# THE FILIPINO DEBT TRAP: ASSESSING THE CURRENT STATE OF LEGAL PROTECTION AGAINST PREDATORY LENDING PRACTICES AND USURIOUS TRANSACTIONS*

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**ABSTRACT**

The Filipino borrowing community continues to face significant challenges and vulnerabilities when it comes to abusive and predatory lending practices. This Note delves into complex issues surrounding secured transactions and the longstanding policy of *pactum commissorium*, which contribute to the prevalence of predatory and usurious lending practices in the country. Additionally, it examines how lenders exploit the Bouncing Checks Law as a tool for coercion and intimidation.

Furthermore, it highlights regulatory gaps by analyzing various special laws, such as Republic Act No. 11765, or the Financial Products and Services Consumer Protection Act of 2022, as well as the rules and principles governing secured and unsecured credit transactions. It also scrutinizes the existing policies related to usurious and predatory lending practices and explores relevant jurisprudence pertaining to exorbitant interest rates.

To address these pressing concerns, proposals for legal reforms are offered, emphasizing the need to modernize outdated procedural and substantive rules governing the enforcement of security arrangements. This Note also advocates for the exploration and promotion of alternative forms of lending that prioritize fairness and protect the rights and interests of borrowers.

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## I. INTRODUCTION

The practice of imposing interest on borrowed money is not unlawful, and neither does it compromise one's moral compass. The very nature of lending produces the economic consequence of requiring payments to cover the cost of borrowing. In fact, interest as the foundation of a growing modern economy remains to be the very incentive for the lender to part with their money.[1] However, as with all other practices, lending is also prone to abuse.

More than a decade after the 2008 financial crisis, the global economy faced another significant blow, amplifying the magnitude of losses worldwide. This time, the catalyst was an unprecedented emergency—the COVID-19 pandemic, which left the world grappling with a multifaceted disaster that not only ravaged economies on a global scale.

The far-reaching impacts of the crisis led to an unprecedented number of shutdowns and closures across various sectors, as governments implemented mandatory lockdowns and companies struggled to sustain their operations amid the economic turmoil. In fact, the COVID-19 pandemic triggered a wave of closures and forced many businesses into retirement.[2] In the United States, during the earlier months of the pandemic, the number of working business owners fell from 15 million to 11 million, caused by COVID-19 government mandates and economic demand shifts, with the 3.3 million decrease as the largest drop on record.[3] Although businesses were able to rebound strongly after the initial shock of the COVID-19 crisis, US data still showed that smaller businesses experienced more disproportionate losses during the crisis compared with large businesses, which also translated to smaller businesses' higher chances of permanent closure post-pandemic.[4] This untoward economic effect on small businesses has led to the emergence of U.S. government aid through the Coronavirus Aid, Relief, and Economic Security (CARES) Act,[5] which gave additional funding to smaller

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[1] Jonas Miguelito C. Cruz, *A Proposed Approach to Streamline the Imposition of Interest in Tax Refund Cases,* 95 PHIL. L. J. 86, 88 (2022).

[2] *See* Robert Fairlie & Frank M. Fossen, *The early impacts of the COVID-19 pandemic on business sales,* 58 SMALL BUS. ECON. 1853–64 (2022).

[3] Robert Fairlie, *The impact of COVID-19 on small business owners: Evidence from the first three months after widespread social-distancing restrictions,* 29 (4) J. ECON. & MGMT. STRATEGY, 727–740 (2020). doi: 10.1111/jems.12400

[4] Robert Fairlie, Frank M. Fossen, Reid Johnsen & Gentian Droboniku, *Were small businesses more likely to permanently close in the pandemic,* 60 Small Bus. Econ. 1613–1629 (2023). doi: 10.1007/s11187-022-00662-1

[5] CARES Act, S.3548, 116th Cong. (2020).

enterprises to survive the crisis.[6] However, analysis showed that many small businesses were reluctant to apply for the stimulus package because of concerns about administrative complexity, bureaucratic hassles, and difficulty in establishing their eligibility.[7] When businesses are unable to access financial markets, they might turn to informal financing channels, such as trade credits[8] and personal loans, such as borrowing from family and friends.[9]

The Philippines also saw a comparable scenario during the early days of the crisis: seven out of ten micro, small, and medium-sized enterprises ("MSMEs") were forced to stop operating for weeks throughout the implementation of the community quarantine.[10] To help the surviving businesses, the Bayanihan COVID-19 Assistance to Restart Enterprises or Bayanihan CARES Program was created and implemented to give collateral-free and interest-free loans.[11] However, following a thorough post-audit of the funds two years later, it was discovered that the government had not fully disbursed the allocated PHP 10 billion funding as mandated by the Bayanihan to Recover as One Act.[12] Instead, only approximately PHP 6.7 billion had been utilized, highlighting a

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[6] The CARES Act is a USD 2 trillion stimulus package that provided unemployment benefits, cash stipends, and the Paycheck Protection Program, which gave forgivable loans to small businesses. *See* Carl Hulse & Emily Cochrane, *As Coronavirus Spread, Largest Stimulus in History United a Polarized State*, THE NEW YORK TIMES, Mar. 26, 2020, *at* https://www.nytimes.com/2020/03/26/us/coronavirus-senate-stimulus-package.html; Kelsey Snell, *What's Inside the Senate's $2 Trillion Coronavirus Aid Package*, NPR, *at* https://www.npr.org/2020/03/26/821457551/whats-inside-the-senate-s-2-trillion-coronavirus-aid-package.

[7] Alexander W. Bartik, Marianne Bertrand, Zoe Cullen, and Christoper Stanton, *The impact of COVID-19 on small business outcomes and expectations*, 119 (30) PROCEEDINGS OF THE NAT'L ACAD. OF SCI. 17656, 17657, at https://www.pnas.org/doi/10.1073/pnas.2006991117. doi: 10.1073/pnas.200699111.

[8] Trade credit occurs "when a buyer delays payment for purchased goods or services." In trade credit, suppliers deliver the customer the goods or services without upfront payment. *See also* Daniel Seifert, Ralf W. Seifert, & Margarita Protopappa-Sieke, *A review of trade credit literature: Opportunities for research in operations*, 231 (2) EUR. J. OF OPERATIONAL RESEARCH 245–256 (2013), at https://www.sciencedirect.com/science/article/abs/pii/S0377221713002245. doi: 10.1016/j.ejor.2013.03.016.

[9] Nurullah Gur, Mehmet Babacan, Ahmet Faruk Aysan, & Selim Suleyman, *Firm Size and Financing Behavior during COVID-19 Pandemic: Evidence from SMEs in Istanbul,* 23 (4) BORSA ISTANBUL REV. 804–17, 806 (2023), *available at* https://www.sciencedirect.com/science/article/pii/S2214845023000352.

[10] Shigehiro Shinozaki & Lakshman N. Rao, *COVID-19 Impact on Micro, Small, and Medium-Sized Enterprises under the Lockdown: Evidence from a Rapid Survey in the Philippines*, ADBI WORKING PAPER SERIES NO. 1216 (2021), *available at* https://www.adb.org/sites/default/files/publication/677321/adbi-wp1216.pdf.

[11] Cherrie Regalado, *P10 billion COVID-19 loans for small businesses undisbursed, underutilized*, Dec. 8, 2022, RAPPLER, *available at* https://www.rappler.com/business/covid-19-loans-small-businesses-undisbursed-underutilized-pcij-report-2022/.

[12] Rep. Act No. 11494 (2020). Bayanihan to Recover as One Act.

significant shortfall in the implementation of the intended financial support.[13] Meanwhile, the emergency fund was able to help only less than five percent of the MSMEs.[14]

Compounding the situation, beneficiaries of the program were burdened with additional charges in the form of service or processing fees, effectively imposing an interest rate ranging from four to eight percent per annum.[15] This contradicted the program's claim of being "interest- and collateral-free,"[16] creating a misleading impression for those seeking financial assistance. The imposition of such fees added an unnecessary financial burden on the beneficiaries, further undermining the intended purpose of providing accessible and affordable support during challenging times.

Amid the loss of confidence from creditors and investors in the financial markets, financial institutions faced a perilous struggle to survive. The larger banks, preoccupied with their own debtors and shielding themselves from bank runs, failed to extend support to small businesses and low-income households.[17] Consequently, these marginalized groups were left with limited options and were forced to turn to high-cost lenders, both formal and informal.[18] These lenders

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[13] Regalado, *supra* note 11.

[14] *Id.* The government was only able to release approximate PHP 6.7 billion, reaching 39,323 MSMEs, which was less than 5% of the total 957,620 registered MSMEs in 2020.

[15] Department of Trade and Industry Small Business Corporation. *Bayanihan Cares: Financing Assistance to Help Businesses Restart*, DEPARTMENT OF TRADE AND INDUSTRY WEBSITE, *available at* https://sbcorp.gov.ph/programs-and-services/bayanihancares/.

[16] *Id.*

[17] In the United States, banks that had "less headroom (i.e., the amount of capital resources above minimum capital regulatory requirements and buffers) tended to lend less during the pandemic that those with more headroom". Eric Milstein & David Wessel, *What did the Fed do in response to the COVID-19 crisis?* Brookings, Jan. 2, 2024, *available at* https://www.brookings.edu/articles/fed-response-to-covid19/. Further, during the pandemic, banks also intentionally reduced credit supply to small businesses, tightening their lending standards and cutting loan supplies. *See* Jose M. Berrospide, Arun Gupta, & Matthew P. Seay, *The Usability of Bank Capital Buffers and Credit Supply Shocks at SMEs During the Pandemic,* INTL J. OF CENT. BANKING (July 2024), *available at* https://www.ijcb.org/journal/ijcb24q3a5.pdf?.

[18] "US consumers may turn to the private market for credit when income and government benefits fall short. […] [G]enerous state unemployment insurance benefits were associated with a lower probability of high-cost credit use during the first seven quarters of the [COVID-19] pandemic. This inverse association was concentrated among consumers living in low-income households." Lawrence M. Berger, Meta Brown, J. Michael Collins, Rachel E. Dwyer, Jason N. Houle, Stephanie Moulton, Davon Norris, & Alec P. Rhodes, *Inequality in high-cost borrowing and unemployment insurance generosity in US states during the COVID-19 pandemic,* 8*(9)* NAT. HUM. BEHAV. 1676–1688. doi: 10.1038/s41562-024-01922-8.

In the Philippines, according to the 2021 Financial Inclusion Survey by the Bangko Sentral ng Pilipinas (BSP), borrowing from informal sources (e.g., family and friends, informal lenders), slightly grew in 2021 at 47% and 14%, respectively, whereas the percentage of borrowers

took advantage of the borrowers' lack of knowledge, enticing them with the promise of quick cash loan releases, further exacerbating the financial hardships faced by these vulnerable individuals and businesses.[19] These loans varied from "payday loans," or small principal high-interest loans payable in the short term (i.e., typically due on the borrower's next pay date) to loans offered by informal and unregistered lenders imposing exorbitant interest rates,[20] including the popular twenty-percent interest lending coined in the Philippines as "Five-Six."[21] As a result, individuals trapped in this challenging financial situation resorted to a cycle of borrowing to cover both their mounting debt and day-to-day living expenses.

This pattern of borrowing to meet immediate financial needs while simultaneously trying to address the growing debt burden by paying previous lenders is known as the vicious cycle of the debt-trap.[22] Rarely do minimum-wage-earning Filipinos and low-income sole proprietors evaluate future debt burden, nor do they avail of complex secured credit transactions, especially at times of hardship and inevitable expenses, such as hospitalization and living costs. The information asymmetry and lack of legal protection exacerbate these challenges.[23]

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from microfinancing non-governmental organizations (NGOs) declined from 31% in 2019 to 23% in 2021. *See* Bangko Sentral ng Pilipinas Financial Inclusion Office, *2021 Financial Inclusion Survey*, BANGKO SENTRAL NG PILIPINAS, *available at* https://www.bsp.gov.ph/Inclusive%20Finance/Financial%20Inclusion%20Reports%20and%20Publications/2021/2021FISToplineReport.pdf.

[19] *See* e.g., Dan Cassara, Arianna Zapanta, & Seth Garz, *Mobile Instant Credit: Impacts, Challenges, and Lessons for Consumer Protection,* CENTER FOR EFFECTIVE GLOBAL ACTION, UNIVERSITY OF CALIFORNIA, BERKELEY, Sept. 2023, *available at* https://cega.berkeley.edu/wp-content/uploads/2023/09/FSP_Digital_Credit_Research_test.pdf? on how mobile instant credit providers lure Philippine users with fast access and lack of understanding of their terms; Song Wang & Jeremy St. John, *Present Bias, Payday Borrowing, and Financial Literacy* [Preprint]*,* Apr. 25, 2024, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4806897.

[20] Hunt Allcott, Joshua Kim, Dmitry Taubinsky, & Jonathan Zinman, *Are High-Interest Loans Predatory? Theory and Evidence from Payday Lending*, 89*(3)* Rev. of Econ. Stud. 1041–1084 (2022), *available at* https://academic.oup.com/restud/article-abstract/89/3/1041/6374508?redirectedFrom=fulltext.

[21] Efren Ll. Cruz, *How add-on-rate, 5-6 loans work*, INQUIRER.NET, Apr. 13, 2016, a*vailable at* https://business.inquirer.net/209425/add-rate-5-6-loans-work.

[22] Gaurav Jalan & Aashika Jain, *How to Avoid a Debt Trap?* FORBES, Aug. 4, 2022, a*vailable at* https://www.forbes.com/advisor/in/personal-finance/how-to-avoid-debt-trap/.

[23] In the Philippines, some borrowers are overwhelmed by multiple loan products, failing to anticipate or evaluate future repayment obligations, as some of them have inadequate knowledge on loan management. *See* Aireen A. Eseo, *Operational Practices of Microfinance: Evidence from the Philippines*, 7(*2*) Malay. E-Com. J. 62–67, 66 (2023), *available at* https://journals.indexcopernicus.com/api/file/viewByFileId/1983461?.

As aptly observed by G.W. Healy, "usury is not a common problem in a nation enjoying a healthy economy"[24] and can only thrive where "people do not receive income proportionate to their needs as human beings."[25] Instead, he described it as "a symptom of a serious disorder in the economic life of a people."[26] The difficulty arises in determining this disorder, as well as its cause. Consistent with this classical thought, this symptom also arises from the lack of legal protection supposedly preventing the abuse of the people's economic status.

## II. RELATED CONCEPTS IN CREDIT TRANSACTIONS

Credit transactions include "all transactions involving the purchase or loan of goods, services, or money with the promise to pay or deliver in the future."[27] Lending is in the form of a simple loan, which is defined under the Civil Code as a contract "where one of the parties delivers to another money or other consumable thing on the condition that the same amount of the same kind and quality be paid."[28]

The purpose of credit transactions is tied to the overall efficient reallocation of financial resources. It is to take advantage of opportunities, both for the lender and the borrower. Further, credit is a tool for the lender to seek refuge against the effects of inflation and to earn proceeds from interest and investment returns. On the other hand, the borrower is given the convenience to access funds and to utilize the same for productive uses.[29]

A secured transaction is a business arrangement by which a buyer or borrower gives collateral to the seller or lender to guarantee the payment of an obligation.[30] Secured transactions also contemplate credit arrangements where a third person promises to pay in lieu of the principal debtor, referred to as contracts of guaranty or suretyship. On the other hand, unsecured transactions are credit arrangements that are not supported by any collateral nor guaranteed by any third person.

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[24] G. W. Healy, *Usury in the Philippines Today* 3(*2*) PHIL. STUD.: HIST. AND ETHNOGRAPHIC VIEWPOINTS 136–56, 136 (1955), *available at* https://archium.ateneo.edu/cgi/viewcontent.cgi?article=3413&context=phstudies.

[25] *Id.*

[26] *Id.*

[27] HECTOR S. DE LEON & HECTOR M. DE LEON, JR., COMMENTS AND CASES ON CREDIT TRANSACTIONS 1 (2021).

[28] CIVIL CODE, art. 1933.

[29] *See*, e.g., N. Gregory Mankiw, *The Allocation of Credit and Financial Collapse*, 101(*3*) THE Q. J. OF ECON. 455–470 (1986) on credit's primordial role in efficient reallocation of financial resources; Alin Marius Andrieş, Steven Ongena, & Nicu Sprincean, *Sectoral credit allocation and systemic risk,* 76 J. OF FIN. STABILITY (2025) on credit facilitating borrower access for productive use.

[30] Ronald P. de Vera, *How Much Credit Is There in a Promise: Forging a Unified Law on Secured Transactions*, 83 PHIL. L. J. 236 (2008).

### A. Forbearance of Money and Interest

Interest in the general sense is the cost of borrowing money. It may be classified into two concepts: (a) conventional or monetary interest, or the interest voluntarily agreed upon by the parties; and (b) legal or compensatory interest, or the interest prescribed by law or by the courts for penalty or indemnity for damages arising from the delay in paying a fixed sum or a delay in assessing and paying damages.[31] As of date, the legal interest per annum is fixed at six percent.[32]

### B. Lending Versus Financing Companies

A lending company (LC) is a corporation engaged in granting loans from its own capital funds or from funds sourced from not more than nineteen (19) persons and is synonymous to the term "lending investors."[33] Meanwhile, a financing company (FC) is primarily organized for the purpose of extending credit facilities by direct lending or discounting commercial papers, by buying and selling evidence of indebtedness, or by financial leasing of movables and immovables.[34]

A common characteristic between LCs and FCs is that both exclude banking institutions, investment houses, savings and loan associations, insurance companies, and other financial institutions. Thus, they are supervised not by the central monetary authority of the Philippines (i.e., the Bangko Sentral ng Pilipinas [BSP]), but by the Securities and Exchange Commission (SEC).

Popular among LCs and FCs is the operation through online lending platforms (OLPs), which are also referred to as peer-to-peer (P2P) lending, are marketplaces that connect financial consumers or businesses with lenders. With the advent of technology, loan applications have become easier and more streamlined than the traditional process of submitting piles of documents to banks.[35] LCs and FCs cater to both natural persons and businesses.

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[31] Lara's Gifts & Decors, Inc. v. Midtown Industrial Sales, Inc., G.R. No. 225433, slip op., Sept. 20, 2022.

[32] Bangko Sentral ng Pilipinas (BSP) Circ. No. 799 (2013). Rate of Interest in the Absence of Stipulation. This Circular took effect on July 1, 2013.

[33] Rep. Act No. 9474 (2007), § 3. Lending Company Regulation Act of 2007.

[34] Rep. Act No. 9474 (2007), § 3.

[35] *See,* e.g., Eunjung Yeo & Jooyong Jun, *Peer-to-Peer Lending and Bank Risks: A Closer Look*, 12(*15*) Sustainability (2020), *available at* https://www.mdpi.com/2071-1050/12/15/6107; Francis Mark A. Quimba, Mark Anthony A. Barral, & Jean Clarisse T. Carlos, *Analysis of the FinTech Landscape* 1–56 (Philippine Institute for Development Studies, Discussion Paper Series No. 2021-29, 2021), *available at* https://pidswebs.pids.gov.ph/CDN/PUBLICATIONS/pidsdps2129.pdf.

### C. Predatory Lending in General

Broadly, predatory lending is the practice of imposing unfair, deceptive, or abusive loan terms on borrowers.[36] It may be intentional[37] or unintentional,[38] so long as the terms of the lending arrangement, in essence, exploit the borrower's need for funds in exchange for profit and other excessive interests, exorbitant fees, and other similar inequitable schemes resulting in a ballooning inescapable debt trap. It may be resorted to by a creditor who is unsecured or secured.

An example of a common predatory lending practice is the use of exorbitant fees that are separated from the loan's interest and indicated in fine print.[39] Another is the condition of a ballooned payment at the end of the term to make the prior installments appear low.[40] After being burdened by the debt, loan flipping then follows wherein the lender takes advantage of the borrower's need to repay the loan by offering to refinance, resulting in a vicious debt cycle.[41]

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[36] "Community advocates use the term 'predatory lending' as shorthand to describe [various] practices that exploit vulnerable borrowers, such as the elderly or undereducated. […] However, there is no established, objective definition of the term." Deborah Goldstein, *Protecting Consumers from Predatory Lenders: Defining the Problem and Moving Toward Workable Solutions*, 35 HARV. CIV. RTS.–CIV. LIBERTIES L. REV. 225–256, n.5 (2000). "Theoretically, predatory lending may be found in any loan where the borrower's expenses cannot be justified on the basis of the lender's additional risk and cost." *Id.* at 231.

[37] Predatory lending may be systemic or intentional, displayed in "patterns of selling over-priced [sic] loans to populations whose mental, physical or intellectual status makes them vulnerable to the lenders' sales tactics." Deborah Goldstein, *Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions*, HARV. JOINT CTR. FOR HOUS. STUD. (Sept. 1999), *available at* https://www.jchs.harvard.edu/sites/default/files/media/imp/goldstein_w99-11.pdf.

[38] Even if borrowers voluntarily take loans, there is an urgent potential for predatory lending, as long as they misunderstand or misinterpret loan contract terms. *See* Philip Bond, David K. Musto, & Bilge Yilmaz, *Predatory Lending in a Rational World* (Federal Reserve Bank of Philadelphia, Working Paper No. 06-2, 2005), *available at* https://www.philadelphiafed.org/-/media/frbp/assets/working-papers/2006/wp06-2.pdf?.

[39] *See* Lucia Constantine, Christelle Bamona, & Sara Weiss, *Not Free: The Large Hidden Costs of Small-Dollar Loans Made Through Cash Advance Apps,* CTR. FOR RESPONSIBLE LENDING (2024), *available at* https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-not-free-hidden-costs-apr2024.pdf.

[40] Balloon payments that exceed a borrower's ability to pay when they fall due may be considered as predatory lending. Often, balloon payments slow down the repayment of the principal amount when the periodic payments are unable to cover the full amount of the interest due, adding the unpaid interest with the principal balance. This then heightens the right of default. Roberto G. Quercia, Michael A. Stegman, & Walter R. Davis, *The impact of predatory loan terms on subprime foreclosures: The special case of prepayment penalties and balloon payments,* 18(*2*) HOUS. POL'Y DEB. 311–346, 313, 318 (2007). doi: 10.1080/10511482.2007.9521603.

[41] *Id.* at 313.

**D. Payday Loans**

A payday loan is an unsecured loan that typically requires full repayment within a short timeframe, often ranging from a few weeks to a month. The term "payday loan" was derived from the usual practice of scheduling the deadline of the payment on the day that the borrower receives their next paycheck.[42]

In the Philippines, payday loans are commonly obtained by borrowers who do not have sufficient property to secure the loan. As a result, lenders often require access to the borrower's bank accounts, which can be done through electronic transfers or by presenting post-dated checks against the borrower's account. These loans are typically offered by LCs and FCs, with loan amounts ranging from one to tens of thousands of pesos.

Unregistered lenders offering payday loans are also widespread in the Philippines so as not to be bound by any regulation. As observed by one author, most lenders impose a term of a maximum of two weeks but at the cost of "ridiculously high interest rates" averaging an annual percentage rate from 390–780%.[43] More often than not, a penalty is imposed for every day of non-payment, which is applied on top of the interest imposed.[44]

Payday lenders, however, are not without a purpose. Low-income individuals with emergency costs, such as hospitalization, and tight cash flow to cover living expenses, benefit from the highly accessible payday loans. Compared to the process of obtaining bank loans, which tends to be slower due to extensive documentation requirements, payday loans offer a more practical solution for covering expenses that require immediate payment.[45] The streamlined nature of payday loan applications allows for quicker processing, making it a viable option for individuals in need of urgent funds. This expedited process helps borrowers

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[42] *See* Federal Deposit Insurance Corp. (FDIC), *An Update on Emerging Issues in Banking: Payday Lending*, FDIC ANALYSIS WEBSITE, Jan. 29, 2003, *available at* https://www.fdic.gov/analysis/archived-research/fyi/012903fyi.pdf.

[43] Edgard Hilario, *Everything you need to know about payday loan in the country*, MANILA BULL., Mar. 25, 2022, *available at* https://mb.com.ph/2022/3/25/everything-you-need-to-know-about-payday-loan-in-the-country.

[44] *Id.*

[45] In the United States, payday loans are marketed as helpful for unexpected or emergency expenses, but seven out of 10 borrowers often use the payday loans for basic expenses. *See* Jeannette Bennett, *Fast Cash and Payday Loans*, FED. RESERVE BANK OF ST. LOUIS, Apr. 10, 2019, *available at* https://www.stlouisfed.org/publications/page-one-economics/2019/04/10/fast-cash-and-payday-loans.

promptly address pressing financial needs, without the prolonged waiting periods often associated with traditional bank loans.[46]

When it comes to the convenience of obtaining a payday loan, the evaluation of credit history is often minimal or even absent. Lenders typically focus on verifying the identification and income source of the borrower rather than conducting an in-depth analysis of their credit history. This streamlined screening process allows borrowers with less-than-ideal credit scores or limited credit history to still have access to payday loans.[47]

## III. USURIOUS TRANSACTIONS

### A. Concept and Origin of Usury

Usury is commonly defined as the "lending money at exorbitant interest rates" or "an unconscionable […] amount of interest."[48] The Supreme Court defines it as "receiving something in excess of the amount allowed by law for the loan or forbearance of money, goods or chattels."[49] The same Court views it as "taking of more interest for the use of money, goods or chattels or credits than the law allows."[50]

Ancient forms of usury included the very interest imposed on borrowed money. The earliest record of usury dates as far back as 2,000 to 1,400 B.C. from the Vedic texts of Ancient India where a "usurer" was interpreted as any lender at interest.[51] During the Roman period, usury was defined as "any interest charged above and beyond the return of the principal amount," with the act punishable under Christianized Roman law.[52] Although *Lex Genucia* reforms in Republican Rome in 340 B.C. criminalized interest altogether, ways to circumvent such law were found, leading to usury being widespread again by the last period of the

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[46] Often, securing a payday loan is relatively fast. In an article discussing payday loans in the United States, it was mentioned that "[w]ith the appropriate documents, a customer [may walk] out with cash in hand in about 30 minutes." This is in contrast to bank loans, which usually "require appointments with a loan officer, […] a credit check, proof of income and assets, and several days to process the application with no guarantee of approval." Lakitquana Leal, *The Unbanked and Payday Loan Consumers,* AM. ECON. ASS'N. 1–39, 3, Dec. 19, 2018, *available at* https://www.aeaweb.org/conference/2019/preliminary/paper/7HneFQsi.

[47] *Id.*

[48] *Usury,* MERRIAM-WEBSTER.COM DICTIONARY, *available at* https://www.merriam-webster.com/dictionary/usury.

[49] Tolentino v. Gonzales, G.R. No. 26085, 50 Phil 558, 573, Aug. 12, 1927.

[50] Tolentino v. Gonzales, 50 Phil 558, 573.

[51] Wayne A.M. Visser & Alastair McIntosh, *A short review of the historical critique of usur*y, 8(*2*) ACCT., BUS., AND FIN., HISTORY 175–189, 176 (1998), *available at* https://www.alastairmcintosh.com/articles/1998-Usury-Visser-McIntosh.pdf.

[52] de Vera, *supra* note 31 at 260.

Republic.[53] Visser and McIntosh, in their work detailing the history of usury prohibition, discussed one of the earliest regulatory acts on interest rates by Rome's Democratic Party. Under the banner of Julius Caesar, Rome had set an interest rate ceiling of 12%, whereas under Justinian rule, the interest rate was lowered it to between 4% and 8%.[54]

Interestingly, the Roman Catholic Church by 4th century A.D. prohibited the taking of interest of clergy, but legal loopholes became prevalent alongside the pro-usury countermovement.[55] Some reasons behind the stances of the Roman Catholic Church and Islam, as well as other religions against usury, are the views that interest is income not earned from labor (unlike profits which are perceived as fruits borne by the efficiency and initiative of a "definite value-creating" process or industry);[56] that interest immorally asks for double the price of a thing;[57] and that interest exploits the needy.[58]

Philippine history is not exempt from the long-standing practice of usury. Usurious transactions in the Philippines have been widespread since the birth of land-tenancy agreements between landlords and tenants.[59] These agreements may either be a share-tenancy system (*kasama*) or the cash tenancy system (*inquilinato*).[60] In both systems, the source of credit to the small farmers are the landlords, merchants, or their relatives acting as lenders, thereby monopolizing the collection and distribution of the tenant-farmers.[61] Like payday lenders, these early forms of creditors "make up for the lack of adequate credit facilities."[62]

**B. Usury Law (Act No. 2655)**[63]

The Civil Code mandates that usurious transactions be governed by special laws.[64] In relation to this, the Usury Law was enacted in 1916 and was further amended by Presidential Decrees Nos. 116, 858, and 1684.

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[53] Visser & McIntosh, *supra* note 54 at 176–77.

[54] *Id.* at 177.

[55] *Id.* at 179.

[56] *Id.* at 181.

[57] *Id.* at 182.

[58] *Id.*

[59] In a 1955 article, usury has been pointed as "one of the major causes of agrarian unrest in the Philippines," highlighting the link between usury and the Philippine agricultural sector, which is primarily composed of land-tenancy agreements. *See* Healy, *supra* note 24, at 140–44.

[60] Tsutomu Takigawa, *Landownership and Land Reform Problems of the Philippines*, 2(*1*) THE DEVELOPING ECON. 58–77, 59 (1964). doi: 10.1111/j.1746-1049.1964.tb00670.x

[61] *Id.* at 66.

[62] *Id.*

[63] Act No. 2655 (1916). An Act Fixing Rates of Interest Upon Loans and Declaring the Effect of Receiving or Taking Usurious Rates, and for Other Purposes [hereinafter "Usury Law"].

[64] CIVIL CODE, art. 1175. Usurious transactions shall be governed by special laws.

Before the Usury Law was amended, it had set a legal rate of interest at 6% per annum, if no interest was stipulated in the contract, and a ceiling of 12% per annum that parties may agree upon if secured by a mortgage. The law had also set a ceiling of 14% per annum if the credit was unsecured.

G.W. Healy notes that although these ceilings include commissions and fees, the penal clause providing liquidated damages in case of failure to pay does not fall within the ambit of the Usury Law.[65] However, after the law was amended by Presidential Decree No. 1684, the Monetary Board has been empowered to prescribe the maximum interest rates imposable on loans.[66]

In 1982, the Monetary Board, pursuant to the amended Usury Law, issued Central Bank ("CB") Circular No. 905,[67] which removed the ceilings on any interest imposed for the forbearance of any money, goods or credit. As clearly pronounced by the Supreme Court in *Advocates for Truth in Lending, Inc. v. Bangko Sentral Monetary Board*,[68] by lifting the interest ceiling, CB Circular No. 905 merely upheld the parties' freedom of contract to be able to agree on the rate of interest.[69] Such principle finds basis from the New Civil Code where the contracting parties may establish stipulations, clauses, terms, and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order, or public policy.[70]

Indeed, conventional interest as the interest agreed upon finds basis in the parties' freedom to stipulate under their statutory and constitutional right of freedom to contract, as will be discussed later.[71]

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[65] Healy, *supra* note 24, at 140.

[66] Usury Law, §1-a, as amended by Pres. Dec. No. 1684, now reads: "The Monetary Board is hereby authorized to prescribe the maximum rate or rates of interest for the loan or renewal thereof or the forbearance of any money, goods or credits, and to change such rate or rates whenever warranted by prevailing economic and social conditions: Provided, That changes in such rate or rates may be effected gradually on scheduled dates announced in advance."

[67] CBP Circ. No. 905-82 (1982). This Circular is pursuant to MB Reso. No. 2224 dated Dec. 3, 1982, which approved new regulations governing interest rates on loans or forbearance of money, goods or credit, as well as amending Books I to IV of the Manual of Regulations for Banks and Other Financial Intermediaries.

[68] [Hereinafter "*Advocates for Truth*"], G.R. No. 192986, 701 Phil. 483, Jan. 15, 2013.

[69] *Advocates for Truth*, 701 Phil. 483, 498.

[70] *Advocates for Truth*, 701 Phil. 483, 498; CIVIL CODE, § 1306.

[71] Morla v. Belmonte, G.R. No. 171146, 661 SCRA 717, Dec. 7, 2011.

## III. RESORT TO PREDATORY LENDING PRACTICES

### A. Loopholes in Legislation

The rules governing credit suffer from inadequacies in practical application, causing creditors and borrowers alike to resort to predatory lending practices.

As stated by Ronald de Vera, secured transactions are not widely practiced in the Philippines unlike in other countries, despite the latter having similar phases of economic development as the former.[72] There is no doubt that the absence of secured transactions between small lenders and low-income borrowers, along with the reliance on informal and unsecured lending practices, is a significant issue. Aside from the lack of sufficient real or personal property that may be given as security, compliance with the lengthy procedure of real estate mortgage foreclosure, whether judicial or extrajudicial, is impractical for short-term and high-risk lenders.

To further limit the creditors' options to real estate mortgage foreclosure in case of default, the prohibition against *pactum commissorium* provided under Article 2088 of the Civil Code[73] is strictly applied to credit agreements.

#### *1. The Ancient Origin of* Pactum Commissorium *and Its Strict Application in the Philippines*

The prohibition against *pactum commissorium* is provided under Article 2088 of the Civil Code. The rule provides that stipulations allowing a creditor to automatically appropriate property given as security in case of default are void. The prohibition requires two elements: *first,* there must be a property mortgaged by way of security to pay the principal obligation; and *second*, there must be a stipulation for automatic appropriation by the creditor of the thing mortgaged in case of non-payment of the principal obligation within the stipulated period.[74]

The provision was adopted from Article 1884 of the Old Civil Code,[75] which was copied from the Spanish Civil Code enforced in the Philippines during the Spanish colonial era. Since the Spanish Civil Code made reference to canon

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[72] de Vera, *supra* note 31.

[73] CIVIL CODE, art. 2088. The creditor cannot appropriate the things given by way of pledge or mortgage, or dispose of them. Any stipulation to the contrary is null and void.

[74] [Hereinafter "*Dimas-San Juan*"], Dimas-San Juan v. Belo, G.R. No. 243165, slip op., Jan. 25, 2023.

[75] CIVIL CODE (1889), art. 1884. The non-payment of the debt within the term agreed upon does not vest the ownership of the property in the creditor. Any stipulation to the contrary shall be void.

law and Roman law, among others,[76] the policy of *pactum commissorium* under the prevailing Article 2088 of the Civil Code of the Philippines may be traced back to the underlying policy against *pactum commissorium* during the period of ancient Rome and the extensive history of Christianity.

Prior to Emperor Constantine's prohibition, *pactum* allowed a secured creditor to appropriate to his own use or to resell the collateral pledged by the debtor if the latter defaulted.[77] The use of high value collateral then allowed creditors to collect above the principal loan to circumvent the Christianized Roman Law against usury which, as discussed, was viewed during the ancient times as anything above the value of the principal loan. Therefore, Constantine's policy for creating the prohibition was in accordance with the ancient policy against interest in its entirety.

Today, despite the worldwide perspective that interest is an essential economic driver, the Philippines continues to enforce, and even strengthens the implementation of, the prohibition against *pactum commissorium* resulting in a rigid limitation on the transmission of rights over secured property.

To illustrate, the recent case of *Dimas-San Juan v. Belo* promulgated on 2023 is discussed.[78] Petitioners therein obtained a loan amounting to a sum of PHP 1,600,000.00 from private respondent Belo payable within six months, evidenced by a promissory note. To secure the loan, a deed of real estate mortgage was also executed on petitioners' real property. After the term of the loan, petitioners were in default, but foreclosure proceedings were never initiated. Subsequently, the parties executed a *dacion en pago* sale, a special form of payment that extinguishes the loan obligation by performance of another obligation not originally intended. As a consequence of the *dacion en pago*, ownership over the real property used as security was transferred to private respondent.

Although the Regional Trial Court upheld the validity of the *dacion en pago* sale, the Court of Appeals and the Supreme Court both ruled that the *dacion en pago* sale was void as it was "indicative of *pactum commissorium*" and that "the circumstances […] reflect badges of *pactum commissorium* even without stipulation for a creditor's automatic appropriation of the mortgaged property."[79]

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[76] L. Neville Brown, *The Sources of Spanish Civil Law*, 5(*3*) THE INTL AND COMPARATIVE L. Q., 373 (1956).

[77] Boris Kozolchyk & Dale Beck Furnish, *The OAS Model Law on Secured Transactions: A Comparative Analysis*, 12 SW. J.L. & TRADE AMERICAS 101 (2006).

[78] *Dimas-San Juan,* G.R. No. 243165.

[79] *Dimas-San Juan,* G.R. No. 243165.

Two reasons were provided for striking down the *dacion en pago* sale: *first,* the *dacion en pago* contract was held to have been executed by reason of the same loan; and *second,* the subject of the *dacion en pago* was viewed by the Supreme Court as the same property used as collateral for the loan, without any other additional consideration.

Thus, although the *dacion en pago* may be viewed as valid, as the Regional Trial Court found because the sale had been executed to extinguish the principal loan obligation when it became due and demandable, the Court's instant ruling indicates the difficulty in extinguishing a loan obligation using *dacion en pago* due to the Court's strict application of the rule against *pactum commissorium*, invoking the legal presumption in favor of equitable mortgages.

*2. The Rules on Foreclosure of Real Estate Mortgage and the Personal Property Security Act (PPSA)*

The procedural rules governing judicial and extrajudicial foreclosure and the creation, perfection, and enforcement of security interest under the Personal Property Security Act ("PPSA")[80] are complex and not easily comprehensible for the common borrowers to determine their rights under the law. Even if revised into simpler terms, the compliance with the rules on judicial and extrajudicial foreclosure of real estate mortgage remain time-consuming, tedious, and extremely inconvenient. As opined by De Vera, the rigid and technical rules of procedure make transferring title to the creditor under a legal mortgage more complicated than transferring title under an equitable mortgage.[81]

Rules on judicial foreclosure are provided by Rule 68 of the Rules of Court. Following Rule 68, the early stages of judicial foreclosure are already costly since about a month to half a year may be incurred depending on the complexity of the case. Such early stages involve assessing the terms of the contract, building the case and evidentiary documents, drafting the action for judicial foreclosure, and ensuring that such initiatory pleading contains sufficient facts in compliance with Rule 68.[82]

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[80] Rep. Act No. 11057 (2017). Personal Property Security Act [hereinafter "PPSA"].

[81] de Vera, *supra* note 31 at 262.

[82] RULES OF COURT, Rule 68, § 1. *Complaint in action for foreclosure.* — In an action for the foreclosure of a mortgage or other encumbrance upon real estate, the complaint shall set forth the date and due execution of the mortgage; its assignments, if any; the names and residences of the mortgagor and the mortgagee; a description of the mortgaged property; a statement of the date of the note or other documentary evidence of the obligation secured by the mortgage, the amount claimed to be unpaid thereon; and the names and residences of all persons having or claiming an interest in the property subordinate in right to that of the holder of the mortgage, all of whom shall be made defendants in the action.

After initiating the judicial foreclosure proceedings, the plaintiff is then required to comply with the rule on summons in accordance with the mortgagor's due process rights. Hearings are then conducted to determine not just the veracity of the claims and defenses but also the merit of the action. Thus, from the service of summons until the last trial date, several months to a year may lapse, depending on the trial court's pace in conducting hearings. Judgment must then be rendered within a period of not less than 90 days nor more than 120 days from entry of judgment to provide the debtor a period to pay the debt obligation.[83] This 3–4 month period is also known as the equity of redemption.

As an alternative to the lengthy process of judicially foreclosing mortgages, the mortgagee may resort to extrajudicial foreclosure as provided under Act No. 3135[84] and the Supreme Court's Procedure in Extrajudicial Foreclosure of Mortgages.[85]

The primary purpose of extrajudicial foreclosure is, as the term suggests, to provide avenues to foreclose without resorting to the tedious process of complying with the Rules of Court. Although extrajudicial foreclosure of mortgage streamlines the procedure of foreclosure by doing away with judicial processes, such as the conduct of hearings and the compliance with strict rules of summons and evidence, there remain several inconveniences that make the procedure for extrajudicial foreclosure time-consuming. For instance, the inefficiencies of court institutions still highly influence extrajudicial foreclosure processes, given that the personnel and facilities involved in extrajudicial foreclosure are still officers and employees of the courts, such as the clerks of court and the court sheriffs.

Under the rules on extrajudicial foreclosure of real estate mortgage, the application for extrajudicial foreclosure is filed with the Executive Judge through the clerk of court.[86] The clerk of court is responsible for collecting the filing fees[87] and determining compliance with the legal requirements,[88] such as the existence of a power of attorney inserted into or attached to the deed of real estate mortgage. The examination stage itself may take a month to several months depending on the number of cases under the administration of the clerk of court and the number of extrajudicial foreclosure applications required to be examined which may differ in each trial court.

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[83] RULES OF COURT, Rule 68, § 2.

[84] Act No. 3135 (1924). An Act to Regulate the Sale of Property Under Special Powers Inserted in or Annexed to Real Estate Mortgages.

[85] REAL EST. FORECLOSURE PROC. SC Adm. Order No. 99-10-05-0 (2001).

[86] REAL EST. FORECLOSURE PROC., § 1.

[87] REAL EST. FORECLOSURE PROC., § 2(b).

[88] REAL EST. FORECLOSURE PROC., § 2(c).

After the clerk of court examines the application, the same is raffled to a court sheriff who must prepare a notice of extrajudicial sale and cause its publication.[89] The publication of the notice must be made at least once a week for at least three consecutive weeks in a newspaper of general circulation.[90]

The newspaper publication requirement is not only an archaic manner of publishing notices, but it also consumes an unreasonably long period for the public to be notified relative to the average speed of circulating information today. With the advent of technology, information is quickly disseminated to the public not through newspaper circulations, but through text messaging and the internet, including social media platforms. With the use of websites and social media platforms, notice and the auction sale itself may be conducted online to dispense with the three-week publication requirement. Instead, the three-week period may be used not to notify the public, but to allow the public to bid and participate in the online auction sale, thereby creating a faster and more participative extrajudicial foreclosure sale.

The direction toward the use of digital platforms is obvious in the establishment of a Personal Property Security Registry (PPSR), an online and centralized registry created by the PPSA for the registration of security interests over personal properties.[91]

Aside from the PPSR's creation, the PPSA also provides convenient ways to execute loan agreements secured by personal property while protecting both borrowers and lenders alike.[92] For lenders, registration mechanisms under the PPSA protect lenders' security interests in personal properties by allowing lenders to give constructive notice to the whole world regarding such security interests.[93] Incidental to this, information regarding security interests in personal properties is easily accessed and verified.[94]

Under its Chapter 4 (Priority of Security Interest), the PPSA also provides rules on competing claims over a collateral.[95] As to the retention of the personal property used to secure credit, the PPSA allows lenders to retain the collateral and utilize the assets in which their security interest is perfected.[96] Lastly, one of the innovative features of the PPSA is the provision allowing secured creditors to exercise the option to appropriate the collateral with the consent of the borrower

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[89] REAL EST. FORECLOSURE PROC., § 5.
[90] REAL EST. FORECLOSURE PROC., § 3.
[91] *See* PPSA, § 3(h), § 26.
[92] *See* PPSA, § 2.
[93] PPSA, §§ 26–27 declare the PPSR as public record, providing constructive notice.
[94] PPSA, §§ 26–27.
[95] PPSA, §§ 17–25.
[96] PPSA, § 54.

for the satisfaction of the debt obligation.[97] While this approach may seem inconsistent with the prohibition against *pactum commissorium,* the latter may be reconciled with the PPSA, as discussed further below.

With regard to the benefit to the borrowing community, the PPSA expands the scope of personal properties in which security interests may be created and perfected. The statute recognizes a wider range of personal properties, whether tangible or intangible,[98] as possible collaterals, making secured credit arrangements more accessible to borrowers. By encouraging the utilization of personal property to secure debt obligations, the PPSA promotes loans with low interest rates and alleviates high-cost unsecured credit.[99]

Further, the PPSA reduces the practice of using checks as loan security and excessive filing of criminal actions under Batas Pambansa Blg. 22 ("Bouncing Checks Law")[100] by establishing legal principles for control agreements, essentially providing a more legally appropriate alternative to granting access to bank accounts.

An examination of both the PPSA and the rules on judicial and extrajudicial foreclosure also reveals that the legal remedies of lenders and borrowers under Philippine law are significantly limited as opposed to the remedies provided in other countries. These legal remedies may come in various forms, but common to such remedies are mandatory mediation proceedings, opportunities to execute a sale in lieu of foreclosure, and loan refinancing or restructuring through government programs. In addition to such remedies, "nonrecourse laws" or laws prohibiting lenders from seeking deficiency after enforcement of security interests or sale of personal property are also observed in other jurisdictions.

Before the PPSA's enactment, Civil Code provisions on chattel mortgage and pledges were consistent with the policy of nonrecourse laws. However, the PPSA now allows a creditor to recover the deficiency, if any, after the enforcement of his or her security interest. Examples of jurisdictions adopting nonrecourse laws are the California Commercial Code and the Australia's Personal Property Securities Act of 2009.

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[97] PPSA, § 54(a).

[98] PPSA, § 3(e).

[99] *See, e.g.,* Mary Grace Padin, *Personal Property Security Act to ease bank lending to MSMEs,* PHILSTAR GLOBAL, Dec. 17, 2018, *available at* https://www.philstar.com/business/2018/12/17/1877516/personal-property-security-act-ease-bank-lending-msmes.

[100] Batas Blg. 22 (1979). An Act Penalizing the Making or Drawing and Issuance of a Check Without Sufficient Funds or Credit and for Other Purposes [hereinafter "Bouncing Checks Law"].

If nonrecourse laws are again to be adopted by the Philippines for personal property securities, such rules must be subject to limitations given that nonrecourse laws are prejudicial to creditors. Examples of the limitations to nonrecourse laws include limiting non-recovery of deficiency only when the borrower has other existing creditors, and/or limiting the nonrecovery of deficiency only as to the portion of the loan pertaining to the interest.

## B. Alternative Predatory Practices

### *1. Circumventing the Non-Imprisonment Clause Through the Bouncing Checks Law*

Enacted in 1979, the Bouncing Checks Law essentially punishes a person who makes or draws a worthless check, which is subsequently dishonored by a drawee bank upon presentation of payment.[101] The law was enacted to afford protection to business and the public in general and to minimize the circulation of worthless checks.[102] Worthy to note is that it was also enacted to prevent the fraudulent practice in commercial transactions of issuing checks without maintaining sufficient funds with the drawee bank. In a case where its

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[101] Bouncing Checks Law, § 1 provides:

> *Checks without sufficient funds.* — Any person who makes or draws and issues any check to apply on account or for value, knowing at the time of issue that he does not have sufficient funds in or credit with the drawee bank for the payment of such check in full upon its presentment, which check is subsequently dishonored by the drawee bank for insufficiency of funds or credit or would have been dishonored for the same reason had not the drawer, without any valid reason, ordered the bank to stop payment, shall be punished by imprisonment of not less than thirty days but not more than [one] year or by a fine of not less than but not more than double the amount of the check which fine shall in no case exceed [PHP 200,000.00], or both such fine and imprisonment at the discretion of the court.
>
> The same penalty shall be imposed upon any person who, having sufficient funds in or credit with the drawee bank when he makes or draws and issues a check, shall fail to keep sufficient funds or to maintain a credit to cover the full amount of the check if presented within a period of [90] days from the date appearing thereon, for which reason it is dishonored by the drawee bank.
>
> Where the check is drawn by a corporation, company or entity, the person or persons who actually signed the check in behalf of such drawer shall be liable under this Act.

[102] Lorna Patajo-Kapunan, *Revisiting Batas Pambansa Blg. 22 or the bouncing checks law*, BUSINESSMIRROR, Nov. 16, 2015, *available at* https://businessmirror.com.ph/2015/11/16/revisiting-batas-pambansa-blg-22-or-the-bouncing-checks-law/.

constitutionality was questioned because of its alleged violation of debtors' right against imprisonment for nonpayment of debt, the Supreme Court upheld its validity, ratiocinating that:

> [T]he gravamen of the offense punished by BP 22 is the act of making and issuing a worthless check or a check that is dishonored upon its presentation for payment. *It is not the nonpayment of an obligation which the law punishes.* The law is not intended or designed to coerce a debtor to pay his debt. *The thrust of the law is to prohibit, under pain of penal sanctions, the making of worthless checks and putting them in circulation.* Because of its deleterious effects on the public interest, the practice is proscribed by the law. The law punishes the act not as an offense against property, but an offense against public order.[103]

Although theoretically speaking, it is not the nonpayment of the loan obligation but the issuing of worthless check that is the gravamen of the offense, it has been an established practice among creditors to require post-dated checks before loan proceeds are released. The checks serve as security for the creditor who may present the check against the account of the debtor, in case of the latter's default. Creditors then compel debt payments by threatening to present the worthless check despite both parties knowing that the check will be dishonored by the bank.

Because of the possibility of arrest and imprisonment, the Bouncing Checks Law is used to compel payment against the debtors who issued the post-dated checks in good faith. Such debtors are forced to pay lest they be subject to criminal prosecution. In view of this modern practice, the constitutional prohibition against imprisonment for nonpayment of debt is rendered illusory.[104]

*2. Securing Credit Through a Deed of Sale*

Another unlawful alternative resorted to by creditors to circumvent the prohibition against *pactum commissorium* is the execution of *pacto de retro* sales. A *pacto de retro* sale is a sale with the agreed condition that the seller has the right to repurchase, within a certain period not exceeding 10 years,[105] the property transferred to the buyer.[106] This is commonly used to disguise a security agreement, with the creditor assuming the role of the ostensible buyer and the

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[103] Lozano v. Martinez, G.R. No. 63419, 146 SCRA 323, 308, Dec. 18, 1986. (Emphasis supplied).

[104] CONST, art. VII, § 20. No person shall be imprisoned for debt or non-payment of a poll tax.

[105] CIVIL CODE, art. 1606.

[106] CIVIL CODE, art. 1601.

borrower as the ostensible seller.[107] In this arrangement, the borrower permanently loses ownership over the property after the lapse of the period in case of nonpayment of the loan obligation, creating the impression that it serves as the consideration of the *pacto de retro* sale.

Under Philippine law, if the *pacto de retro sale* (or even a deed of sale without the right of repurchase) has the true intent of securing an obligation, courts treat it as an "equitable mortgage." If deemed to be so by a competent court, three legal effects take place: *first,* any money or fruits received by vendee as rent is considered as interest payment, which is governed by laws on usury;[108] *second,* the apparent vendor may ask for the reformation of the instrument,[109] (i.e., the judicial remedy that the true intent be declared by the courts); and *third*, the stipulation vesting ownership over the property will be deemed void for being in violation of the prohibition against *pactum commissorium*.

Because of the strict application of *pactum commissorium*, where courts give mortgagees no other option but to cause foreclosure and to buy the mortgaged property at a foreclosure sale, deeds of sale are postdated so as to make it appear as a *dacion en pago* executed beyond the due date of the loan obligation.

*3. Usurious Transactions*

The risk of default is higher in unsecured and short-term lending, which may justify a premium to the added interest. This risk, however, may be abused by predatory lenders, where they impose unconscionable interest rates.

As discussed, predatory lending is characterized as loans that have exorbitantly high interest rates, excessive fees, large prepayment penalties, negatively amortized payment plans, or required balloon payments.[110] Although payday loans may fulfill a valid social purpose, as mentioned at the beginning of this Note, numerous studies have highlighted their detrimental effects on consumers. These include high loan costs, structuring of transactions as a loan

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[107] In one case, although the parties' deed transaction was denominated as a *Kasulatan ng Biling Mabibiling Muli*, whereby the sellers sold a land subject to their right to repurchase for the same amount at a time beneficial to them, the Court noted that the transaction showed hallmarks of a security arrangement, such as the vendors' continued possession, payment of taxes, and an indefinite redemption period. Heirs of Jose Reyes, Jr., v. Reyes, G.R. No. 158377, 626 SCRA 758, Aug. 4, 2010.

The Court "has [also] taken judicial notice of the fact that *pacto de retro* sales have been frequently used to conceal contracts of loan secured by a mortgage." Ching Sen Ben v. CA, G.R. No. 124355, 314 SCRA 762, 769, Sept. 21, 1999.

[108] CIVIL CODE, art. 1601.

[109] CIVIL CODE, art. 1605.

[110] Nicholas Bagley, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79(*6*), N.Y.U. L. REV. 2274 (2004).

broker transaction, rolling over of the loan, inability of borrower to make partial payments on principal and high credit fees and other technical terms which cause the vicious cycle of debt trap.[111]

### C. Insufficiencies in Legal Protections Against Usurious Transactions

*1. Imposition of Interest Rate Ceilings*

Before the effectivity of CB Circular No. 905 in 1982, the Monetary Board was authorized under the Usury Law to prescribe the interest-rate ceiling. The Usury Law's suspension was based on the principle that the interest rate must be left to the parties, pursuant to their right of freedom to contract, provided that such interest is not contrary to law, morals, good customs, public order or public policy. For almost 40 years, the freedom to contract regarding interest rates has been upheld, provided that the interest imposed is not unconscionable so as to be contrary to morals. Today, regulatory interest rate caps are imposed on two forms of credit: credit cards and loans extended by LCs, FCs and their OLPs.

The widespread use of credit cards made it highly convenient to obtain credit from banks for purchasing goods and services, leading to credit card holders incurring insurmountable debt balances from uncontrollable spending by consumers who often overlooked the effects of monthly interest rates buried in the fine print of credit card applications. Hence, through BSP Circular No. 1098[112] in 2020, BSP imposed an interest rate cap of twenty four percent (24%) per annum.

Meanwhile, through BSP Circular No. 1133[113] in 2021, the BSP imposed an interest rate cap on unsecured loans offered by LCs, FCs and their OLPs, which cover loans not exceeding PHP 10,000. The nominal interest rate ceiling imposed on such loans is 6% per month, whereas the effective interest rate or the total interest inclusive of all other fees and charges cannot exceed 15% per month.

LCs failing to comply with the rate limits will face penalties of PHP 25,000 and PHP 50,000 for the first and second offenses, respectively, whereas FCs will be penalized with PHP 50,000 for the first offense and PHP 100,000 for the

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[111] *Id.*

[112] BSP Circ. No. 1098 (2020). Ceiling on Interest or Finance Charges for Credit Card Receivables. The Monetary Board through Reso. No. 1185, dated Sept. 17, 2020, amended the "Manual of Regulations for Banks (MORB) and the Manual of Regulations for Non-Bank Financial Institutions (MORNBFI) on the ceiling on interest or finance charges for credit card receivables."

[113] BSP Circ. No. 1133 (2021). Ceiling/s on Interest Rates and Other Fees Charged by Lending Companies (LCs), Financing Companies (FCs), and Their Online Lending Platforms (OLPs).

second offense. The penalty for the third offense for both lending and financing companies will be twice the amount imposed for the second offense, up to PHP 1 million. This penalty also coincides with the suspension of their financing and lending activities for 60 days, as well as the revocation of their Certificates of Authority to Operate as an LC or FC.[114]

Although recent issuances by the Monetary Board and the SEC have aimed to regulate interest rates by imposing fines and other administrative sanctions against LCs and FCs, Congress has yet to enact penal legislation to regulate unconscionable interest rates. It is important to note that the fear of criminal liability will not prevent lenders from extending credit but may lead to more reasonable and proportionate interest rates reflecting the risk assumed by the lender. Although it is true that high-risk borrowers bear higher interest rates reflecting the lender's assumed risk, there is a compelling state interest in forbidding unconscionable interest rates and regulating the underlying malicious intent that aims to ensnare debtors in unmanageable debts. Imposing exorbitant interest rates goes beyond providing credit assistance, exposing a clear intention to exploit borrowers and generate unearned profits through a cycle of debt. Thus, state intervention plays a crucial role in safeguarding individuals from such predatory practices and fostering fair and responsible lending.

To balance the interests of creditors without deterring honest and lawful lending businesses, laws imposing criminal liability should specifically target creditors who knowingly and maliciously subject the debtor to an unconscionable interest rates. As for what constitutes criminal usury, different levels of interest rate caps are imposed on different forms of loans, which vary across state jurisdictions in the United States, as elaborated further later on.

*2. Economic Consequences of Regulating Interest Rates*

Imposing regulatory interest rate caps to prevent usurious lending practices, however, is not without consequences. Reasonableness of the level of interest, being the price of borrowing money, is highly influenced by market players and elements, such as the borrowers, lenders, financial intermediaries, income, consumption, productivity and other economic factors.[115] Related to this concept is the BSP's main function to maintain price stability by adjusting

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[114] SEC Mem. Circular No. 3 (2022). This Memorandum Circular implements BSP Circ. No. 1133 (2021).

[115] Jarle Bergo, *The role of the interest rate in the economy*, NORGES BANK, Oct. 19, 2003, *available at* https://www.norges-bank.no/en/news-events/news-publications/Speeches/2003/2003-10-19/.

overnight rates *vis-à-vis* the inflation rate, or the rate of increase in price within a given period of time, growth rate and other related factors.[116]

Hence, to mitigate the effects of a high inflation rate, the BSP may opt to increase overnight rates, aiming to curb borrowing and consumption.[117] Consequently, this would compel the banks to increase their individual interest rates so as to maintain a profitable credit spread.

In theory, imposing interest rate regulations may lead to market inefficiency if the interest rate caps prevent banks from adjusting their lending rates in response to natural economic conditions. Intermediaries thriving on a thin credit spread and on tight liquidity may be forced out of the industry. If the market rate exceeds the ceilings, Iain Ramsay posits that "ceilings will result in lenders either attempting to clawback costs through other charges or, if this is not possible, excluding higher-risk borrowers and driving them to borrow from illegal lenders."[118]

Relevant to the discussion is Efraim Benmelech and Tobias J. Moskowitz's study on the political economy of financial regulation.[119] This study found that usury laws had a significant impact on financial and economic activity, particularly among smaller borrowers.[120] The authors found that "when market interest rates approach or exceed the maximum legal rate, usury laws become more binding" and loans *per capita* decrease."[121] This confirms that usury laws indeed reduce lending, and since high interest rates are more common among smaller borrowers, they are the most affected.[122]

In relation to growth rates, although the study found that relaxation of usury laws leads to higher growth rates for small farms, the authors cautioned the readers by providing an alternative interpretation of the results, such that is not that usury laws affect growth directly, but that the political economy drives both financial regulation and growth.[123] After testing this argument, Benmelech and

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[116] Bangko Sentral ng Pilipinas, *Price Stability — Inflation Targeting: The BSP Approach to Monetary Policy*, BSP WEBSITE, Dec. 2019, *available at* https://www.bsp.gov.ph/Pages/PriceStability/InflationTargetting.aspx.

[117] Bangko Sentral ng Pilipinas Departmtent of Economic Research, *Inflation Targeting: The BSP and Price Stability*, 1–18, 3, BSP WEBSITE, Dec. 2019, *available at* https://www.bsp.gov.ph/Price%20Stability/targeting.pdf.

[118] Iain Ramsay, *Of Payday Loans and Usury: Further Thoughts*, 38 CAN. BUS. L. J. 386 (2003).

[119] Efraim Benmelech & Tobias J. Moskowitz, *The Political Economy of Financial Regulation: Evidence from US State Usury Laws in the 19th Century*, 65(*3)* J. OF FIN. 1029–1073 (2010). doi: 10.1111/j.1540-6261.2010.01560.x

[120] *Id.* at 1040.

[121] *Id.* at 1041.

[122] *Id.* at 1042.

[123] *Id.* at 1054.

Moskowitz obtained data showing that market interest rates approaching usury ceilings result in increases in regulatory rate ceilings.[124] Conversely, when lending becomes less costly, a reduction of regulatory ceilings follows.[125]

Such data is consistent with the relationship between relaxing usury laws and growth rates of small farms. The reduction of the interest rate ceiling is attributable to the lower market interest rate, which in turn drives the growth of small businesses due to the cheaper cost of borrowing money.

*3. Criminal Usury Laws and Other Borrower–Protection Laws Against Usurious Transactions*

Usury is criminalized in almost every state in the United States. The level of interest rate classified as punishable, the type of loan arrangement involved, and the corresponding penalties vary in each state.[126]

In New York, its penal law criminalizes the offense of usury in the second degree, which makes it a felony to knowingly charge or collect interest rates exceeding 25% per annum (classified as a class E felony).[127] Additionally, the offense of usury in the first degree is committed when either the actor had previously been convicted of the crime of criminal usury or of the attempt to commit such crime, or the actor's conduct was part of a scheme or business of making or collecting usurious loans (classified as a class C felony).[128]

Another example is the Illinois Criminal Code, in which Article 39 thereof punishes a person for criminal usury if he or she offers a loan with an interest higher than 20% per year (classified as a Class 4 felony).[129]

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[124] *Id.* at 1050.

[125] *Id.*

[126] *See also* Colleen Honigsberg, Robert J. Jackson, Jr., & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment,* 68(*2*) J.L. & ECON. 673–712 (2017), *available at* https://law.stanford.edu/wp-content/uploads/2017/08/Honigsberg__Jackson__Squire__2017_.pdf.

[127] N.Y. Penal Law §§ 190.40.

[128] N.Y. Penal Law §§ 190.42.

[129] 720 Ill. Comp. Stat. 5/39 et seq. (2024).

Criminal usury laws are likewise enforced in Pennsylvania, Georgia, and Texas where imposition of interest rates are punishable when they exceed 36% per year,[130] 5% per month,[131] and 20% per year,[132] respectively.

The closest that the Philippines has gotten to providing a criminal usury law is the enactment of the Usury Law, as amended, where it provides:

> Violation of this Act and the implementing rules and regulations promulgated by the Monetary Board shall be subject to criminal prosecution and the guilty person shall, upon conviction, be sentenced to a fine of not less than [PHP 50.00] nor more than [PHP 500.00], or to imprisonment for not less than [30] days nor more than one year, or both.[133]

Although this penal clause appears to punish usury, it must be reconciled with the provision that delegates the determination of interest rate ceilings to the Monetary Board. Thus, assuming that the Monetary Board sets an interest rate ceiling, criminal prosecution is still not proper, since what is violated is the Monetary Board's Circular and not the Usury Law or its implementing rules and regulations.

To be criminally prosecuted under the amended Usury Law requires that the law itself imposes an interest-rate ceiling, an act which only Congress can do through the amendment of the law, and that such ceiling be violated.

The United States also protects its borrowing community through the Dodd-Frank Wall Street Reform and Consumer Protection ("Dodd-Frank") Act.[134] The law's main purpose was to address the abusive lending practices of financial institutions that led to the Global Financial Crisis of 2008. One of the features of the law is that it strictly prohibits the issuance of loans without a reasonable determination of the borrower's ability to pay, prescribing certain documents such as annual tax returns and assessments.[135] Notably, the Dodd-Frank Act created the Consumer Financial Protection Bureau (CFPB) as an independent agency responsible for enforcing financial consumer protection laws

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[130] 18 Pa. Cons. Stat. § 4806.1 (2024). This provision from the Pennsylvania Consolidated Statutes Title 18 criminalizes usurious lending in the state by penalizing interest rates exceeding 36% per annum.

[131] O.C.G.A. § 7-4-18 (2024). The Official Code of Georgia Annotated enforces the state's criminal usury laws by making it a misdeeaneor to "reserve, charge, or take" any interest rate greater than 5% per month (or 60% per annum).

[132] Tex. Fin. Code § 305.008 (2024).

[133] Usury Law, § 10.

[134] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

[135] *Recent Regulation*, 131 HARV. L. R., Vol. 1852 (2018).

and promoting transparency and fairness between borrowers and lending institutions.

*4. Judicial Standard in Striking Down Unlawful Interest Rates: Subjective Levels of "Excessive" Interest and The Lack of Consistent Policy Against Usury*

Despite the fact that it is legally impossible to convict under the prevailing amended Usury Law, civil remedies are fortunately available. When interest rate stipulations are declared void for being contrary to law, morals, or public policy, Philippine courts have the power to declare the interest rate stipulation void. Since the interest rate stipulation may be severed from the entire contract, only the interest rate is nullified by the courts. This is pursuant to the Civil Code, which provides that "in case of a divisible contract, if the illegal terms can be separated from the legal ones, the latter may be enforced."[136]

Stipulations authorizing "iniquitous" or "unconscionable" interests have consistently been struck down for being contrary to morals, if not against the law. Being contrary to morals, these contracts are deemed void under the Philippine law.[137]

For instance, the Supreme Court in *Macalinao v. BPI* declared that the interest rate of 3% per month (and higher) imposed on credit cards was excessive and therefore invalid.[138] However, the same Court upheld the validity of an interest rate of 21% per annum and 24% per annum in *Bautista v. Pilar Development Corp.*[139] and *Garcia v. Court of Appeals*,[140] respectively. Although the interest rate in *Garcia* was upheld, the penalty charges in such case amounting to 3% per month were deemed excessive and unconscionable.

Decades later, in the previously discussed case of *Dimas-San Juan,* where a monthly interest rate of 4.75% (or 7% per annum) was indicated in the promissory note, the Supreme Court held that this rate was clearly excessive.[141] The Court cited its ruling in *Megalopolis Properties, Inc. v. D'Nhew Lending Corp.,*[142] where an interest rate of 36% per annum or "three times more than the default legal rate"[143] is excessive and unconscionable, echoing the ruling in *Macalinao.* Thus,

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[136] CIVIL CODE, art. 1420.

[137] *Advocates for Truth*, 701 Phil. 483.

[138] [Hereinafter "*Macalinao*"], Macalinao v. BPI, G.R. No. 175490, 600 SCRA 67, Sept. 17, 2009.

[139] G.R. No. 135046, 312 SCRA 611, Aug. 17, 1999.

[140] G.R. Nos. 82282-83, 167 SCRA 815, Nov. 24, 1988.

[141] *Dimas-San Juan*, G.R. No. 243165.

[142] [Hereinafter "*Megalopolis*"], G.R. No. 243891, 982 SCRA 428, May 5, 2021.

[143] 982 SCRA 428, 444.

although there is no general or universal numerical limit on conscionability regarding a validly binding rate of interest, the Supreme Court has consistently pegged invalid interest rates starting at 3% per month.

It is worth noting that the Supreme Court itself emphasized that the "illegality of usury is wholly the creature of legislation."[144] In the same breadth, the consistent pattern of the Supreme Court nullifying interest rates equivalent to 3% per month or higher raises questions and may be seen as an issue in itself. The tension between the judiciary's duty to interpret and apply the law and the legislature's authority to create laws on usury underscores an ongoing debate about the proper boundaries of judicial power. This topic warrants further examination and consideration to strike the appropriate balance between the branches of government and ensure the fair and consistent application of the law.

## IV. EVALUATING THE INSUFFICIENCIES OF SPECIFIC PHILIPPINE STATUTES GOVERNING LENDING

### A. Specific Statutes on Lending

*1. Truth in Lending Act of 1963*[145]

The Truth in Lending Act ("TILA") was enacted in the Philippines in 1963 to penalize lenders who conceal information from their borrowers with regard to the true cost of their credit. It is apparent that, after implementation of the law for more than half a century, TILA's effectiveness in safeguarding consumers against predatory lending practices, particularly those involving loans that are impossible to repay, is questionable.

The law merely mandates that the following statements be set forth in writing prior to the consummation of the credit transaction:

a) The cash price or delivered price of the property or service to be acquired;
b) The amounts, if any, to be credited as down payment and/or trade-in;
c) The difference between the amounts set forth under clauses (a) and (b);
d) The charges, individually itemized, which are paid or to be paid by such person in connection with the transaction but which are not incident to the extension of credit;
e) The total amount to be financed;

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[144] First Metro Investment Corp. v. Este Del Sol Mountain Reserve, Inc., G.R. No. 141811, 369 SCRA 99, 111, Nov. 15, 2001.

[145] Rep. Act No. 3765 (1963). An Act to Require the Disclosure of Finance Charges in Connection with Extensions of Credit [hereinafter "TILA"].

> f) The finance charge expressed in terms of pesos and centavos; and
> g) The percentage that the finance bears to the total amount to be financed expressed as a simple annual rate on the outstanding unpaid balance of the obligation.[146]

Congress enacted this law to provide meaningful disclosure of fees, assuming that the cause of debt traps is because of the borrower's ignorance of the finance charges. However, even if the borrower is aware of the enumerated information and the finance charges, TILA does not protect the borrower from predatory lenders who utilize complex fees and penalty structures in the guise of "itemized" charges, which are comprehensible only to finance experts.

Payday loans necessitate more than transparency in finance charges in the form of percentages. Such attractive and highly accessible loans should also emphasize the large estimates of the debt obligation at the end of the week, month and year for ease of comprehending the possible ballooning of the debt if assumed to be unpaid. It is only when the impulsive borrower is aware of the worst-case scenario that he or she will take a step back to thoroughly reconsider his or her decision.

Another insufficiency of the law is its failure to provide any civil remedies to the borrower in case of noncompliance with the TILA. Nondisclosure of the finance charge neither renders the contract void nor gives the borrower a right to rescind the agreement. The TILA even expressly states that "nothing contained in this Act or any regulation contained in this Act or any regulation thereunder shall affect the validity or enforceability of any contract or transactions."[147]

Thus, even if the lender fails to comply with the disclosure requirements of TILA, the borrower is bound by the stipulations of the contract. Although this is without prejudice to the borrower's ordinary remedy under the Civil Code to seek annulment of the contract, he or she still has the burden to prove that he or she did not consent to the unwritten terms of the loan agreement.

*2. Financing Company Act of 1998 and Lending Company Regulation Act of 2007*

The Financing Company Act of 1998[148] and the Lending Company Regulation Act of 2007[149] prescribe registration and capital requirements for

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[146] TILA, § 4.
[147] TILA, § 6(b).
[148] Rep. Act No. 8556 (1998). Financing Company Act of 1998.
[149] Rep. Act No. 9474 (2007). Lending Company Regulation Act of 2007.

financing companies and lending companies, respectively. Through these laws, it becomes imperative that lenders may only provide payday loans if they have complied with the necessary registration requirements. This allows the SEC to conveniently monitor the lending activities of such entities. However, both laws do not in any way protect the buyer from predatory lending practices as the latter themselves are not expressly prohibited under the said statutes.

*3. PAGCOR and Casino Loan Sharks*

Casinos often serve as hotspots for predatory lending practices, exploiting highly vulnerable potential borrowers who suffer from gambling addictions. Consequently, it is not uncommon for casino players to be caught in a vicious debt cycle.[150] Neither Philippine Amusement and Gaming Corporation (PAGCOR)'s charter nor any of its issuances regulate the practice of predatory lending by junket operators[151] or by loan sharks in the gaming industry. Given the behavior of casino players and the public interest imbued in operating casinos, both PAGCOR or Congress has yet to provide a regulation to protect casino players from predatory financing and lending practices.

*4. Personal Property Security Act*

Section 66 of the PPSA repealed the laws enumerated under the said provision,[152] but only if the law enumerated is inconsistent with the provisions of the PPSA. Although the PPSA has repealed many of the archaic provisions of the Civil Code of the Philippines, the prohibition against *pactum commissorium* under

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[150] *See also* Atte Oksanen, Iina Savolainen, Anu Sirola, & Markus Kaakinen, *Problem gambling and psychological distress: A cross-national perspective on the mediating effect of consumer debt and debt problems among emerging adults,* 15 Harm Reduction J. (2018), *available at* https://harmreductionjournal.biomedcentral.com/articles/10.1186/s12954-018-0251-9.

[151] Junket operators are those who act as intermediary between the casino player and casinos, providing financial services to the casino player including credit, especially when the casino player is unable to bring in large funds from abroad. *See also* United Nations Office on Drugs and Crime, *Casinos, Money Laundering, Underground Banking, and Transnational Organized Crime in East and Southeast Asia: A Hidden and Accelerating Threat,* UNITED NATIONS (Jan. 2024), 1, n.2, *available* at https://www.unodc.org/roseap/uploads/documents/Publications/2024/Casino_Underground_Banking_Report_2024.pdf.

[152] PPSA, § 66 provides that the following provisions are repealed:

(a) Act No. 1508 (1906), or the Chattel Mortgage Law;
(b) Civil Code, arts. 2085–2123, 2127, 2140–2141, 2241, 2243, and 2246–2247;
(c) Rep. Act No. 5980 (1969), § 13, or the Financing Company Act;
(d) Pres. Dec. No. 1529 (1978), §§ 10, 114–116, or the Property Registration Decree; and
(e) Rep. Act No. 4136 (1964), § 5(e), or the TRANSP. & TRAFFIC CODE.

Article 2088 of the Civil Code[153] was not repealed. This is because the old-age policy against *pactum commissorium* is not inconsistent with the PPSA.

*Pactum commissorium* has been construed by the Philippine Supreme Court as having the following elements:[154] (a) there should be a property mortgaged by way of security for the payment of the principal obligation, and (b) there should be a stipulation for automatic appropriation by the creditor of the thing mortgaged in case of non-payment of the principal obligation within the stipulated period.

A seemingly inconsistent rule under the PPSA is Section 54(b)[155] of the said law which allows a secured creditor to *propose* to the debtor or grantor to retain the personal property in total or partial satisfaction of the unpaid debt in case of default. The same provision, however, is not inconsistent with the prohibition against *pactum commissorium* since the former does not provide or allow for automatic appropriation of the collateral in case of non-payment within the stipulated period. Instead, the creditor is required to obtain the consent of the grantor to retain the personal property in satisfaction of the unpaid debt. Failure of the grantor to send a written objection is tantamount only to an implied acceptance. This, far from being contrary to *pacum commissorium,* is in fact a form of *dacion en pago*, which is already practiced and allowed even before the PPSA's enactment as this form of extinguishment of obligation finds basis under the Civil Code.

Another seemingly inconsistent provision is Section 48(c) and (d)[156] of the PPSA regarding the deposit accounts maintained by the secured creditor (such

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[153] CIVIL CODE, art. 2088. The creditor cannot appropriate the things given by way of pledge or mortgagee, or dispose of the same.

[154] Bustamante v. Spouses Rosel*,* G.R. No. 126800, 319 SCRA 413, Nov. 29, 1999.

[155] PPSA, § 54. *Retention of Collateral by Secured Creditor.* — (b) The secured creditor may retain the collateral in the case of:

1. A proposal for the acquisition of the collateral in full satisfaction of the secured obligation, unless the secured creditor receives an objection in writing from any person entitled to receive such a proposal within twenty (20) days after the proposal is sent to that person; or
2. A proposal for the acquisition of the collateral in partial satisfaction of the secured obligation, only if the secured creditor receives the affirmative consent of each addressee of the proposal in writing within twenty (20) days after the proposal is sent to that person.

[156] PPSA, § 48(c)–(d). *Recovery in Special Cases.* — Upon default, the secured creditor may without judicial process:

c) In a deposit account maintained by the secured creditor, apply the balance of the deposit account to the obligation secured by the deposit account; and

d) In other cases of security interest in a deposit account perfected by control, instruct the deposit-taking institution to pay the balance of the deposit account to the secured creditor's account.

as a bank) and other cases of security interest in a deposit account perfected by a control agreement. Section 48 provides that the secured creditor, who holds the deposit account, may apply the balance of the deposit account to the obligation secured in case of default.[157] This is also not inconsistent with the prohibition against *pactum commissorium*, since this is an extinguishment of obligation through compensation. The funds deposited with the secured creditor are, in fact, already under the secured creditor's ownership to begin with as these funds were transferred under the contract of a simple loan or *mutuum*.

As for cases where security interest in a deposit account is perfected by a control agreement, PPSA allows the execution of such agreement to grant the creditor the right to instruct the deposit-taking institution to pay the secured creditor's account. It must be noted that this right is also not an automatic appropriation of any property belonging to the grantor. To reiterate, the nature of a deposit is a simple loan. Consequently, the right of the creditor granted under the PPSA is merely a right to garnish the funds under the deposit account. Therefore, the control agreement executed between the secured creditor and the depositor-grantor is equivalent to the act of assigning in favor of the former the latter's rights to the contract of *mutuum* executed between the depositor-grantor and the deposit-taking institution.

Needless to say, the law uses the phrase "balance of the deposit account"[158] to refer to fund deposits, contemplating only money deposited as opposed to specific non-fungible property. In view of the PPSA's provisions being reconcilable with the prohibition against *pactum commissorium*, Article 2088 of the Civil Code subsists and remains effective.

*5. Financial Products and Services Consumer Protection Act of 2022*

Enacted in 2022, Republic Act No. 11765, also known as the Financial Products and Services Consumer Protection Act ("FPCA")[159] is the most recent innovative piece of legislation that applies broadly to regulate financial activity. The law uses the term "financial consumers" to refer to any person who is a purchaser, lessee, or recipient of a financial product or service or any person who had or has current or prospective financial transaction with a financial service provider.[160] Meanwhile, "financial service providers" are those who provide "financial products" which include savings, deposits, credit, insurance, and digital financial products or services and are under the jurisdiction of financial regulators,

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[157] PPSA, § 48.

[158] PPSA, § 48.

[159] Rep. Act No. 11765 (2022). Financial Products and Services Consumer Protection Act [hereinafter "FPCA"].

[160] FPCA, § 3(a).

such as the BSP, SEC, Insurance Commission (IC), and the Cooperative Development Authority (CDA).[161]

The FPCA provides avenues for consumer redress and complaints, with the adjudication granted to financial regulators. The BSP and SEC are given the authority to adjudicate actions from financial transactions that are purely civil in nature and where the claim does not exceed PHP 10,000.00.[162] In relation to predatory lending practices, the borrower under this law is also granted the right to prepay a loan or other credit transaction at any time prior to the agreed maturity.[163]

The FPCA also functions as a penal law insofar as it punishes any violation of the said law by imprisonment of not less than one year but not more than five years, or by a fine of not less than PHP 50,000.00 but not more than PHP 2,000,000.00, or both such imprisonment and fine.[164]

A punishable act under the FPCA is the practice of employing "abusive collection or debt recovery practices"[165] by the financial service providers. Worthy to note however is that the law does not specify the acts that constitute as these abusive practices.

Further, the phrase "abusive collection or debt recovery practices" only refers to acts during the stage of collection and does not cover predatory lending practices committed *prior* to or during the perfection of the loan agreement. These acts are, in fact, more essential than those committed during the collection stage, since acts prior to and during the perfection of the loan agreement are the ones that trap the borrower into a heavy debt burden. These acts include negligent assessments of the consumer's financial capacity to pay and the stipulation of exorbitant interest rates and fees as discussed.

In contrast to the FPCA, the Dodd-Frank Act of the United States outlines specific acts of unfair and predatory lending practices, collectively referred to as Unfair, Deceptive, or Abusive Acts or Practices (UDAAP), as provided under Section 1036 thereof. The standard for unfairness in the Dodd-Frank Act is that an act or practice is unfair when: (1) it causes or is likely to cause substantial injury to consumers; (2) the injury is not reasonable avoidable by

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[161] FPCA, § 3(e).
[162] FPCA, § 6(f).
[163] FPCA, § 8(b)(3).
[164] FPCA, § 15.
[165] FPCA, § 8(d).

consumers; and (3) the injury is not outweighed by countervailing benefits to consumers or to competition.[166]

Another insufficiency of the FPCA is that it is product-focused. No enforcement mechanism is provided for the fulfillment of the financial provider's duty to fairly assess and evaluate consumers. The law mandates that financial service providers continuously evaluate their financial products to ensure that they are suited to the needs, understanding and capacity of their markets and clients.[167] This includes, among others, the duty of financial providers to establish written procedures to assess whether a particular financial product or service is suitable and affordable for their clients to protect financial consumers from hasty credit arrangements that may trap them into inescapable debt burdens. However, despite the law requiring written procedures to take into account the client's ability to pay, the financial provider is still given sufficient discretion whether or not to comply with such procedures.

To add, given that no penalty is imposed on any failure to comply with the formulated written procedure, the FPCA has no teeth, showing inadequacy in enforcing its state policy. Stated differently, there are no means for enforcing the written procedures. Instead, financial providers are granted the discretion to disregard these procedures and may not thoroughly evaluate the consumer.

Notwithstanding this discretion, an interesting feature of the FPCA, which may protect borrowers from predatory lending practices and help avoid hasty borrowings is the cooling-off policy under Section 8(b)(2) thereof. The FPCA provides that financial service providers are "expected" to adopt a cooling-off policy, which should provide a cooling-off period that will allow a client to consider the costs and risks of a financial product or service, free from the pressure of the sales team of the financial service provider.[168] It may be conceded that the cooling-off policy, an innovative rule under the FPCA, protects the consumers from *impulsive* borrowing, and that failure to adopt a cooling-off policy will subject the financial provider to administrative and criminal penalties.

Nevertheless, similar to the previously discussed provisions, the FPCA fails to provide a clear enforcement mechanism in case of non-compliance with the cooling-off policy itself once already adopted. Further highlighting the ineffectiveness of the law, the first paragraph of Section 8(b)(2) grants financial

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[166] Consumer Financial Protection Bureau (CFPB), Supervision & Examination Manual V.3: Unfair, Deceptive, or Abusive Acts or Practices (UDAAP), 1 (Mar. 2022), *citing* Dodd–Frank Act, Pub. L. No. 111–203, tit. X, §§ 1031–36, 124 Stat. 1376 (2010).

[167] FPCA, § 8(b)(1).

[168] FPCA, § 8(b)(2), ¶ 1. "Financial service providers are expected to adopt a clear cooling-off policy. […] Financial providers may opt not to provide for cooling-off period for short-term transaction or contracts."

providers the discretion to forgo creating a cooling-off policy for short-term transactions or contracts, allowing financial providers "to opt not to provide for cooling-off period for short-term transaction."[169] It is precisely these short-term lending arrangements that necessitate the cooling-off policy the most, given the accessibility and substantial debt burden they may impose on borrowers.

### B. Lending Restrictions as Violations of the Freedom to Contract

As previously mentioned, the Supreme Court has established a longstanding principle that the debtor's consent to an unconscionable interest rate holds no bearing on its validity.[170] However, it is important to consider the opposing viewpoint, which upholds the principle of freedom of contract. This principle recognizes the constitutional and statutory rights of individuals to enter into agreements, as long as those agreements are not contrary to law, morals, good customs, public order, or public policy.

Although interest-rate ceilings provide direct protection against exorbitant interest rates, they also encroach upon the freedom of borrowers and lenders to negotiate in accordance with their own market dynamics and risk considerations. Indeed, the implementation of effective interest rate ceilings hinders the lender and borrower's ability to agree upon penalties in the event of borrower default. The inclusion of a penal clause in the agreement serves, among other purposes, as a deterrent for the borrower to default, acting as a coercive measure to ensure compliance with the primary obligation. However, the imposition of effective interest rate ceilings, which cap the maximum total interest rate, including penalties in the event of default, diminishes the bargaining power of lenders during contract negotiations.

Another regulation that may be viewed as an interference with the principle of freedom of contract, specifically the principle of mutuality of contracts, is the FPCA's mandate to grant borrowers the right to prepay a loan. Whenever in an obligation a period is designated, Article 1196 of the Civil Code presumes that the period is established for the benefit of both the creditor and the debtor.[171] This presumption prohibits any unilateral exercise to forego the period and is consistent with the principle of mutuality of contracts.

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[169] FPCA, § 8(b)(2), ¶ 1.

[170] *Megalopolis,* 982 SCRA 428, 441–42.

[171] CIVIL CODE, art. 1196 provides "[w]henever in an obligation a period is designated, it is presumed to have been established for the benefit of both the creditor and the debtor, unless from the tenor of the same or other circumstances it should appear that the period has been established in favor of one or of the other."

However, through the FPCA's enactment, this presumption is made inapplicable to loan agreements. On the contrary, the provision granting borrowers the right to prepay before the loan reaches maturity creates a presumption that the stipulated period was solely intended for the benefit of the borrower, who retains the option to waive such a period. Consequently, it has become legally unfeasible to establish a period that guarantees interest payments for the lender. This poses a challenge for lenders who rely on those interest payments as expected revenue to cover legitimate expenses associated with their lending business.

With regard to creditworthiness regulations, not only do they have the potential to restrict access to credit facilities, but they also pose an obstacle to the borrower's freedom to incur obligations and the creditor's freedom to assume risks. The stringent and cumbersome credit evaluation procedures followed by banks are precisely what drive small-loan borrowers to seek products from payday lenders who are willing to bear the high risk of default in exchange for charging higher interest rates. When requirements are imposed to assess the borrower's ability to repay, borrowers may turn to unregistered lenders who engage in illegal lending practices and impose even more unconscionable interest rates compared to regulated payday lenders.

## V. RECOMMENDATIONS

### A. Revisiting Laws Governing Secured Transactions

#### *1. Relaxing the Prohibition Against* Pactum Commissorium

As previously discussed, *pacto de retro* sales are contracts of sale that include the right to repurchase. However, when these contracts are executed with the intention of securing obligations, they are often seen as a means of circumventing the rule against *pactum commissorium*. To address this issue, the law treats *pacto de retro* sales as equitable mortgages, rendering any transfer of rights from the owner-debtor to the buyer-creditor ineffective. Consequently, deeds of sale are postdated for practical purposes to secure debts.

Given these prevailing practices, it is necessary to adopt new policies and interpretations that apply the general rules of novation more liberally. This approach relaxes the application of the *pactum commissorium* prohibition and of the presumption in favor of equitable mortgages.

As discussed, the historical prohibition against *pactum commissorium* was initially intended to address the Church's opposition to the imposition of interest. The Philippines, however, continues to adhere to this ancient policy and strictly

enforces the prohibition. Although it is possible to assume a modern purpose for the prohibition, such as allowing the mortgagor an opportunity to raise defenses related to the enforcement of the security, this policy, in itself, is insufficient in precluding the streamlining of foreclosure procedures, such as the intent of extrajudicial foreclosures to dispense with the hearing of the parties.

Although the PPSA already permits the transfer of ownership of collateral upon the creditor's proposal and the lapse of a certain period, this rule must be made applicable to real properties as well, as it conveniently allows the parties to extinguish the contractual obligation through novation or through a *dacion en pago*. By relaxing the prohibition against *pactum commissorium*, the convenience in enforcing security interests facilitated by the PPSA could be extended to credit arrangements secured by real properties. A *dacion en pago* is a legal form of payment, extinguishing the loan obligation by performance of another obligation not originally intended. Although this form of payment is similar to the concept of securing credit through a *pacto de retro* sale, a *dacion en pago* should be treated differently by the courts since the same is a legally recognized form of extinguishing obligations.

In recent cases, such as in *Dimas-San Juan*,[172] the Supreme Court has exhibited an aversion against extinguishing a loan obligation through a *dacion en pago*. Similarly, in the case of *Dacquel v. Spouses Sotelo*,[173] the parties involved, convinced that the debtor would be unable to fulfill the payment obligation, reached an agreement to settle the debt by executing a Deed of Sale. This agreement entailed the transfer of property in consideration of the loan amount. However, when the debtor refused to surrender the property, the creditors in this case were compelled to file a complaint for the reconveyance of the title.

Ultimately, the Supreme Court decided in favor of the defendant, accepting the defendant's position that the agreement should be declared as an equitable mortgage. Despite therefore the subsequent agreement to convert the demandable monetary obligation to be settled by way of *dacion en pago*, the subsequent contract was still struck down as an equitable mortgage to the prejudice of the creditors.

*2. Legal Alternatives in Enforcing Security Interests*

In the Philippines, the available remedies for a mortgagee are limited to either judicial or extrajudicial foreclosure of the mortgage, or resorting to an ordinary civil action for collection. However, the rules governing foreclosure, as previously discussed, are often perceived as burdensome and ineffective in

[172] *Dimas–San Juan,* G.R. No. 242718.

[173] Dacquel v. Spouses Sotelo, G.R. No. 203946, 996 SCRA 111, Aug. 4, 2021.

achieving their intended purposes, particularly concerning the requirements for notice and publication.

An alternative to the traditional foreclosure of mortgage is the execution of a deed of trust as a security agreement. Although not recognized by Philippine law, the deed of trust for purposes of securing credit was first discussed in a 1923 case, *El Hogar Filipino v. Paredes,*[174] wherein such deed was defined as "a deed conveying land to a trustee as mere collateral security for the payment of a debt, with the condition that it shall become void on the payment of the debt when due, and with power to the trustee to sell the land and pay the debt in case of default on the part of the debtor."[175]

A distinctive feature of a deed of trust used to secure a loan is the transfer of title to a third-party trustee for the borrower's use and benefit.[176] In *El Hogar*, the *ponente*, Justice Thomas A. Street, invoked US jurisprudence to recognize the concept of a deed of trust in the nature of a mortgage. Given that such concept had no basis in law in the Philippines, Justices George Malcolm and Justice Elia Finley Johnson dissented, both emphasizing that Philippine law does not sanction the grant of "powers of sale" in favor of trustees and mortgagees.

Also relevant to the discussion is Justice Johnson's observation concerning the geographic and linguistic conditions of the Philippines to support his position against allowing the power of sale to be given to creditors as means to facilitate foreclosure sales. As Justice Johnson explained:

> It is a matter of common knowledge in the United States, founded, upon the same basis are here, that more than [100%] of the people read the newspaper, and the whole country is threaded with railroads, telephone and telegraph lines, and the people have and use a common language, and the mail carries letters and newspapers in four days from one side of the continent to the other, and the whole United States is composed of one contiguous body of land.
>
> Make a contract between that and the geographical conditions in the Philippine Islands, and the length of time it requires for a letter to go from one island to another, and the many different dialects and languages spoken, and the percentage of people who read the newspaper.

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[174] G.R. No. L-19843, 45 Phil. 178, Oct. 3, 1923.

[175] 45 Phil. 178, 192.

[176] Legal Information Institute, *Deed of Trust,* CORNELL L. SCH. LEGAL INFORMATION INSTITUTE, *available at* https://www.law.cornell.edu/wex/deed_of_trust.

> This court is not dealing with conditions that exist in the United States, or in Great Britain, or in Spain, but it is dealing with the economic and physical conditions that exist in the Philippine Islands.[177]

These reasons, however, have become obsolete in today's era because of the emergence of technology, the widespread availability of information, and the seamless communication flow among the islands of the Philippines. In contrast, Justice Johnson's reasons are actually valuable considerations as to why more alternatives to foreclosure of mortgage are preferable.

Several laws in the United States recognize securing credit through a deed of trust. An example is the California Civil Code, which contains rules governing deeds of trust as a form of mortgage, such as allowing a stipulation in the deed to grant the appointed trustee the power to sell the property.[178] Similar to this is the rule that extrajudicial foreclosure of mortgages in the Philippines requires that the debtor grants a special power or authority to sell real property in favor of the mortgagee.[179]

Though similar, there are several advantages in resorting to a deed of trust compared to resorting to extrajudicial foreclosures. The enforcement of a deed of trust is faster and more convenient to both parties. In the enforcement of a deed of trust, the mortgagee is not required to follow court procedures, such as filing an application before the clerk of court, as mandated by the rules on extrajudicial foreclosure.[180] Furthermore, because of the rule allowing only court sheriffs to conduct the auction sale, a high volume of applications for extrajudicial foreclosures can contribute to delays in the process.

On the other hand, in a deed of trust, the inclusion of a third-party trustee with the power of sale eliminates the need for court sheriffs or clerks of court to facilitate the extrajudicial mortgage and auction sale on behalf of the mortgagee, as long as the requirements for notice are met. Granting the power to sell to a third-party trustee represents a form of delegation, making the process faster, more cost-effective, and fairer compared to traditional extrajudicial foreclosure methods. In the United States, a "title company" often assumes the role of the third-party trustee to whom legal title of the real property is transferred in a deed of trust. Such company is duly authorized by both the borrower and the lender to conduct the auction sale in the event of borrower default.[181]

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[177] 45 Phil. 178, 199.
[178] CAL. CIV. CODE, § 2924.
[179] Baysa v. Plantilla, G.R. No. 159271, 762 SCRA 433, July 13, 2015.
[180] *See* REAL EST. FORECLOSURE PROC., 1.
[181] Legal Information Institute, *supra* note 181.

Another possible proposal to enhance the enforcement of secured credit transactions is the introduction of mandatory mediation or negotiation as a prerequisite prior to the sale of the secured property. Unlike the existing rules on judicial and extrajudicial foreclosure and the enforcement of security interests in personal property, which do not require such a prerequisite, mandatory mediation serves as both a legal safeguard for borrowers to potentially restructure their loan agreements and an opportunity for creditors to recover the owed amount based on adjusted terms. Additionally, this requirement offers debtors the chance to reassess their financial capacity and current situation. The involvement of mediators in adjudicating and assessing the validity of stipulations may also foster early compromise agreements, which could help reduce the number of court cases related to foreclosure and debt collection. Implementing mandatory mediation could provide a more balanced and efficient approach to resolving disputes between borrowers and creditors, offering benefits to both parties involved.

In relation to personal property security agreements, certain mechanisms still need to be followed to enforce security interests in personal property. However, the PPSA includes an innovative provision that allows creditors to retain the collateral as means to enforce their security interests. In the event of default, the law grants the creditor the right to retain the collateral if the creditor first proposes to retain it as satisfaction of the debt and the debtor does not object within twenty days of receiving the proposal. As suggested previously, applying this provision to real estate mortgage foreclosures could potentially help reduce predatory lending practices since it provides a similar opportunity for creditors to retain collateral and satisfy the debt, discouraging the use of exploitative alternatives in lending transactions.

### B. Establishment of a Consumer Financial Protection Bureau

A proposed measure to address unfair and predatory lending practices is the establishment of a CFPB, modeled after the Dodd-Frank Act. This unified agency would serve as a watchdog, specifically focused on safeguarding consumers against abusive lending practices. The primary objective of such a bureau would be to ensure transparency, promote responsible lending, and protect consumers from deceptive financial practices. By consolidating regulatory oversight and enforcement efforts, the CFPB could play a vital role in safeguarding consumer rights and fostering a fairer lending environment.

Although the FPCA enacted by the Philippine Congress defines "financial regulators" as including the SEC, BSP, IC, and PCA,[182] it does not establish a specific agency or bureau to oversee consumer protection in the financial sector.

[182] FPCA, § 3(d).

Instead, the FCPA grants these existing agencies the powers and duties to implement its provisions. The FCPA could have enhanced coordination, consistency, and cohesive oversight in tackling unfair lending practices by creating a unified body or bureau such as the CFPB. This would help streamline efforts, promote effective consumer protection, and provide a central point of contact for addressing issues related to unfair and predatory lending.

Other than the CFPB of the United States, similar financial consumer protection agencies also exist. Among others, these agencies are the Financial Conduct Authority (FCA) of the United Kingdom, which oversees and regulates consumer credit;[183] and the Financial Services Commission (FSC) of South Korea, which investigates financial consumer complaints and initiates civil lawsuits against responsible individuals.[184]

### C. Interest-Free Credit Arrangements as Alternative Lending Practices

Lending with interest has long been recognized as an efficient and economically sound practice. It allows financial institutions to allocate capital efficiently, incentivizes savings, and enables individuals and businesses to access funds for investment and consumption. However, it is crucial to acknowledge that the traditional interest-based lending may not always be suitable or accessible for everyone, particularly for low-income individuals and businesses who often fall prey to predatory lending practices. In this context, promoting Islamic lending practices as an alternative form of lending can offer better opportunities for these marginalized groups.

#### *1. Foundation of Islamic Lending Practices*

Islamic lending operates on the principles of fairness, risk-sharing, and ethical conduct, while adhering to Islamic law or *Shariah*. This alternative model emphasizes the importance of social justice and aims to provide inclusive financial services that address the needs of underserved communities. The foundation of Islamic lending practices is the *Qard al-Hasan* or the principle of extending loan without interest.[185] Although no direct benefit is given to the lender, the lending

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[183] Fin. Conduct Auth. (FCA), *About the FCA,* FIN. CONDUCT AUTH. WEBSITE, *available at* https://www.fca.org.uk/about/what-we-do/the-fca.

[184] Fin. Serv. Comm'n (FSC), *Powers and Functions of the Financial Services Commission*, FIN. SERV. COMM'N WEBSITE, *available at* https://www.fsc.go.kr/.

[185] *See* GETTING THE DEAL THROUGH: ISLAMIC FINANCE & MARKETS (Rafael A. Morales, SyCip Salazar Hernandez & Gatmaitan, Bishr Shiblaq, & Arendt & Medernach, eds., 2016) (2016), *available at* https://syciplaw.com/wp-content/uploads/2024/03/edition-393-chapter-111-151120032925341-islamic-finance-markets-2016-philippines.pdf.

activities are sustained because of profits arising from other arrangements with the same borrower or with other borrowers.

Although fees are exacted, the profits generated by the underlying arrangements of equity participation and other contractual arrangements contribute mainly to the viability of Islamic lending practices. These arrangements, free from any potential debt trap as they do not involve interest, are thus recommended sources of credit for borrowers. The availability and promotion of such arrangements must therefore be encouraged. The risk assessment is not only based on the ability of the consumer to pay but also the potential of the consumer to generate income.

*2. Popular Islamic Lending Models*

Some credit arrangements that produce profits (rather than interest) focus on risk-sharing between the lender and the borrower. Instead of fixed interest rates, one such arrangement is the *mudabarah,* which is an equity-based arrangement where the lender pools investors' money and assumes a share of the profits and losses.[186]

This arrangement involves three parties: the lender or bank as intermediary, the corporation or business venture, and the investor as the source of the funding. According to one author, *mudabarah* differs from a partnership or *Mushakarah*, since the former involves only one party contributing capital, while in the latter, the parties or partners all contribute capital and/or labor.[187] In both arrangements, however, the purpose is to foster a sense of partnership and to ensure that the lender shares in the risks and rewards of the financed venture. Furthermore, both are necessary for "the promotion of entrepreneurship and creation of [small and midsize enterprises]."[188]

By aligning the interests of both lender and borrower, the arrangement encourages responsible and sustainable financial transactions. Additionally, the sustainability of the arrangement is attributable to the fact that no risk is assumed by the financial intermediary, as the capital provider or investor bears the loss

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[186] Marc L. Ross, *Working with Islamic Finance*, INVESTOPEDIA, *available at* https://www.investopedia.com/articles/07/islamic_investing.asp

[187] Habibur Rahman, *Mudabarah and its Applications in Islamic Finance: An Analysis*, ASIAN J. OF RESEARCH IN BANKING AND FIN. (2018).

[188] Muhammad Jais, Faizah Sofyan, & Asmaou Mohamed Bacha, *Mudarabah and Musharakah as an Equity Financing Model: Issues in Practice*, 2 PROCEEDINGS ACEH GLOB. CONF. — BUS. ECON. & SUSTAINABLE DEV. TRENDS 107–114, 109 (2020), *available at* https://jurnal.usk.ac.id/AGC-BEST/article/view/16869/12320.

whereas the intermediary assumes a share in the profit, all at a pre-determined ratio.[189]

Aside from equity-based financing, a lease arrangement or *ijarah* is also a popular Islamic lending arrangement.[190] This arrangement is suitable for small businesses that need large capital to purchase assets.[191] Unlike a contract of loan, *ijarah* involves a lessor or *muajjir* who retains ownership over an asset while the lessee attains the right to use and enjoy such asset throughout the lease period but is liable to pay rent and, in case of delayed rental payments, penalties.[192]

A variation of the arrangement is the *ijarah wa iqtina,* where there is an agreement to sell the leased property to the lessee at the end of the lease period at a predetermined residual value.[193] The general benefit of *ijarah* is for the lessee to be able to use the assets productively without purchasing them and thus saving them from capital expenditure. As for the *muajjir*, the rental payments serve as a source of funding for its other financial activities.

*3. The Al-Amanah Bank in the Philippines*

Almost half a century after the establishment of Al-Amanah Bank in 1973, Congress continued the recognition of lending practices in the country by enacting Republic Act No. 11439[194] in 2019. This marks a significant development in the regulation of Islamic banking and lending practices in the Philippines, as the law establishes a clear legal framework and guidelines for the operation of Islamic banks, ensuring their proper functioning and oversight.

Despite being one of the early adopters of Islamic banking, the Philippines has lagged behind in developing a robust Islamic finance industry. The country's efforts in this regard have primarily been channeled through a single institution, Al-Amanah Bank, which operates as a subsidiary of the Development Bank of the Philippines. Although the establishment of Al-Amanah Bank was a

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[189] *Id.*

[190] Norton Rose Fulbright, *Islamic Project Finance: Structures and Challenges,* PROJ. FIN. NEWSWIRE 1–56, 35 (Feb. 2010), *available at* https://www.projectfinance.law/media/1563/pfn0210.pdf.

[191] *Id.*

[192] Muhammad Haroon Ameer & Muhammad Saud Ansari, *Islamic Banking: Ijarah and Conventional Leasing*, 4(*9*) DEVELOPING COUNTRY STUD. 126–29 (2014).

[193] An *ijara wa iqtina'a* typically "includes a promise by the Islamic lenders as lessor to transfer the ownership of the leased asset to the borrower, as lessee, either at the end of the lease period or in stages during the term of the *Ijara.* [This] is essentially the Islamic equivalent of a conventional equipment lease contract." Norton Rose Fulbright, *supra* note 195 at 36.

[194] Rep. Act No. 11439 (2018). An Act Providing for the Regulation and Organization of Islamic Banks.

significant milestone, further steps are necessary to promote and expand Islamic lending practices in the country and to study possible innovations to such contractual arrangements.[195]

## VI. CONCLUSION

It is unfortunate that minimum-wage-earning Filipinos and low-income sole proprietors often lack the resources and knowledge to thoroughly evaluate the potential future debt burden. Additionally, they tend to avoid engaging in complex secured credit transactions, particularly during times of hardship and when facing inevitable expenses like hospitalization. The insufficient legal protection available to these marginalized groups adds insult to injury, leaving them vulnerable to exploitative lending practices and limited recourse when faced with unfair treatment. Such insufficient legal protection also lead to the practice of compelling borrowers to pay under the threat of criminal prosecution for violation of the Bouncing Checks Law. These systemic challenges deepen the financial hardships experienced by these individuals, perpetuating the cycle of debt and limiting their ability to escape from their dire circumstances.

Although it is accurate that borrowers with a high-risk profile face elevated interest rates as a reflection of the lender's perceived risk, there exists a significant state interest in regulating exorbitant interest rates and punishing the underlying malevolent intention that seeks to trap borrowers in inescapable debt. Moreover, it is appropriate to introduce legal reforms that reexamine outdated credit policies. These reforms encompass various measures such as relaxing the ancient prohibition against *pactum commissorium*, a prohibition originally aimed to forbid interest in its entirety during the Christianization of the Roman Empire.

Additionally, the adoption of alternative security arrangements such as deeds of trust to enforce mortgages, the promotion and innovation of Islamic lending practices, and the revision of current regulations on real estate mortgage foreclosure will provide enhanced benefits and protection to the borrowing community in the Philippines. Simultaneously, these reforms will effectively curb predatory lending practices, seeking to strike a balance between the interests of lenders and borrowers and fostering a more equitable lending environment that encourages responsible and sustainable lending practices.

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[195] *See* GETTING THE DEAL THROUGH: ISLAMIC FINANCE & MARKETS, *supra* note 190.