying (i.e., bribing) the police to leave and allow you to continue on your day (IR # 2, 3, 5 – 11). As one respondent said “the police in India might think their time spent in serving a

seemed to recall it by the mid 1990s and of course it could not have been before 1988 when bounced checks were criminalized.

³⁶ For information on the growth in the Indian housing market see National Housing Bank’s Residex, available at: http://nhb.org.in/Residex/About_Residex.php as well as the National Housing Bank’s Annual Reports.

³⁷ See Khanna and Mahajan (2016) for a more complete description of the criminal investigatory and adjudicatory processes in India.

³⁸ Some of these matters may also be done in other ways (i.e., the borrower’s attorney may be informed of the next hearing date and then inform the borrower).

summons is quite valuable.”³⁹ Although such payments may not occur with every interaction, the possibility that they might would increase the costs of defaulting on the mortgage.⁴⁰ Moreover, for every new court date a new summons would arise thereby making delaying negotiating with the bank more costly over time. These payments, combined with the rest of the costs, generally make it more desirable for borrowers to simply pay the bank (or re-negotiate) rather than default and deal with the Section 138 process (or once they are in default to simply arrange to pay the bank).

Although the Section 138 strategy relies, in part, on what appears like extortion by the police, it is noteworthy that filing bounced check cases is not illegal by itself. Lenders are simply using rights granted under India’s law and the notion that they may anticipate police engaging in extortion as a key component in enforcing their rights is not per se illegal. Of course, if the lenders bribed the police to bring or pursue such actions that would be illegal. Thus, the bounced check strategy relied on dysfunctional aspects of the criminal justice system (e.g., police behavior, extortion-like payments, delays) to address problems created by dysfunctional aspects of the civil justice system (lengthy delays in enforcing a mortgage).

The bounced check strategy seems to have been commonly used across many kinds of loans (e.g., mortgages, car loans, application installment plans) with some respondents indicating that it would not surprise them if banks had filed tens of thousands of mortgage related claims in any given year (IR # 1, 2, 6 – 11)). However, there are some details related to the use of Section 138 that merit comment. First, are some operational details and second, some institutional features that made Section 138 quite effective.

When a bank (or other payee) wants to pursue a Section 138 claim for a bounced check they have to file a complaint with the police (often called a “First Information Report” (FIR)). The costs of filing this complaint primarily involve the time of the individuals in the in-house or collections department of a bank in forming the complaint, the time involved in contacting the police and any on-going follow up as the case progresses, and then any further effort should there be a trial. In addition, in India there are court fees for bringing suits, but typically criminal cases (such as Section 138 cases) have very small fees (e.g., INR

³⁹ IR #2. Other respondents essentially had very similar statements. See IR# 3-11.

⁴⁰ Of course, not every police officer serving a summons might expect (or be willing) to get paid, but what matters is that borrowers may think that many officers expect to get paid.

10). Civil court fees about the same underlying matter are substantially greater as they are based on the damages being sought.⁴¹ This suggests that each bounced check case in India would have been very low cost for the bank to pursue at this time (of course, the aggregate cost across thousands of cases would be larger). Indeed, such a low cost would have made it preferable to relying on organized crime or the “land mafias” to enforce security interests in land.⁴²

Further, some respondents indicated that they had heard that police officers often like to serve the first summons at the borrower’s home address (IR #1, 2, 4 – 7, and 10). This might appear desirable both because it provides the police with an opportunity to embarrass the borrower in front of neighbors (thereby imposing costs), but it also allows the police to assess the borrower’s standard of living, which may be useful in setting an extortion price. The police know the amount of the missed mortgage payment, which would probably be the upper limit on an extortion price. However, where between that amount and zero an extortion price should be struck might depend in part on what the borrower’s standard of living was.⁴³ Thus, a borrower could be living in a fairly fancy part of the city, but in a small apartment rather than a house and this might influence the extortion price.⁴⁴ Later visits by the police could occur either at home or the office, but office visits seemed particularly effective given that the presence of the police would be fairly embarrassing in front of the borrower’s colleagues and superiors.

A borrower might try to avoid paying the police, but that involves substantial risks. This is because the police might just stay at your residence or office for a while and make your (or your family’s or colleagues’) ability to get on with the day more difficult. Further, refusal to pay might trigger the police into using their fairly broad arrest powers or otherwise lead them to harass the borrower (e.g., shouting epithets, visiting more often).⁴⁵ One might consider complaining about the police (or about demands for extortion payments) to other

⁴¹ See The Court Fees Act 1870.

⁴² See Weinstein (2008). Banks may also have been concerned about entanglements with organized crime because of the stigma from association and the possibility of having to provide further funds or other favors to these groups.

⁴³ This might not only include the specific residence, but also any information the police pick up from neighbors or others.

⁴⁴ The police may not need to serve the borrower at home in all instances to assess the borrower’s standard of living. Sometimes it is fairly easy to assess a person’s standard of living by their address or identity (e.g., movie stars) without visiting them.

⁴⁵ For a discussion of the arrest powers of Indian police see Khanna and Mahajan (2016).

authorities, but this is not without risk given the broad arrest powers of the police and general concerns about abuse of police power.⁴⁶

Of course, it might have been possible for the police and borrowers to strike a side deal where the borrower could offer the police some part of the value of the house in exchange for the police officer doing little to aid the Section 138 case. Although plausible, such a move is unlikely because there was no guarantee that every time a new summons was issued that the same police officer would be expected to serve it. Thus, a borrower could not be sure that such side deals would need to be made only once – that would have reduced the value of such deals.

In terms of institutional features, I begin with Section 138 being a “compoundable” offense under Indian law.⁴⁷ Compoundable offenses are offenses in which the complaining party (here the lender) can withdraw their complaint for whatever reason with no penalty (the most likely reason being that the borrower and lender come to agreement on re-payment). This means the prosecution would be dropped (i.e., “compounded”). This made Section 138 a useful method to enhance the likelihood of collecting on bounced checks.⁴⁸

Another institutional feature is the role of prosecutorial discretion. Prosecutors in India do have prosecutorial discretion in bringing cases, but they are generally expected to bring cases where there appears to be merit (this is usually present in bounced check cases brought by banks or mortgage lenders)

⁴⁶ See Khanna and Mahajan (2016). It is also noteworthy that often police officers do not ask for a bribe, but expect the individual to understand that a bribe or other payment is necessary (e.g., imposing delays on whatever the individual is seeking until payment is made).

⁴⁷ Section 138 was originally a non-cognizable offense (where the police cannot arrest someone without a judicial warrant) and a bailable offense (offenses for which after an arrest the police can grant bail themselves (without going to court) if sufficient bonds or sureties are provided). This is an accurate statement for the time frame being examined (1994 to 2003), but in 2006 the Government made Section 138 a cognizable offense (enabling the police to arrest the borrower without a court order). See Mahapatra (2006). For greater discussion of concerns with the police arrest power, especially for cognizable offenses see Khanna and Mahajan (2016).

⁴⁸ Compoundable offenses are crimes where the primary harm might be thought to occur between the victim and the perpetrator (and less to society). Classification of offenses into compoundable or not is governed by Section 320 of the Criminal Procedure Code of India 1973. Some compoundable offenses require the approval of the court before the offense can be compounded (Section 138 is not one of them). There are ways to make non-compoundable offenses useful for extortion, but they require more effort (i.e., cost) than compoundable offenses.

(Anant and Mitra (1998), Ratanlal and Dhirajlal (2010)). Moreover, there is little cost to prosecutors in bringing these cases.

First, many of these cases are likely to be compounded, which is something prosecutors anticipate so prosecutors likely do not invest much time and energy in these cases. Second, prosecutors are not generally assessed or promoted on conviction rates so they may find it expedient to bring cases and invest little effort in them.⁴⁹ Third, prosecutors generally do not run for elected office in India so there are few outside incentives to achieve high conviction rates. This must also be viewed against the background that failing to initiate a prosecution might generate public scrutiny or occasionally lead complaining parties to ask the court to run a prosecution.⁵⁰ Taking these all together prosecutors generally pursue cases that have a plausible basis but may not invest great effort in them at least until the full hearing dates (if they ever arise).

Finally, a few words about the police are important. Like prosecutors they too are not assessed on conviction rates and generally do not run for elected office. Further, they also probably do not spend much time and effort on bounced check cases given that it is a compoundable offense. Of course, the police often make the effort to serve a summons, but the police may be motivated to engage in this effort because they are likely to receive a payment when serving a summons, are thought to be underpaid, and seem unlikely to face any sanctions for such behavior.

These institutional details underscore why Section 138 was useful for obtaining payment for bounced checks. Indeed, Section 138 has been used so frequently for all kinds of debts that it has become one of the most, if not the most, frequently used provisions in India (Law Commission of India (LCI) (2008)). By the early 2000s, most High Courts in India (which are just below the apex Supreme Court of India) had three divisions – civil, criminal and bounced check – and bounced check cases represented around 13% to 16% of all cases in the Indian courts (with one firm reporting that it filed nearly 73,000 claims in one day)(LCI (2008)). These cases were so common and ubiquitous that some businesses sprang up which specialized in helping other firms file these suits in larger numbers (IR # 3, 4, 9, 10). Of course, these cases were not all, or primarily,

⁴⁹ For a broader discussion of prosecutors in criminal law in India see Khanna and Mahajan (2016).

⁵⁰ See generally Ratanlal and Dhirajlal (2010).

mortgages (many involved other kinds of debts paid using checks such as car loans or student loans), but home finance lenders clearly relied on this provision.

IV. REFORMS SUPPORTING GROWTH OF THE HOME MORTGAGE MARKET AFTER 2002

The use of Section 138 combined with changes in the economy were very important in explaining the growth of the formal HMM in India during the 1994 to 2003 time frame. However, from 2002 to 2004 a number of legal changes occurred, or became effective, that directly affected the trajectory of the HMM in India. Many of these were supported by banks and other lenders who benefited from the growth in the HMM. Before exploring these reforms, it is useful to begin with a preliminary question – why did banks and other lenders support these reforms if Section 138 was available and being used?

Although Section 138 facilitated the growth of the HMM early on, many respondents expressed concern with continued reliance on Section 138. In particular, respondents indicated that as the HMM grew the costs to them for relying on Section 138 also grew, which provided the impetus for seeking a better approach.

First, all respondents noted that usage of Section 138 in a growing market came with costs for the in-house department (IR # 1 – 11). Some respondents noted that by the late 1990s and early 2000s more than half the time of their in-house department was spent on managing Section 138 cases. Given that in-house departments at banks and other lenders were also facing rising compliance and regulatory burdens at this time that meant there was quite a lot of work for them and managing Section 138 cases was a challenge (IR # 1-3, 6-8, 10, 11). Of course, one potential solution was that in-house departments could hire more people to deal with the burdens. This strategy, however, suffered from a capacity constraint in the short to medium term. There were not many trained corporate lawyers in India at the time who could effectively work within a bank or other lender. Estimates of the number of people in the corporate legal profession in India today hover around 12,000 (for a country with a population of 1.25 Billion) and in the mid 1990s this number would have been quite a bit smaller (Wilkins, Khanna and Trubek (2016), Gupta, Khanna and Wilkins (2016)). This made it very difficult for in-house departments to bear the work of filing more Section 138 cases as well as keep up with their other work (e.g.,

compliance, contract drafting). These players would have had an incentive to look for other solutions.

Indeed, a number mentioned that they would attempt to outsource part of the Section 138 management process to firms that specialized in assisting banks and lenders in filing and managing these cases (IR # 3, 4, 9, 10). This, of course, came at some cost and still required the involvement of the in-house departments (though to a lesser extent than before). Moreover, even these outside firms were limited in their ability to scale up for the same reasons as in-house departments (i.e., not enough trained and knowledgeable people in the short to medium term).

Second, respondents expressed some concerns about how the growth in the HMM (and increased filing of suits) might influence interactions with the police. Respondents indicated they had heard that other lenders were concerned that police might also charge *lenders* some money to file a case, act on a complaint, or go in person to deliver a summons (IR # 1- 6, 8 – 11). A few respondents noted that they had heard that the police could place the bank's complaints at the top of their stack of things to do or somewhere else (IR # 1 – 6, 8 – 11). Respondents noted that such payments would probably be illegal (as corruption) and would also squeeze margins in the HMM.⁵¹

Finally, some respondents indicated that the courts were also dismayed with the number of Section 138 cases. One respondent said the "Bombay High Court communicated to us that it [the Court] was not our collection agent and we should find other ways to increase collections." (IR # 6).

These costs of using Section 138 appeared to make it a less appealing strategy as the HMM continued to grow. In other words, reliance on Section 138 might have been a useful short-term strategy when the market was beginning to grow, but not when the market was growing quickly and expanding its base.

⁵¹ Once the police demand payments from the banks then this looks much more like an extortion racket run by organized crime. Indeed, one suspects the relatively cheaper cost of relying on Section 138 in the mid 1990s made it an attractive alternative to banks compared to relying on organized crime or "land mafias" (Weinstein 2008) to enforce their security interests. Of course, there may be other reasons for the banks to prefer filing legally permitted claims rather than relying on organized crime (e.g., one is permitted by law, the other forbidden; concerns with entanglements with organized crime).

In light of this banks and lenders supported reforms to improve their ability to enforce mortgages and foreclose on property. The most effective of these various reforms has been the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI).⁵² To better appreciate the significance of this new law it is important to note that it does at least two important things.

First, it makes it easier for secured lenders (i.e., banks and financial institutions) to recover pledged property in case of default.⁵³ Section 13(1) permits secured lenders to enforce a security interest (e.g., a mortgage) without court intervention if the conditions in Section 13 are satisfied. The primary conditions are that the borrower has defaulted on the loan, that the lender has given the borrower notice that she must pay within 60 days, and the borrower has failed to do so.⁵⁴ The Supreme Court of India has held in *Mardia Chemicals v. Union of India*⁵⁵ that the lender must also meet standards of natural justice including giving the borrower the right to be heard and a chance to pay before any action under Section 13 is taken.⁵⁶

If these conditions are met then the lender can take the measures provided in Section 13(4) which include: taking possession of the property and leasing or selling it, taking over management of that part of the borrower's business that related to the pledged property, appointing someone to manage the property, and potentially seeking recovery from third parties who purchased the pledged asset before the lender could secure it. These broad powers can be exercised without court intervention thereby significantly easing the process of foreclosing on property within a matter of a few months.

The borrower can challenge the lender's activity by bringing suit in the courts or other fora on fairly limited grounds. Indeed, as recently as March 2016 the Karnataka High Court held, consistent with the Supreme Court of India's decision in *Kanaiyalal*,⁵⁷ that the courts would not interfere unless there was

⁵² See Narasimhan Report II (1998); Pasricha (2007).

⁵³ See Section 2(1)(zd).

⁵⁴ Another condition is that the borrower must fit within the definition of a non-performing asset under Section 2(1(o)).

⁵⁵ (2004) 4 SCC 311.

⁵⁶ See *id.*

⁵⁷ *Kanaiyalal Lalchand Sachdev v. State of Maharashtra*, (2011) 2 SCC 78.

something seriously amiss.⁵⁸ Overall, the general sense is that Section 13 has made it considerably easier for banks to either enforce (or recover much of the value of) their secured credit of which mortgages are a key example (Pasricha (2007), IR # 1 – 11).⁵⁹

Second, SARFAESI also attempted to spur development of the securitization market in India. Securitization generally involves a party (the “originator”) taking a series of assets (in this case mortgage claims) and placing them in a separate entity – called a special purpose vehicle – and then raising capital by issuing securities in the separate entity. Thus, a bank might take the amounts owed to it in many mortgages (with a total face value of say \$100 million) and put them in a separate entity called an asset recovery vehicle (ARV) and then issue securities in ARV. The amount raised would reflect the anticipated value of these mortgages accounting for the likelihood of collection, its timing and the likely cost. Let us assume, reflecting these concerns, people are willing to invest \$80 million in the ARV at most. That is then the amount the originator recovers (less any fees for securitization) which enables the originator to extract some value from such mortgages. The people who purchase the ARV’s securities may believe they can collect more than \$80 million because they have better or more effective methods of collection compared to the originator.

Thus far, the securitization market in India has been growing somewhat but the general sense is that SARFAESI has not done much for the growth of the securitization market because other market factors seem to have mattered more.⁶⁰ However, the presence of the securitization option would most likely make the HMM a more attractive market for lenders.

Although SARFAESI was subject to Constitutional challenge, it was held to be Constitutional with some amendments and went into effect fairly quickly.⁶¹ This stands in contrast to the reception and effect of the 1993 Act – which

⁵⁸ See *M/s. Deepak Apparels Pvt. Ltd. v. City Union Bank Ltd.*, 2016 SCC Online Kar 686, decided on 22.03.2016.

⁵⁹ Reducing non-performing assets was one of the key goals of the Narasimham committee reports that lead to SARFAESI (Narasimham Reports I (1991) and II (1998)).

⁶⁰ See Pasricha (2007), Vij (2013), Wells and Schou-Zibell (2008).

⁶¹ See *Mardia Chemicals v. Union of India* AIR 2004 SC 2371. The Court held that SARFAESI did allow for the borrower to raise objections to the lender’s activity under Section 17 of SARFAESI, but that the condition that the borrower had to deposit 75% of the alleged claim to proceed under Section 17 was arbitrary and unreasonable. The deposit requirement was struck down, but the rest of SARFAESI was held to be Constitutional.

established Debt Recovery Tribunals (DRTs) as specialized and fast moving debt recovery adjudicators.⁶² The 1993 Act's nationwide implementation was delayed until the early 2000s due to a series of Constitutional challenges. Even after the early 2000s, most accounts of the DRTs suggest that they have also fallen prey to the same forces that cause delays in the Indian courts (Tiwari (2012), Unny (2011)).⁶³

The differing fates of SARFAESI and the 1993 Act merit some brief commentary. When the 1993 Act was enacted India was still in the early phases of the Liberalization process and most banks at that time were owned by the state.⁶⁴ This meant that the 1993 Act would have applied primarily to state run banks thereby weakening the position of the individual vis-à-vis the state right after a Balance of Payments crisis arising under heavy state management of the economy. This might have appeared like the state was benefitting from its own mismanagement. Second, the 1993 Act would also have applied to the fairly new, and small in number, private banks (or privatizing banks) that could have been viewed with suspicion by some as might the Liberalization program more generally.⁶⁵ Indeed, one can imagine some degree of resistance or skepticism to such a law and also that the proponents of the law may not have had the base of political support then that they likely had later in the Liberalization process when its success seemed more clear. Further, the 1993 Act tried to limit the role of the courts in the debt recovery system by creating a separate tribunal (the DRTs) to hear these matters, which would have had fewer procedures. This

⁶² There was also the National Housing Bank Act 1987 (NHBA), which was designed to help financing get into the home mortgage market. Its provisions were designed to speed up the process for bringing a civil suit to enforce a mortgage or to allow for the lender to sell the mortgaged property with limited court intervention. However, the NHBA was available for only a handful of lenders and the general sense is that the NHBA had limited effect on speeding up civil mortgage matters for most lenders (Tiwari 2012). This has led to further attempts at reforming the law – see The National Housing Bank (Amendment) Bill 2012.

⁶³ This is not to suggest that the DRTs had no impact. Visaria (2009) shows some improvement in general debt markets, but nothing that appears to target the HMM or other secured credit sectors.

⁶⁴ See Austin (1999), Muraleedharan (2009), Chakrabarti (2006), Reserve Bank of India (2016).

⁶⁵ The debates on the direction, magnitude and effects of India's Liberalization programs are quite active. See, e.g., Bhagwati and Panagariya (2013), Drèze and Sen (2013), Goswami (2013), DeLong (2003), Aghion, Burgess, Redding and Zilibotti (2008). It is perhaps worth noting that collecting on non-performing assets can raise other types of political issues (e.g., are politically favored groups receiving the loans that are not being paid back), but I do not discuss those here for reasons of brevity.

might not have been received with aplomb by the judiciary or by attorneys who might have felt that some of their livelihood was being threatened.

The situation, however, had changed by the time of SARFAESI's enactment in 2002. India now had more private banks, more experience with these banks, a growing housing market, and a greater base of support for this sector than at the time of the 1993 Act. Moreover, SARFAESI was considerably more targeted (and hence limited) than the 1993 Act because it focused only on secured credit, required the creation of no new institutions (such as the DRTs), did not officially reduce the role of the courts or attorneys and was not advertised as something related to debt recovery, but rather appeared aimed at enhancing a type of financial transaction (i.e., securitization). Both the ground reality and the optics for SARFAESI were very different than for the 1993 Act. Undoubtedly, this influenced the reaction to it.

This also raises the question of why parties did not try the Section 138 strategy earlier than they did or why SARFAESI was enacted when it was or more generally why did the factors leading to the development of the HMM occur when they did. Section 138 could not have been used before 1988, which is when it was enacted. It was not the home mortgage industry that lobbied for this section but rather people concerned with the payments system (also, the HMM was nearly non-existent at this time). Banks could have tried Section 138 soon after it was enacted (e.g., early 1990s) but one suspects that the possibility of the 1993 Act being enacted might have led banks to focus on that rather than search for improvisational methods like Section 138. However, after the 1993 Act was stalled the players in the various debt markets would have been motivated to find alternatives to enhance debt recovery or else face the prospect of not being able to service India's fast growing demand for more formal mortgage credit markets. This is about the time that the banks started using Section 138 more often for mortgages. Given that Section 138 worked well for banks for a few years that would have made it less valuable to the banks to lobby for further law reforms. However, by the turn of the millennium the costs of Section 138 (to the banks) was rising and it is not that surprising that we find attempts to create other methods for recovering secured credit such as SARFAESI.

Once SARFAESI was enacted the ground realities began to change. Mortgages created after SARFAESI came into effect (circa 2003) would be subject to Section 13 and its quicker recovery provisions, while mortgages granted before then were largely left to the DRTs, the fairly nascent securitization market,

and the old reliable Section 138 bounced check strategy. Given that most mortgages in India run for 15 to 20 years one might expect to see the use of Section 138 in the HMM beginning to diminish in only the last few years as the mortgages in existence at the time of SARFAESI's enactment would be beginning to wind down over the last few years thereby changing the mix of mortgages towards those arising after SARFAESI came into effect.

In addition to the legal reforms represented by SARFAESI, there was the development of a credit rating system in India in the early 2000s (called Credit Information Bureau (India) Limited (CIBIL)),⁶⁶ which was aided by the relaxation of the restrictions on sharing of credit information.⁶⁷ It is, perhaps, a measure of the success of SARFAESI and CIBIL that in the last year or so some bank in-house counsels have started suggesting that Section 138 should be decriminalized (Firm (2015)).⁶⁸ In part, this is because the mortgage or debt enforcement function associated with Section 138 is increasingly being overtaken by SARFAESI as more and more secured loans fall within its ambit. Moreover, for banks – which have many matters pending in litigation – reducing one of the largest areas of litigation in India (Section 138) may be beneficial because it will reduce the delays they face in addressing their other matters.⁶⁹

V. INSIGHTS FROM THE GROWTH OF THE HOME MORTGAGE MARKET

The growth of the HMM in India described here provides a number of insights into multiple areas of scholarly inquiry. This Part begins, in Section A, by examining the implications of this account for the debate on the interactions between law, institutions and economic growth. Section B then explores what insights the growth of the HMM provides about private ordering and the role of key players in the development process. Section C discusses what the development of the HMM suggests for other issues such as the impact of corruption and the role of foreign players, amongst others, in market development.

⁶⁶ For more information on CIBIL (which is controlled by TransUnion) see <https://www.cibil.com/>.

⁶⁷ See Tiwari (2012).

⁶⁸ It is plausible that increasing creditor protections may result in lenders being more willing to lend, but might also lead some borrowers to be wary of borrowing. See Vig (2013).

⁶⁹ Another potential benefit to debt recovery is the recent enactment of Bankruptcy Reform in 2016 in India. Its implementation will likely ease debt recovery further.

A. *Interactions Amongst Law, Institutions and Growth*

The HMM in India provides an example of where a market can develop when the law and its enforcement are weak. The ingenuity demonstrated underscores the often improvisational nature of development when working in a weaker rule of law environment (Ang 2016). This has implications for one of the major debates on the interaction between law and economic development – whether law or growth comes first. One school of thought argues that better law and institutions lead to economic growth (North and Thomas (1973), North (1981, 1989a, 1989b, 1990, 1991, 1994, 2005), Acemoglu (2004, 2008), Acemoglu and Robinson (2012), Acemoglu, Johnson and Robinson (2002)). They argue that better institutions enable greater protection of property and contract rights thereby incentivizing economic activity. On the other hand, another school of thought argues that causation runs in the opposite direction – better economic growth leads to better law and institutions (Lipset 1959, Ingelhart and Welzel 2005). Here the argument is that economic growth provides the incentives for the development, enactment and implementation of better law and institutions.

The growth of the HMM in India provides a more complicated story with some evidence in support of both schools of thought, but also evidence suggesting neither account provides a full picture. The HMM in India grew in a multi-step process – first, reliance on Section 138 in the 1994 to 2003 time frame (although with substantial negative collateral effects) and then enactment of SARFAESI in 2002, which had a role in facilitating growth after 2003. The Section 138-related growth is driven by reliance on various dysfunctions associated with India’s criminal justice process and policing practices rather than any “better” attributes of the law.⁷⁰ However, the SARFAESI-related growth might be treated as “better” law leading to growth, but even that is not without controversy.⁷¹ Moreover, the better law account does not address the sizeable collateral damage caused by the Section 138 strategy in terms of flooding the Indian courts with additional litigation thereby worsening the existing delays and also exacerbating police corruption.

⁷⁰ One could argue that “better” law may simply mean law (or a state organ) has an impact – in that sense the Section 138 strategy may be “better” but that does some violence to the concept of better laws and institutions discussed in North and Thomas (1973), North (1981, 1989a, 1989b, 1990, 1991, 1994, 2005), Acemoglu (2004, 2008), Acemoglu and Robinson (2012), Acemoglu, Johnson and Robinson (2002).

⁷¹ See Pasricha (2007); Rao (2012).

On the other hand, one might view the development of the HMM as being more in line with the “economic growth leads to better law” theories because it appears that the growth of the HMM from 1994 to 2003 aided in strengthening the constituencies that lobbied for SARFAESI (the “better” law). Although this is a fair summary of the forces leading to SARFAESI’s enactment, it does not provide a very complete explanation for the 1994 to 2003 growth. This growth appears to be the result of a mix of economic growth arising from Liberalization (which can be treated as law and policy changes) and the “creative” use of existing laws and dysfunctions to improvise a temporary solution to the problem of enforcing mortgages in the Indian civil justice system. Moreover, the “economic growth leads to better law” theories provide little accounting for the collateral effects of the Section 138 strategy.

Neatly categorizing the growth of the HMM in India into either school of thought is thus somewhat challenging. This is perhaps not too surprising because recent literature on economic development (and institutional change) in emerging markets suggests that the story of development is quite complicated and involves the law, institutions and growth often developing in an iterative “rolling” manner (Milhaupt and Pistor 2008), being endogenously determined (Greif and Laitin 2004), co-evolving (Ang 2016), being highly contextual while depending on the surrounding institutions (Greif 2012), and at times emerging in an *ad hoc* manner while taking advantage of institutional voids (Khanna, Palepu and Bullock 2010).

However, the “which comes first” debate is not the only matter of scholarly inquiry that may be impacted by the growth of the HMM. The multi-step development of the HMM may help to elucidate some common patterns in how institutions change or transition when there is substantial uncertainty about some of their effects. This has become a topic of considerable scholarly interest.

For example, Fernandez and Rodrik (1991) provide a model of how trade reform (and more generally any kind of institutional reform) can be stalled when uncertainty about the winners and losers is significant at the beginning or how reform might be reversed if its initial effects are less bountiful than anticipated. Relatedly, Acemoglu, Egorov and Sonin (2012) develop a dynamic model of reform, utilizing Markov voting equilibrium, to show that parties may oppose reform in the current period because they think there is a possibility of it leading to other reforms in later periods they may consider unattractive. The uncertain future effects of the reforms in later periods create a fear of a “slippery slope” of

sorts that might make elites reluctant to support reforms that are beneficial to them in the short run. Greif, Iyigun and Sasson (2012) approach the issue of uncertainty from a different vantage point by examining how social institutions can make other kinds of institutional reform more attractive by providing risk-sharing to assuage some of the downside risks of uncertainty from institutional change. In all these papers uncertainty can stall or hinder institutional reform.

Of course, if uncertainty can be reduced in some manner then its drag on institutional reform would be lessened. A multi-step process may provide a way to reduce uncertainty about institutional reforms. To examine this more fully I begin by summarizing the multi-step development of the HMM and then discuss how that might reduce uncertainty.

The multi-step process for the growth of the HMM can be said to begin in the early 1990s when there was virtually no HMM (except for a small one in the informal credit sector). Liberalization efforts and other economic reforms generated an increase in demand for home finance which, when coupled with a failure to implement debt recovery reforms, led to an environment in which examining new strategies, like the Section 138 bounced check strategy, was worthwhile and pressing for banks and their in-house departments. The Section 138 strategy contributed to the impressive growth of the HMM, but also generated sizeable negative collateral effects (e.g., increasing judicial delays and worsening police corruption). These collateral costs grew with the market and eventually led to a situation when banks (who were bearing some of these costs) again considered institutional reform to be a ripening opportunity. SARFAESI arose in this context in 2002 with support from a secured credit sector that was larger and more important than before. Although SARFAESI was hardly a model debt recovery law, it was enacted and quickly came to be a desirable method for secured credit enforcement.⁷² Increasing reliance on it and credit rating agencies has led banks to now move away from Section 138 and lobby for its de-criminalization.

The overall sense one gets from the development of the HMM is of the incremental and inter-dependent relationship between law and development – one appears to feed off the other and vice versa. Further, the multi-step process

⁷² In this sense SARFAESI is not a true substitute for the 1993 Act, but rather a workable solution to the problems faced by one sector (secured credit) in India given the institutional structures in place at the time. SARFAESI might be viewed as a second best solution in the given circumstances (Rodrik 2008).

witnessed in the HMM context seems consistent with development experiences in other countries (Ang (2016), Arewa (2012), Milhaupt and Pistor (2008)).⁷³ This raises the question – why does it seem common to have multiple steps in the process rather than simply adopting the later stage law (e.g., SARFAESI) at the start of the transition? Moreover, how does this reduce uncertainty?

Multiple steps may be common because in the early transition phases of a market it can be difficult, given the various uncertainties, to convince people to invest the time and resources needed to devise, enact and implement new laws or institutions. In emerging markets like India where many reforms have been tried and have failed one can imagine people being reluctant to expend (or invest) the resources for new laws and their enforcement until there is some proof that the market is likely to be profitable and to develop.⁷⁴ One way then to reduce uncertainty is for entrepreneurs to use existing tools to try to make the market grow (i.e., improvise) and show that this market can generate profits (i.e., “proof of concept”). If that is achieved then one can imagine that broader institutional reforms may become more attractive to other people. In such environments the early growth of markets may often involve improvisation using existing structures (such as the Section 138 strategy) or reliance on informal norms.⁷⁵

⁷³ Ang (2016) argues that China’s development was often the result of “directed improvisation” where the state gave local authorities some room to improvise (in a “directed” manner) and follow multiple pathways to development. Their experiences then informed the next stage of institutional reform. Also, the example of the development of the Nigerian Cinema Industry (Arewa 2012) also bears a similar multi-step process where weak intellectual property law and enforcement facilitated the growth of a market that later led to stronger laws and market growth. Greif’s (1993) description of how Maghribi traders organized their affairs bears a similar structure albeit with a much longer time frame between the development of the informal structures and the more formal structures. The multi-step processes seem similar to discussions about informational cascades ((Bikhchandani, Hirshleifer and Welch (1992)).

⁷⁴ This bears some similarity to the general literature on punctuated equilibriums, see Baumgartner and Jones (1993), Pierson (2004). Also, the reticence in investing in institutional development in the early stages seems related to the discussion in Dixit (2004), Milhaupt and Pistor (2008), and Davis and Trebilcock (2008).

⁷⁵ In the Chinese context Ang (2016) provides examples of “directed improvisation” with the directing occurring by the state. In India the HMM involves improvisation, but with little state direction. Milhaupt and Pistor (2008) discuss the “rolling” iterative manner of development via examples in the US, Germany, Japan, South Korea, China and Russia.

It is noteworthy that the “investment” in new law and institutions argument appears similar to those arguing that growth precedes institutional development. My account of the HMM suggests that this argument is important but that the relationship between growth and institutional development is not as linear as suggested in the growth-leads-to-institutions

Of course, not all improvisation leads to success and it can often generate large collateral effects (negative or positive) that may overwhelm it. However, if there is some measure of success then an opportunity may arise for considering whether greater institutional structure is worth pursuing. This will depend on a number of factors. For example, whether new institutional structures generate expected net benefits (i.e., incremental benefits less incremental costs, including costs to implement the new structures) that exceed the expected net benefits under the improvisational method. Further, the expected net private benefits must be distributed in a manner that they would induce sufficient constituencies to push for new institutional structures to develop and be implemented (North (1990)).⁷⁶ If these conditions are met then institutional reform may be likely to occur. This process may then repeat at some time in the future when there is another prospect for institutional reform.

Through this process we may witness institutional change over time in multiple steps and each step may generate information that is likely to impact the uncertainty associated with institutional reforms and their payoffs. Each step then becomes an opportunity to learn and potentially reduce uncertainty.

The multi-step pattern also seems similar to what one sees when looking at speculative ventures or start-ups. In the early stages there is a lot of scrambling and improvisation and if that results in something that is profitable (or likely to be) then one might find some investors and others willing to expend the resources to build structure and organization to facilitate more growth.⁷⁷ This suggests that the analogy between start-up ventures (relying in part on growth and organizational innovation) and developing new legal structures seems worthy of greater analysis.⁷⁸

literature. Indeed, the HMM account suggests the relationship is rather complex.

⁷⁶ Moreover, any collateral effects would need to be tolerable in both size and distribution so that they do not scuttle efforts at institutional reform.

⁷⁷ For general recent discussion see Taeube (2003), Lerner and Tag (2012), Jalonon (2012), and Bhide (1992). Iyigun and Rodrik (2006) develop a model of institutional change that depends on the entrepreneurial environment in a society that seems consistent with this sort of approach.

⁷⁸ Another intriguing question is: given that multi-step institutional reform can stall at one of the earlier steps (for a variety of reasons) might it be better to push for a fuller reform package all at once rather than taking incremental steps that might be stalled for very long periods of time. This is a difficult question to answer and goes beyond the scope of this paper's analysis. However, choosing between "big bang" reform and incrementalism has generated a wide literature. See, e.g., Murphy, Shleifer and Vishny (1992), McKinnon (1992), Woo (1994), Roland (2000).

None of this should, however, be taken to suggest that the resulting law or institutions will necessarily look the same everywhere or match a global standard quickly. This is because institutional reforms typically build on existing institutional structures that differ across places and hence may well look different even over time.⁷⁹

B. Implications for Private Ordering.

The HMM in India is also an example of how lawyers (in house attorneys at banks and lenders) can play an important role in market development and legal reform, albeit perhaps in unconventional ways. One could compare this to other instances where attorneys have played important roles in the development of markets or sectors to explore how these “transaction cost engineers” may be critical and often under-appreciated change agents.⁸⁰

In addition, one is also struck by how this example of private players being involved in market development seems different to examples in the private ordering literature. Much of the private ordering literature discusses how norms and reputational mechanisms amongst close-knit communities can supplant or supplement weaker legal regimes.⁸¹ These close-knit communities are able to acquire and share information to enable better monitoring of individuals and to coordinate behavior to engage in collective punishment of these individuals.⁸²

These discussions often lead to framing the question as a choice between market development being driven by norms (with little state involvement) or by

⁷⁹ If the speed of institutional reform increases with more reforms that suggests something of an informational cascade (see Bikhchandani, Hirshleifer and Welch (1992)). Of course, the speed of institutional reforms may not accelerate over certain time periods which may appear more like “muddling” through (Lindblom (1959), Lipset (1959)). North (1990) highlights these concerns of path dependence and uncertainty as well.

⁸⁰ The phrase “transaction cost engineer” comes from Gilson (1984). Some examples of corporate attorneys playing a role in development may be the role of New York Attorneys in curtailing corruption in the US in the late 1800s. See Carrington (2012) and more generally Wallis (2005).

⁸¹ See Bernstein (1992), Ellickson (1985, 1991), Gambetta (1993, 2009), Milhaupt and West (2000), Richman (2004, 2016).

⁸² An interesting twist on this is the discussion in Feldman (2006) about how the “Tuna Court” in Japan combines elements of state sponsorship and private ordering to create a fairly remarkable dispute resolution system for the purchase and sale of Tuna. The Tuna Court bears some resemblance to the initial functioning of stock markets.

rule of law (with little space for norms) (Davis and Trebilcock (2008)). The HMM in India does not appear to easily fit either account. It reflects an account of where an inappropriately functioning state organ (the police) is being used to counteract another poorly functioning state organ (the civil courts). Norms are relevant – in the sense that police forces have norms – but they are not the kinds of norms seen in close-knit communities that have traded with each other for centuries or with little state involvement. Instead, the HMM account seems to reflect a point on the continuum between reliance on norms and reliance on rule of law. Further, given that most emerging economies are probably somewhere along this continuum (rather than at the extreme ends) it seems important to examine other instances of this kind of market development to understand how markets in emerging economies often develop. Moreover, this kind of exploration may help in ascertaining when markets are likely to develop using particular combinations of norms and state behavior along the continuum.

Consider for example how one might compare the development of the HMM to extortion rackets run by organized crime. Although the extortionary behavior of the police seems akin to extortion rackets (albeit cheaper for the banks in the beginning), there are important differences too. Extortion rackets typically involve payments going into the organized crime syndicate's coffers, whereas the Indian police force is probably not sharing the payments it receives with the government fisc (or with senior police officers). Relatedly, extortion appears like a core element of organized crime and likely influences its internal structure, incentives and operations. However, even very cynical people would not consider extortion to be a core element of the police suggesting that the internal structure, incentives and operations of the police would not be set up to encourage this behavior. Indeed, in other areas of law where police related extortion is a concern, senior level Indian police officers have tried to curtail this type of behavior.⁸³ Further, the general absence of strong community, kinship or religious ties amongst most police officers suggests that these sources of norms are not as powerful as in organized crime.

Given these differences one might wonder why would players in the HMM prefer to rely on extortion by police rather than hiring members of

⁸³ See Delhi Police, Standing Order No. 330/2008. If senior level police officers benefited from such extortion one might expect to see the police encourage it more, but generally it seems that extortion might be thought to benefit only the lower level police officer rather than the higher level police officer the same way that certain corporate wrongdoing may benefit lower level employees more than C-suite level employees. See Khanna, Kim and Lu (2015).

organized crime groups to engage in extortion. In the context of the HMM, the initial choice may have been influenced by the fairly low cost to the banks of relying on the police and Section 138 in the mid 1990s and concerns about dealing with organized crime. However, as the cost of relying on the police increased then a closer comparison may have been warranted.

Studies suggest that organized crime is more likely the weaker the state and the stronger the norms within the crime syndicate (Gambetta (1993, 2009), Milhaupt and West (2000)). From this one might expect, all else equal, that police extortion is more useful when the state is not that weak and where strong norms are not as necessary. The Section 138 strategy seems to reflect such a mix – although the police are hardly perfect, their behavior is relatively predictable and the Indian state seems to function at the level of granting them substantial power and discretion. Further, it seems unlikely that there would be much need for many detailed norms with respect to implementing the Section 138 strategy. In such a context relying on the police could be preferred to attempting to work with organized crime where its relative advantages are limited and its relative costs might be large (e.g., hiring organized crime to extort for a bank is a crime, but using Section 138 is not). However, even this does not end the analysis because when the costs of relying on the police increased, the banks did not appear to turn to organized crime per se, but rather lobbied for a new law to address concerns with continued reliance on Section 138.

This kind of comparative institutional analysis may be useful in laying out what kinds of measures along the continuum between reliance on norms and reliance on the rule of law are likely to be chosen by the players and this in turn may influence policy development and implementation. Moreover, given that many emerging economies are already somewhere along the continuum between reliance on norms and on rule of law the kind of comparative institutional analysis suggested here may be useful and may merit further inquiry.

C. Implications for Other Research Questions.

The discussion in Sections A and B highlight two large areas of scholarly inquiry where the HMM account may make some contributions. But the HMM account may also inform other areas of scholarly inquiry. A few of these are listed below to round out the discussion, with greater discussion of them left to future research.

The development of the HMM is consistent with prior research suggesting that corruption can be useful for economic growth at early stages of market growth (because of the predictability it adds), but it is likely to be deleterious for further growth (Mendez and Sepulveda (2006), Aidt, Dutta and Sena (2008), Bardhan (1997)). Further, the HMM in India provides an example of how institutional weaknesses or “voids”, such as weak intellectual property protection or the absence of credit cards, might be overcome in emerging markets in order to facilitate business (Khanna, Palepu and Bullock (2010)). In particular, the HMM provides an account of how weaknesses in the debt enforcement system were first addressed and then improved upon. Yet another intriguing aspect of the HMM story is that not only were domestic players important in effecting change, but so were foreign players. The enactment of SARFAESI comes on the heels of greater foreign investment in banking in India and concerns that the Section 138 strategy might generate liability risks for banks (e.g., FCPA-like liability in their home country or corruption proceedings in India). Some respondents indicated that foreign banks were important in pushing for reforms such as SARFAESI (IR # 1, 2, 5, 7 and 8). This connects with the literature examining the role of foreign investment in aiding economic growth (Aitken and Harrison (1999), Balasubramanyam, Salisu and Sapsford (1999), Beck and Levine (2003), Carkovic and Levine (2002)). However, in the HMM example foreign players are important not just for the capital they may invest, but their potential direct efforts at influencing policy and legal institutional features.

VI. CONCLUSION

The interactions between law, institutions, and economic development have generated an immense scholarship producing a series of important theories. However, few have studied how development actually occurs which may be critical in obtaining a better understanding of the theoretical (and practical) connections between law and economic development. This paper addresses this by exploring how the HMM developed in India in a time frame (1994 - 2003) where there were no effective changes to mortgage laws.

The key findings are that critical players in the in-house departments of banks and other lenders improvised a creative strategy for overcoming the mammoth delays in enforcing mortgages in Indian courts. The in-house departments relied on what I have called the Section 138 “bounced” check strategy where they required borrowers to sign post-dated checks for the entire term of the mortgage at the beginning of the mortgage. If any of the borrowers’

checks did not clear that might generate a Section 138 claim, which carried with it the potential for a one year jail term. The in-house departments did not anticipate a serious chance of conviction and did not expect any adjudications quickly either, but rather relied on the cost to the borrowers of responding to Section 138 and the likely extortion by the police of the borrowers as ways to enhance the likelihood that borrowers would pay. When combined with changes in the underlying economy (more young people moving to urban areas to start professional jobs), this allowed for quite speedy growth of the HMM. However, it generated substantial collateral effects that led to increased police corruption and greater delays in the India courts due to the staggering number of Section 138 cases, representing at its peak almost 15% of all litigation in India (including both mortgage matters and other debts paid for by check). This might have continued for some time, but the Section 138 strategy became more expensive for the banks as the HMM grew because its collateral costs were increasingly being borne by the banks. This led the banking sector to support new laws that made it easier to enforce mortgages and to start moving away from the Section 138 strategy. The nimbleness and creativity demonstrated in the development of the HMM in India suggests a number of insights.

In particular, the multi-step pattern of development represented by the HMM in India (first improvisation using existing tools and then development of new laws and institutions that replace those tools) may provide a better description of how law, institutions, and economic development interact and why. Early stage markets are ones where people may not be willing to expend resources in building institutions until some indicia of profitability (or “proof of concept”) is provided. We might thus see a variety of improvisational techniques used before the laws begin to get reformed and then too the reforms are likely (at least initially) to proceed down paths that depend on prior institutional structures. In addition, the HMM case study also provides insights on a number of issues including the role of key private players, such as in-house lawyers, in economic and legal development and implications for our understanding of the role of private ordering. In particular, the account of the HMM in India suggests that we should explore more deeply institutional structures between the extremes of reliance on norms and reliance on rule of law in order to obtain a better understanding of many emerging markets, which lie between these extremes. Such greater inquiry is likely to enhance our understanding of the role of private ordering and the interactions between law, institutions and economic development. It is further inquiry in this space that I hope will be encouraged by this research.

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Appendix A

Requirements for a Successful Section 138 Case

A complaint against an individual whose check was not paid (i.e., bounced) would trigger criminal liability under Section 138 if the following requirements were met:

1. The accused must have submitted a check on a bank account maintained by him (a common strategy by payors is to misspell their name or signature which may lead to a bounced check).
2. The check must be in partial or full satisfaction of any debt or liability.
3. The check has been submitted for payment to a bank when the check is still valid.
4. The check is returned unpaid by the bank (i.e., it bounced) because of insufficient funds or it exceeds the amount arranged to be paid.
5. The payee (the person to whom the check was originally issued) must make a demand for payment (via notice in writing) within 30 days of his learning from the bank that the check bounced.
6. The payor does not make payment of the money within 15 days of receiving the written notice from the payee.
7. The complaint must be made within one month of the cause of action occurring.