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Legal Analysis of Compound Interest in Ecuador

Análisis Jurídico Del Anatocismo En El Ecuador

Garcés Córdova Felipe Alejandro[1], Suárez Albino Manuel Augusto[2], Robles Zambrano Genesis Karolina[3]

Abstract

This scientific article provides a legal analysis of the existence of the practice of anatocismo (compound interest) in the renegotiations of monetary obligations proposed by Financial Institutions in Ecuador through a supposed mutual contract that essentially contains the application of compound interest. Compound interest involves the charging of interest on interest or the accumulation of interest onto the principal amount. This practice by Financial Institutions is prohibited by the Constitution and Article 2113 of the Civil Code, which explicitly forbids stipulating interest on interest. Therefore, no mutually agreed-upon arrangement should contain practices that are prohibited or violate the normative parameters established in Ecuadorian legislation. The methodology employed adopts a qualitative approach with a descriptive scope, utilizing scientific methods. The results obtained are based on the fact that, during the renegotiation or novation of the primary monetary obligation into a second obligation referred to as refinancing or restructuring, it leads to the inclusion of interest on interest. The absence of legal regulation regarding compound interest leaves debtors in a vulnerable position, and the judiciary lacks a clear regulatory framework for resolution.

Keywords: *Compound Interest, Renegotiation, Novation.*

Resumen

El presente artículo científico analiza jurídicamente sobre la existencia de la figura del anatocismo en las renegociaciones de las obligaciones dinerarias propuestas por las Instituciones Financieras del Ecuador, mediante un supuesto contrato muto que en el fondo contiene una práctica de anatocismo. El anatocismo consiste en el cobro de intereses sobre intereses; o en la acumulación de los intereses al capital, por lo que esta práctica por parte de las Instituciones Financieras, se encuentra prohibida por la Constitución, así como también el artículo 2113 del Código Civil determina la prohibición de estipular intereses sobre intereses, por lo que ningún acuerdo consensuado puede contener prácticas prohibidas o que quebranten los parámetros normativos establecidos en la legislación ecuatoriana. La metodología empleada tiene un enfoque cualitativo con un alcance descriptivo mediante la aplicación de métodos científicos. Los resultados obtenidos se basan en que al momento de renegociar o novar la obligación dineraria principal, por una segunda obligación denominada como refinanciamiento o reestructuración, da lugar a la estipulación de intereses sobre intereses, por lo que la falta de regulación jurídica del anatocismo deja a las o los deudores en indefensión, y los administradores de justicia no tienen una normativa clara para resolver.

PalabrasClave: *Anatocismo, Renegociación, Novación.*

[1]Universidad Regional Autónoma de Los Andes, Extensión Quevedo, Ecuador. ORCIDID: https://orcid.org/0000-0002-1136-2344, Email: extensionuq.felipegc09@uniandes.edu.ec
[2]Universidad Regional Autónoma de Los Andes, Extensión Quevedo, Ecuador. ORCIDID: https://orcid.org/0000-0002-9257-273X2, Email: uq.manuelsa97@uniandes.edu.ec
[3]Universidad Regional Autónoma de Los Andes, Extensión Quevedo, Ecuador. ORCIDID: https://orcid.org/0000-0002-2965-2091, Email: uq.genesisrobles@uniandes.edu.ec

Introduction

The economic situation in Ecuador, as a result of the COVID-19 pandemic, led to the destruction of jobs and a significant decline in the income of the population. In this way, individuals who held productive loans with financial institutions, whether public or private, chose to renegotiate their debts due to their lack of economic resources to pay the full amounts owed. It is from these circumstances that the institution of interest arises as a mechanism that benefits the creditor of the obligation.

In this regard, financial institutions, when proposing the refinancing or restructuring of liabilities, accumulate the accrued interest onto the owed capital, creating a new capital with new interest, thereby harmfully violating what is established in the second clause of Article 308 of the Constitution of the Republic of Ecuador, which states: "*The State shall promote access to financial services and the democratization of credit. Collusive practices, compound interest, and* usury *are prohibited.*" This means that, despite the prohibition of compound interest, financial institutions, when renegotiating a monetary obligation stemming from a loan, still retain this practice at the core of a supposed mutual contract.

According to the author (Encalada, 2021), the concept of compound interest is defined as the stipulation of interest on interest. Therefore, it is essential to understand the renegotiation of monetary obligations proposed by financial institutions, in order to avoid the application of compound interest.

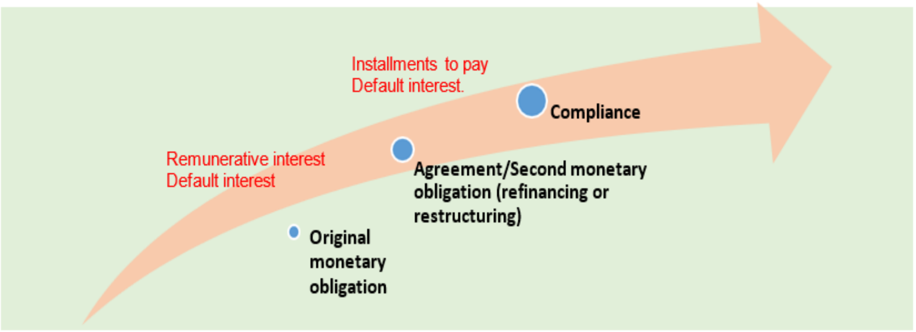
The Codification of Monetary, Financial, Securities, and Insurance Resolutions, Book I, Volume V, categorizes the various avenues that financial institutions can pursue to enforce overdue monetary obligations. These avenues include (i) novation, (ii) refinancing, and (iii) the restructuring of obligations (Ecuador National Assembly, 2017).

For this discussion, novation in Ecuadorian legislation is described as a way to wholly or partially extinguish a specific obligation. Article 1644 of the Civil Code defines novation as the substitution of a new obligation for a previous one, thereby extinguishing the latter. In this context, financial institutions, by misusing the legal concept of novation, increase debts through the refinancing or restructuring of credit debt, which includes the accumulation of interest. This results in new capital and interest being generated, making the credit debt seemingly never-ending for the debtor (Ecuador National Assembly, 2005).

Despite the absence of explicit regulation for the concept of compound interest in Ecuadorian legislation, Article 2113 of the Civil Code also states: "The stipulation of interest on interest is prohibited." In other words, an agreement cannot be made when, in essence, compound interest is being applied, which financial institutions should refrain from doing, considering that no law can supersede the Constitution, the supreme norm that prevails over the legal framework of the Ecuadorian state.

Given this situation, the renegotiation of a credit debt, based on a mutually agreed-upon arrangement between the debtor and the creditor, creates a legal issue. Since there are two obligations - the original one and the second, which, by substituting the original, maintain a legal relationship that gives rise to the creation of the mutual contract - calculating moratory interest on the second obligation based on the total sum of the principal obligation, which already includes the initial moratory interest, would lead to the application of compound interest.

Figure 1: Compound Interest.



Source: (Encalada, 2021)

According to the analysis of the previously detailed Figure, when renegotiating or novating the primary monetary obligation into a second obligation referred to as refinancing or restructuring, it leads to the stipulation of compound interest.

Methods

Qualitative approach

Qualitative research is descriptive in nature because it identifies the elements that make up a case, event, or legally relevant phenomenon, determining their connections, and enabling the description of processes, contexts, institutions, systems, and individuals. Through this research approach, relevant and up-to-date information was obtained about the phenomenon of compound interest in Ecuador and how it is manifested in the renegotiations (refinancing and restructuring) carried out by financial institutions (Nizama & Nizana, 2020).

Descriptive scope

In this scope of the research, the characteristics of the phenomenon are already known, and what is being sought is to expose its presence in a specific human group. Therefore, we proceeded to describe the existence of the concept of compound interest in agreements or arrangements between the debtor and creditor, as a result of the non-fulfillment of a monetary obligation (Ramos, 2020).

Methods of the Theoretical Level of Knowledge

Deductive-Inductive

Deductive thinking serves to apply universal rules or laws to specific situations, while inductive thinking generates general premises from individual phenomena. By applying this method, a holistic study was conducted on compound interest and its legal effects, allowing deductions to be made regarding the prohibition of this concept in the legal framework of the Ecuadorian state, as well as the existence of a legal vacuum concerning its regulation, characteristics, and the sanctions that must be imposed by the judge in cases of its commission (Alava, 2018).

Methods of the Empirical Level of Knowledge Document Analysis

Document analysis arises for scientific and informational guidance purposes, and its products, the documents, represent a synthesis of the originals. They contain basic information from the original documents and are freely accessible. By applying this method, the studies on the concept of compound interest as presented in scientific articles and books were analyzed (Gómez et al., 2017).

Hermeneutic method

The hermeneutic method is a form of analysis that tends toward interpretation. Initially, it was applied to the study of texts, but over time, it has been employed in various contexts. This method allowed for the analysis and interpretation of what is established in Article 308, the second clause of the Constitution of the Republic of 2008, Article 2113 of the Ecuadorian Civil Code, and the Codification of Monetary, Financial, Securities, and Insurance Resolutions, Book I, Volume V (Sanchez, 2019).

Results

The concept of loans has evolved over time, with lenders or creditors becoming legally established financial institutions. This evolution has also given rise to what is called "compound interest," which, due to its burden on debtors, can even lead them to insolvency due to the lack of assets to fully repay their credit obligations. For this reason, over time, it has been prohibited by several legal systems and limited by others. In the case of Ecuador, the practice of compound interest is expressly prohibited (Encalada, 2021).

Legally, compound interest is defined as "the accumulation of accrued interest onto the principal, thereby generating new interest." In this way, a financial credit arrangement between two parties, a debtor and a creditor, includes an interest charge based on the agreed-upon time for the debtor to repay the principal to the creditor. This interest is expressed as a percentage of the total credit amount, meaning it is applied to the credit's principal.

In the legislative context of Ecuador, the Codification of Monetary, Financial, Securities, and Insurance Resolutions, Book I, Volume V, classifies the various avenues that financial institutions can take to ensure individuals meet overdue monetary obligations, including (i) novation; (ii) refinancing; and (iii) restructuring of obligations (Ecuador. National Assembly, 2017).

In this regard, when financial institutions propose the refinancing or restructuring of liabilities, they accumulate the overdue interest onto the owed principal. This practice contradicts what is stipulated in Article 308, the second clause of the Constitution of the Republic of Ecuador, which prohibits financial entities from exercising compound interest. In other words, they cannot duplicate, and often even triple, the credit amount through the use of "interest." This leads to credit obligations that seem never-ending. Consequently, despite the prohibition of applying compound interest, financial institutions maintain this concept at the core of what appears to be a mutual agreement (Ecuador. National Assembly, 2008).

Based on the above considerations, in Ecuador, financial institutions within the Economic Financial System have proceeded to increase credit debt through the misuse of novation, restructuring, and refinancing. In this situation, due to the lack of specific determination regarding what compound interest is and the procedures to assist victims (debtors) of this concept, they have no means to defend themselves in executive judgments. Even the judiciary lacks clear regulations to process and resolve such cases or complaints presented to them on this matter.

In accordance with Article 5 of the Commercial Code: "*In cases not expressly regulated, the provisions of this Code shall be applied by analogy, and in the absence thereof, those of the Civil Code. Likewise, this Code serves as a subsidiary norm for other special areas in which acts exhibit a commercial nature or purpose*" (Ecuador. National Assembly, 2019).

In reference to the mentioned above, the Ecuadorian Civil Code, in Article 2113, stipulates: "*Agreements for interest on interest are prohibited.*" Therefore, the law explicitly prescribes that an agreement cannot be made when, in essence, there is a compound interest, which should not be practiced by financial institutions, considering that no law supersedes the Constitution as the supreme norm that governs the legal framework of the Ecuadorian State.

In summary, financial activities must be regulated in strict accordance with the Constitution, as it is the supreme norm. Therefore, by prohibiting compound interest, financial entities cannot enter into agreements that contravene what is prescribed by law. Thus, when entering into a restructuring or refinancing through the concept of novation, which, according to the Civil Code, is defined as: "*Novation is the substitution of a new obligation for a previous one, which is therefore extinguished.*" When a debtor has overdue installments, financial institutions renegotiate the debt, provided that the debtor accepts the new capital, which includes accrued and late interest. This will generate new interest (compound interest).

Discussion

In Ecuadorian legislation, compound interest constitutes an illegal concept within the economic and financial sector, as it involves charging interest on interest or accumulating interest with the capital. Consequently, financial institutions, when renegotiating a debt, generate new capital, which, in turn, results in the generation of new interests. However, when renegotiating a debt, it increases the debt to the point where it becomes impossible to continue paying it. Therefore, both restructuring and refinancing occur as a consequence of significant payment difficulty.

A debt is understood as the obligation to perform a specific task, placing the debtor under the responsibility to fulfill it, settle it, or pay it in its entirety. This obligation considers the interest arising from the money provided as a loan. Thus, when capital is loaned between two parties, the debtor and creditor (financial institutions), it is associated with accrued interest based on the time agreed upon for the debtor to repay the capital. However, interest rates higher than those established by law cannot be agreed upon, and charging interest on interest is prohibited. This unlawful practice manifests as compound interest when agreements are made that include the accumulation of overdue interest with the capital owed, summing them up. These practices can be evident in renegotiations, such as refinancing or restructuring.

It should be noted that the Constitution is the supreme norm that governs the legal framework of the Ecuadorian state. Therefore, agreements or covenants between the debtor and the creditor cannot contravene what the Constitution prescribes. The Constitution prohibits collusion, compound interest, and usury within the financial system. To illustrate, due to the lack of regulations on compound interest, it is challenging to clearly define what compound interest entails, and judges cannot adequately resolve cases because there is no clear and comprehensive legal framework regarding situations where compound interest is applied and its legal consequences when practiced by the financial system.

When exemplifying the practice of compound interest in the renegotiation of credit debts, it becomes evident that through refinancing or restructuring of liabilities, overdue interest is added to the capital. This increases the capital, generating new interest. Considering the comparative law doctrine, in Peruvian legislation, compound interest is regulated by agreement between the parties, provided that at least one year has passed since interest payments were delayed and that a subsequent agreement exists. The requirements are related to the consensus between the parties and the delay in payment (Jiménez, 2019).

Finally, this legal gap regarding prohibited practices in the financial system, such as compound interest, poses a significant problem for the economically active population of the country and the judiciary. The lack of regulation and clear determination of compound interest makes it very challenging to rule in such cases. For legal professionals representing the victims of compound interest (debtors), it becomes even more difficult to prove that financial institutions in Ecuador, like Banco Pichincha S.A., have engaged in this illegal practice.

Conclusions

In the context of Ecuadorian legislation, compound interest is an illegal concept prohibited by the second clause of Article 308 of the Constitution of the Republic of Ecuador. Therefore, financial institutions are violating the law when they enter into agreements that fundamentally involve the practice of compound interest. It consists of charging interest on interest or accumulating interest with the principal amount, resulting in the generation of new interest. Financial institutions benefit more from this practice, while debtors acquire endless debts, which, in certain cases, can lead to insolvency.

Emphasizing the renegotiation of credit debt through refinancing or restructuring of liabilities (new payment terms) with the support of a consensus agreement between the debtor and the creditor creates a legal issue. This is because there is a prohibition against stipulating interest on interest. Due to the existence of two obligations, an original one and the second one that replaces the original, a legal relationship is established, giving rise to the creation of a mutual contract. If the moratory interest of the second obligation is calculated on the total sum of the principal obligation, including the initial moratory interest, the concept of compound interest comes into play.

The legal gap regarding the regulation of compound interest in our legal framework is insufficient, particularly in the regulation of economic activities conducted by financial institutions in the event of non-compliance with a financial obligation. This includes the interest charges associated with productive loans or outstanding credit card payments. Therefore, it is essential to determine the characteristics and penalties for this practice, which should be applied by the judge when dealing with execution proceedings. This is due to the presence of a promissory note, which must be fulfilled containing a clear, pure, specific, and currently enforceable obligation.

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