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PHASING OUT THE RULE OF 78 IN MALAYSIA: TOWARDS FAIRER FINANCING AND CONSUMER PROTECTION

Dr Nurhuda binti Othman

A Landmark Shift in Consumer Financing

Malaysia's financial landscape is on the verge of a pivotal transformation as Bank Negara Malaysia (BNM) moves to abolish the Rule of 78 through its 'Exposure Draft on Personal Financing', issued on 13 December 2024 (BNM, 2024). This amortisation method, applied in both conventional and Islamic personal financing, has long been criticised for disproportionately disadvantaging borrowers by front-loading profit or interest charges (Zainuddin & Harmidy, 2022; Abdullah, 2021, p. 91; Halim *et al.*, 2019). The front-loaded profit allocation under the Rule of 78 contradicts fundamental Islamic finance principles such as justice, transparency, and equitable risk-sharing, raising serious concerns about its ethical compatibility (Muhamad Sori, 2025a).

Originally introduced in the United States in 1935, the Rule of 78 subsequently gained widespread use in consumer lending (Johnson, 1981). However, it became a topic of significant controversy, prompting many regulatory bodies around the world to restrict its use throughout the 1990s and 2000s. Countries such as the United States, the United Kingdom, Canada, Australia, and various European Union member states have imposed restrictions on their application for long-term loans due to concerns over fairness (Mississippi Department of Banking and Consumer Finance, 2020; Consumer Measures Committee, 2002; European Union, 2008; Muhamad Sori, 2025b). Malaysia's decision to follow suit demonstrates a regulatory shift toward fairer and more transparent consumer financing. However, the success of this reform depends on more than regulatory intention. The transition must be carefully designed to ensure that borrowers, particularly those in vulnerable groups, are not left behind and that financial institutions have sufficient time and clarity to adjust their systems and product offerings.

Understanding the Problem: Why the Rule of 78 Must Go

The Rule of 78 operates by applying a sum-of-the-digits formula to determine interest payments across a loan's lifespan. This method disproportionately allocates interest in the earlier months or years of a financing agreement, resulting in significant front-loading of costs (Abdullah, 2021; Muhamad Sori, 2025b). Borrowers who attempt to settle their loans early often find they have already paid the majority of the interest despite having barely reduced the principal.

Such practices create a twofold injustice:

1. They penalise borrowers who seek early settlement or refinancing, resulting in unfair financial burdens.

2. They conceal the true cost of credit until borrowers are already deeply committed, undermining transparency and informed decision-making.

This misalignment with fair finance principles has led to its abolition by regulatory bodies in advanced jurisdictions, as indicated earlier, mainly due to its incompatibility with modern consumer protection frameworks. In the Malaysian context, the continued implementation of the Rule of 78, notably within hire-purchase contracts and Islamic financing structures such as Al-Ijārah Thumma Al-Bay' (AITAB), has drawn significant criticism from Shariah scholars and practitioners. It is argued that the formula's disproportionate profit recognition, particularly in the early stages of the contract, contravenes the spirit of Shariah, which upholds justice, transparency, and mutual risk-sharing (Muhamad Sori, 2016; Mohamed & Mohd Isa, 2017; Halim *et al*., 2019). Even the endorsed industry effective interest rate method (EIRM), promoted under IFRS 9, has been shown to produce front-loaded profit recognition patterns that mirror the outcomes of the Rule of 78. Muhamad Sori (2016) argues that this method, although technically more refined, often results in the implicit risk transfer to borrowers—a practice fundamentally at odds with the Islamic finance principle of risk-sharing (*mushārakah*). He further cautions that profit allocation models rooted in conventional frameworks may distort Shariah compliance by adopting form over substance, particularly when interest-based mechanics are merely relabelled as 'profit' without altering the underlying structure.

In practical terms, retaining the Rule of 78 may have notable financial implications. The Table 1 illustrates a comparison to aid understanding:

This comparison illustrates that under the Rule of 78, borrowers pay a disproportionately high profit amount in the early period – for instance, RM1,982 in the first year compared to only RM1,000 under the Reducing Balance Method (RBM). Such front-loaded profit allocation creates a clear financial disadvantage for those who settle early, raising concerns about fairness,

Table 1: Comparison of Borrower Cost under Rule of 78 vs. Reducing Balance Method (RBM)*

Loan Amount	Tenure	Annual Profit Rate	Method	1st Year Profit Payment	Early Settlement on Month 24
RM100,000	9 years	12%	Rule of 78	RM1,982	Higher outstanding principal (RM96,160) compared to the Reducing Balance Method when settling early
RM100,000	9 years	12%	Reducing Balance Method (RBM)	RM1,000	Lower outstanding principal (RM86,016) when settling early

Source: Author's own

** Refer to Appendix for detailed illustrations* transparency, and ethical compatibility in financing contracts. Specifically, if a loan is settled early at month 24, the outstanding principal under Rule of 78 remains higher at RM96,160 compared to RM86,016 under RBM. This is because the Rule of 78 calculates profit as a flat rate on the full principal, resulting in a higher total cost over the loan tenure, while RBM calculates profit based on the reducing outstanding balance, leading to a lower overall profit charge. Consequently, the Rule of 78 penalises early repayment, making it less favourable for borrowers compared to RBM, which more accurately reflects the actual remaining loan balance. This mechanism could exacerbate financial vulnerability, particularly among low-income borrowers who may need to settle early due to financial distress or refinancing needs.

The Case for Change: Data That Demands Action

Several international and domestic developments underscore the urgency of regulatory reform. The United Kingdom has restricted the Rule of 78 in 2006 under the Consumer Credit Act, citing its disproportionate burden on borrowers who repay early. In Thailand, the Bank of Thailand introduced progressive lending reforms starting in 2020, including the prohibition of prepayment penalties for personal loans and nano-finance. These measures significantly lowered the cost of early loan settlement and promoted more competitive refinancing terms (Tangprasitti & Tiyajamorn, 2023; Sirikan, 2023). The European Union's *Directive 2008/48/EC* mandated the use of a harmonised actuarial method to calculate the annual percentage rate of charge (APR), ensuring that interest costs are disclosed transparently and proportionally reflect the reducing principal balance (European Union, 2008). While the Directive does not explicitly mention the Rule of 78, its implementation effectively replaced prior practices such as the Rule of 78 in member states by requiring APR calculations based on the actuarial method, thus enhancing fairness and comparability in consumer credit agreements.

In Malaysia, the urgency is underscored by the country's high household debt level, which stood at 84.2 per cent of GDP, with personal financing comprising 15.3 per cent as of 2023 (CEIC Data, 2023; Dhesi, 2025). The Khazanah Research Institute (2024) highlights a notable shift in Malaysia's household debt composition, particularly in motor vehicle and personal financing loans. Motor vehicle loans, where the Rule of 78 is commonly applied, doubled from RM94.3 billion in 2006 to RM202.5 billion in 2023, while personal financing loans—also subject to the Rule of 78 in many products—grew even more rapidly, from RM37.9 billion to RM193.3 billion over the same period. Although the share of car loans declined proportionally, they remain a significant contributor to household debt, with a resurgence observed since 2022 due to backlog fulfilments and promotional campaigns. In contrast, personal financing rose from 9 per cent to 12.6 per cent of household debt, driven by an average annual growth of 10 per cent, the highest among all categories.

This trend highlights the growing reliance on debt to sustain household needs and maintain lifestyles. The widespread use of the Rule of 78 in these products exacerbates the burden, as borrowers attempting early settlement often find they have paid the bulk of the interest while barely reducing their principal. This mechanism deepens financial vulnerability, particularly among lower-income borrowers who rely heavily on personal loans to bridge income gaps or sustain essential expenditures.

Policy Recommendations: A Roadmap for Implementation

For the reform to be effective and equitable, it must be implemented through a carefully phased timeline that strikes a balance between urgency and operational readiness. A recommended transition period of 12 to 18 months would allow financial institutions to reconfigure their pricing models, update their IT systems, and redesign financing products without creating systemic shocks.

The first phase, spanning the initial six months, should focus on ensuring that all new financing agreements apply the reducing balance method. In the subsequent six months, this method should be extended to cover refinanced or restructured personal financing products. The final phase should ensure that all existing financing facilities align with the new standard, thereby completing the transition by the end of the 18-month period. A phased implementation strategy is consistent with global financial regulatory practices, such as the Basel III framework, which introduced capital reforms over a multi-year period to avoid market disruptions (Basel Committee on Banking Supervision, 2011).

Consumer education must also form the backbone of this transition. Without a comprehensive public awareness campaign, borrowers may misunderstand the implications of the shift, thereby undermining trust in the system. BNM and financial institutions should jointly implement financial literacy programs that clearly explain the differences between the Rule of 78 and the Reducing Balance Method (RBM) in a straightforward manner, enabling the public to comprehend them. For example, loan documents should contain side-by-side comparisons of repayment schedules under both methods to promote transparency. Similar disclosure-driven reforms in jurisdictions like Hong Kong have demonstrated positive outcomes, with enhanced transparency contributing to a decline in consumer complaints regarding loan terms (Consumer Council, 2019; TransUnion, 2018). In Malaysia, the need for such an initiative is especially pressing, given that fewer than 40 per cent of Malaysian adults demonstrate sufficient financial knowledge, including understanding how amortisation works (Loke *et al*., 2022).

Concurrently, safeguard measures must be instituted to preserve affordability and credit access, especially for low-income and underserved borrowers. While the transition to the Reducing Balance Method (RBM) may result in short-term pricing adjustments, BNM should closely monitor financing rates to prevent an undue burden on consumers. Where needed, targeted tools—such as temporary rate ceilings or regulatory incentives—can help maintain a healthy level of competition. Equally important is the adoption of flexible financing models to ensure borrowers with weaker credit profiles are not excluded. Thailand's recent lending reforms, which included longer repayment tenures, capped interest rates, and the elimination of prepayment penalties, have contributed to improved borrower affordability and greater repayment discipline (Tangprasitti & Tiyajamorn, 2023; Sirikan, 2023). A similar mechanism could be adopted in Malaysia to ensure that the removal of the Rule of 78 does not inadvertently widen the credit gap.

A post-implementation review conducted within 12 months of the final rollout would enable regulators to assess the effectiveness of the reform, identify any emerging challenges, and implement necessary course corrections. This review could also serve as a platform for engaging with stakeholders, including financial institutions, consumer groups, and religious bodies, to ensure that the new system is meeting its intended objectives.

Conclusion: Aligning Malaysia with Global Best Practices

The abolition of the Rule of 78 marks a crucial step towards promoting fairness, transparency, and ethical integrity in Malaysia's consumer financing landscape. By removing an amortisation method that disproportionately burdens borrowers through front-loaded profit allocations, this reform aligns financing practices with the fundamental principles of Islamic finance, such as justice and equitable risk-sharing. International experience has shown that such regulatory shifts can enhance consumer confidence and strengthen the credibility of the financial system.

However, successful implementation requires more than regulatory change alone. Financial institutions must be provided with clear guidance and sufficient time to transition their systems, while consumer awareness initiatives should be intensified to ensure borrowers fully understand their rights and repayment obligations under the new method.

Ultimately, this reform represents an opportunity to reinforce Malaysia's commitment to value-based intermediation by ensuring financing practices uphold fairness and contribute to broader socioeconomic well-being. Effective stakeholder engagement, clear operational guidelines, and strong monitoring mechanisms will be pivotal in realising these objectives and ensuring that no borrower is left disadvantaged in the process.

Dr Nurhuda binti Othman
Research Fellow
Centre of Excellence for Research and Innovation in Islamic Economics (i-RISE)
ISRA Institute, INCEIF University
Email: nurhuda-isra@inceif.edu.my

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APPENDIX

Comparison of Borrower Cost under Rule of 78 vs. Reducing Balance Method (RBM)

1. Key Information Calculation: Rule of 78

Loan amount (RM):	100,000
Tenure (months):	108
Annual Profit Rate (%)	12
Monthly Profit Rate (%)	1
Total Profit	108,000
Monthly Instalment	1,926
Sum of Digits (Rule of 78)	5,886

Month	Start Principal (RM)	Profit per Month (Rule of 78) (RM)	Principal per Month (RM)	Monthly Instalment (Rule of 78) (RM)	Outstanding Principal (Rule of 78) (RM)
1	100,000	1,982	-	1,926	100,000
2	100,000	1,963	-	1,926	100,000
3	100,000	1,945	-	1,926	100,000
4	100,000	1,927	-	1,926	100,000
5	100,000	1,908	18	1,926	99,982
6	99,982	1,890	36	1,926	99,946
7	99,946	1,872	54	1,926	99,892
8	99,892	1,853	73	1,926	99,819
9	99,819	1,835	91	1,926	99,728
10	99,728	1,817	109	1,926	99,619
11	99,619	1,798	128	1,926	99,491
12	99,491	1,780	146	1,926	99,345
13	99,345	1,761	164	1,926	99,180
14	99,180	1,743	183	1,926	98,998
15	98,998	1,725	201	1,926	98,796
16	98,796	1,706	220	1,926	98,577
17	98,577	1,688	238	1,926	98,339
18	98,339	1,670	256	1,926	98,083
19	98,083	1,651	275	1,926	97,808

Month	Start Principal (RM)	Profit per Month (Rule of 78) (RM)	Principal per Month (RM)	Monthly Instalment (Rule of 78) (RM)	Outstanding Principal (Rule of 78) (RM)
20	97,808	1,633	293	1,926	97,515
21	97,515	1,615	311	1,926	97,204
22	97,204	1,596	330	1,926	96,875
23	96,875	1,578	348	1,926	96,527
24	96,527	1,560	366	1,926	96,160
25	96,160	1,541	385	1,926	95,776
26	95,776	1,523	403	1,926	95,373
27	95,373	1,505	421	1,926	94,951
28	94,951	1,486	440	1,926	94,512
29	94,512	1,468	458	1,926	94,054
30	94,054	1,450	476	1,926	93,577
31	93,577	1,431	495	1,926	93,083
32	93,083	1,413	513	1,926	92,569
33	92,569	1,394	531	1,926	92,038
34	92,038	1,376	550	1,926	91,488
35	91,488	1,358	568	1,926	90,920
36	90,920	1,339	586	1,926	90,334
37	90,334	1,321	605	1,926	89,729
38	89,729	1,303	623	1,926	89,106
39	89,106	1,284	642	1,926	88,464
40	88,464	1,266	660	1,926	87,804
41	87,804	1,248	678	1,926	87,126
42	87,126	1,229	697	1,926	86,429
43	86,429	1,211	715	1,926	85,715
44	85,715	1,193	733	1,926	84,981
45	84,981	1,174	752	1,926	84,230
46	84,230	1,156	770	1,926	83,460
47	83,460	1,138	788	1,926	82,671
48	82,671	1,119	807	1,926	81,865
49	81,865	1,101	825	1,926	81,040
50	81,040	1,083	843	1,926	80,196
51	80,196	1,064	862	1,926	79,335
52	79,335	1,046	880	1,926	78,455
53	78,455	1,028	898	1,926	77,556

Month	Start Principal (RM)	Profit per Month (Rule of 78) (RM)	Principal per Month (RM)	Monthly Instalment (Rule of 78) (RM)	Outstanding Principal (Rule of 78) (RM)
54	77,556	1,009	917	1,926	76,639
55	76,639	991	935	1,926	75,704
56	75,704	972	953	1,926	74,751
57	74,751	954	972	1,926	73,779
58	73,779	936	990	1,926	72,789
59	72,789	917	1,008	1,926	71,780
60	71,780	899	1,027	1,926	70,754
61	70,754	881	1,045	1,926	69,708
62	69,708	862	1,064	1,926	68,645
63	68,645	844	1,082	1,926	67,563
64	67,563	826	1,100	1,926	66,463
65	66,463	807	1,119	1,926	65,344
66	65,344	789	1,137	1,926	64,207
67	64,207	771	1,155	1,926	63,052
68	63,052	752	1,174	1,926	61,878
69	61,878	734	1,192	1,926	60,686
70	60,686	716	1,210	1,926	59,476
71	59,476	697	1,229	1,926	58,247
72	58,247	679	1,247	1,926	57,000
73	57,000	661	1,265	1,926	55,735
74	55,735	642	1,284	1,926	54,451
75	54,451	624	1,302	1,926	53,149
76	53,149	606	1,320	1,926	51,829
77	51,829	587	1,339	1,926	50,490
78	50,490	569	1,357	1,926	49,133
79	49,133	550	1,375	1,926	47,757
80	47,757	532	1,394	1,926	46,364
81	46,364	514	1,412	1,926	44,951
82	44,951	495	1,431	1,926	43,521
83	43,521	477	1,449	1,926	42,072
84	42,072	459	1,467	1,926	40,605
85	40,605	440	1,486	1,926	39,119
86	39,119	422	1,504	1,926	37,615
87	37,615	404	1,522	1,926	36,093

Month	Start Principal (RM)	Profit per Month (Rule of 78) (RM)	Principal per Month (RM)	Monthly Instalment (Rule of 78) (RM)	Outstanding Principal (Rule of 78) (RM)
88	36,093	385	1,541	1,926	34,552
89	34,552	367	1,559	1,926	32,994
90	32,994	349	1,577	1,926	31,416
91	31,416	330	1,596	1,926	29,821
92	29,821	312	1,614	1,926	28,207
93	28,207	294	1,632	1,926	26,574
94	26,574	275	1,651	1,926	24,924
95	24,924	257	1,669	1,926	23,255
96	23,255	239	1,687	1,926	21,567
97	21,567	220	1,706	1,926	19,861
98	19,861	202	1,724	1,926	18,137
99	18,137	183	1,742	1,926	16,395
100	16,395	165	1,761	1,926	14,634
101	14,634	147	1,779	1,926	12,855
102	12,855	128	1,797	1,926	11,057
103	11,057	110	1,816	1,926	9,242
104	9,242	92	1,834	1,926	7,407
105	7,407	73	1,853	1,926	5,555
106	5,555	55	1,871	1,926	3,684
107	3,684	37	1,889	1,926	1,795
108	1,795	18	1,795	1,926	(0)
CHECK		108,000	100,000	208,000	

Note:

Why was no principal paid in the first four months?

Under the Rule of 78, the total profit is calculated upfront and spread across the instalment period. This method charges more profit in the earlier months. In this example, the profit for the first four months is actually higher than the monthly instalment, so none of the payment reduces the loan principal yet. Principal repayment only starts when the profit charged becomes less than the instalment amount.

2. Key Information Calculation: Reducing Balance Method

Loan amount (RM):	100,000
Tenure (months):	108
Annual Profit Rate (%)	12
Monthly Profit Rate (%)	1
RBM Monthly Instalment	1,518

Month	Start Principal (RM)	Profit per Month (RBM) (RM)	Principal per Month (RM)	Monthly Instalment (RBM) (RM)	Outstanding Principal (RBM) (RM)
1	100,000	1000	518	1,518	99,482
2	99,482	995	524	1,518	98,958
3	98,958	990	529	1,518	98,429
4	98,429	984	534	1,518	97,895
5	97,895	979	539	1,518	97,356
6	97,356	974	545	1,518	96,811
7	96,811	968	550	1,518	96,260
8	96,260	963	556	1,518	95,705
9	95,705	957	561	1,518	95,143
10	95,143	951	567	1,518	94,576
11	94,576	946	573	1,518	94,003
12	94,003	940	578	1,518	93,425
13	93,425	934	584	1,518	92,841
14	92,841	928	590	1,518	92,251
15	92,251	923	596	1,518	91,655
16	91,655	917	602	1,518	91,053
17	91,053	911	608	1,518	90,445
18	90,445	904	614	1,518	89,831
19	89,831	898	620	1,518	89,211
20	89,211	892	626	1,518	88,585
21	88,585	886	633	1,518	87,952
22	87,952	880	639	1,518	87,313
23	87,313	873	645	1,518	86,668
24	86,668	867	652	1,518	86,016
25	86,016	860	658	1,518	85,358
26	85,358	854	665	1,518	84,693

Month	Start Principal (RM)	Profit per Month (RBM) (RM)	Principal per Month (RM)	Monthly Instalment (RBM) (RM)	Outstanding Principal (RBM) (RM)
27	84,693	847	671	1,518	84,022
28	84,022	840	678	1,518	83,344
29	83,344	833	685	1,518	82,659
30	82,659	827	692	1,518	81,967
31	81,967	820	699	1,518	81,268
32	81,268	813	706	1,518	80,562
33	80,562	806	713	1,518	79,849
34	79,849	798	720	1,518	79,129
35	79,129	791	727	1,518	78,402
36	78,402	784	734	1,518	77,668
37	77,668	777	742	1,518	76,926
38	76,926	769	749	1,518	76,177
39	76,177	762	757	1,518	75,420
40	75,420	754	764	1,518	74,656
41	74,656	747	772	1,518	73,884
42	73,884	739	780	1,518	73,105
43	73,105	731	787	1,518	72,317
44	72,317	723	795	1,518	71,522
45	71,522	715	803	1,518	70,719
46	70,719	707	811	1,518	69,908
47	69,908	699	819	1,518	69,088
48	69,088	691	828	1,518	68,261
49	68,261	683	836	1,518	67,425
50	67,425	674	844	1,518	66,581
51	66,581	666	853	1,518	65,728
52	65,728	657	861	1,518	64,867
53	64,867	649	870	1,518	63,997
54	63,997	640	878	1,518	63,119
55	63,119	631	887	1,518	62,232
56	62,232	622	896	1,518	61,335
57	61,335	613	905	1,518	60,430
58	60,430	604	914	1,518	59,516
59	59,516	595	923	1,518	58,593
60	58,593	586	932	1,518	57,661

Month	Start Principal (RM)	Profit per Month (RBM) (RM)	Principal per Month (RM)	Monthly Instalment (RBM) (RM)	Outstanding Principal (RBM) (RM)
61	57,661	577	942	1,518	56,719
62	56,719	567	951	1,518	55,767
63	55,767	558	961	1,518	54,807
64	54,807	548	970	1,518	53,836
65	53,836	538	980	1,518	52,856
66	52,856	529	990	1,518	51,866
67	51,866	519	1,000	1,518	50,867
68	50,867	509	1,010	1,518	49,857
69	49,857	499	1,020	1,518	48,837
70	48,837	488	1,030	1,518	47,807
71	47,807	478	1,040	1,518	46,767
72	46,767	468	1,051	1,518	45,716
73	45,716	457	1,061	1,518	44,655
74	44,655	447	1,072	1,518	43,583
75	43,583	436	1,083	1,518	42,500
76	42,500	425	1,093	1,518	41,407
77	41,407	414	1,104	1,518	40,302
78	40,302	403	1,115	1,518	39,187
79	39,187	392	1,127	1,518	38,060
80	38,060	381	1,138	1,518	36,923
81	36,923	369	1,149	1,518	35,773
82	35,773	358	1,161	1,518	34,613
83	34,613	346	1,172	1,518	33,440
84	33,440	334	1,184	1,518	32,256
85	32,256	323	1,196	1,518	31,061
86	31,061	311	1,208	1,518	29,853
87	29,853	299	1,220	1,518	28,633
88	28,633	286	1,232	1,518	27,401
89	27,401	274	1,244	1,518	26,156
90	26,156	262	1,257	1,518	24,899
91	24,899	249	1,269	1,518	23,630
92	23,630	236	1,282	1,518	22,348
93	22,348	223	1,295	1,518	21,053
94	21,053	211	1,308	1,518	19,745

Month	Start Principal (RM)	Profit per Month (RBM) (RM)	Principal per Month (RM)	Monthly Instalment (RBM) (RM)	Outstanding Principal (RBM) (RM)
95	19,745	197	1,321	1,518	18,424
96	18,424	184	1,334	1,518	17,090
97	17,090	171	1,348	1,518	15,742
98	15,742	157	1,361	1,518	14,381
99	14,381	144	1,375	1,518	13,007
100	13,007	130	1,388	1,518	11,618
101	11,618	116	1,402	1,518	10,216
102	10,216	102	1,416	1,518	8,800
103	8,800	88	1,430	1,518	7,370
104	7,370	74	1,445	1,518	5,925
105	5,925	59	1,459	1,518	4,466
106	4,466	45	1,474	1,518	2,992
107	2,992	30	1,489	1,518	1,503
108	1,503	15	1,503	1,518	(0)
CHECK		63,990	100,000	163,990	

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