



INCEIF Discourse Series 20: Towards Financial Fairness: Why It's Time to Remove Rule 78

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What? Who? When? Why?



RM100,000 Principal
RM20,000 Profit
RM120,000 SP
Deferred Pmt – 9 Yrs
Monthly Installment RM1,000=>
Profit? Principal?



Business Owner?

RM1,000 Costs
RM1,300 SP
Payment – On the Spot
Principal RM1,000
Profit RM300

Bank?

Rule 78 How?

- ▶ Rule of 78 -"Sum-of-the-Digits Method"
 - ▶ Used to allocate interest over the term of a loan with precomputed interest.

- ▶ The proportion for each month is determined by dividing the remaining months by the total weight.
 - ▶ For instance, in
 - ▶ Month 1 of a 12-month loan, the interest proportion is 12/78;
 - ▶ for Month 2, it is 11/78, and so on.

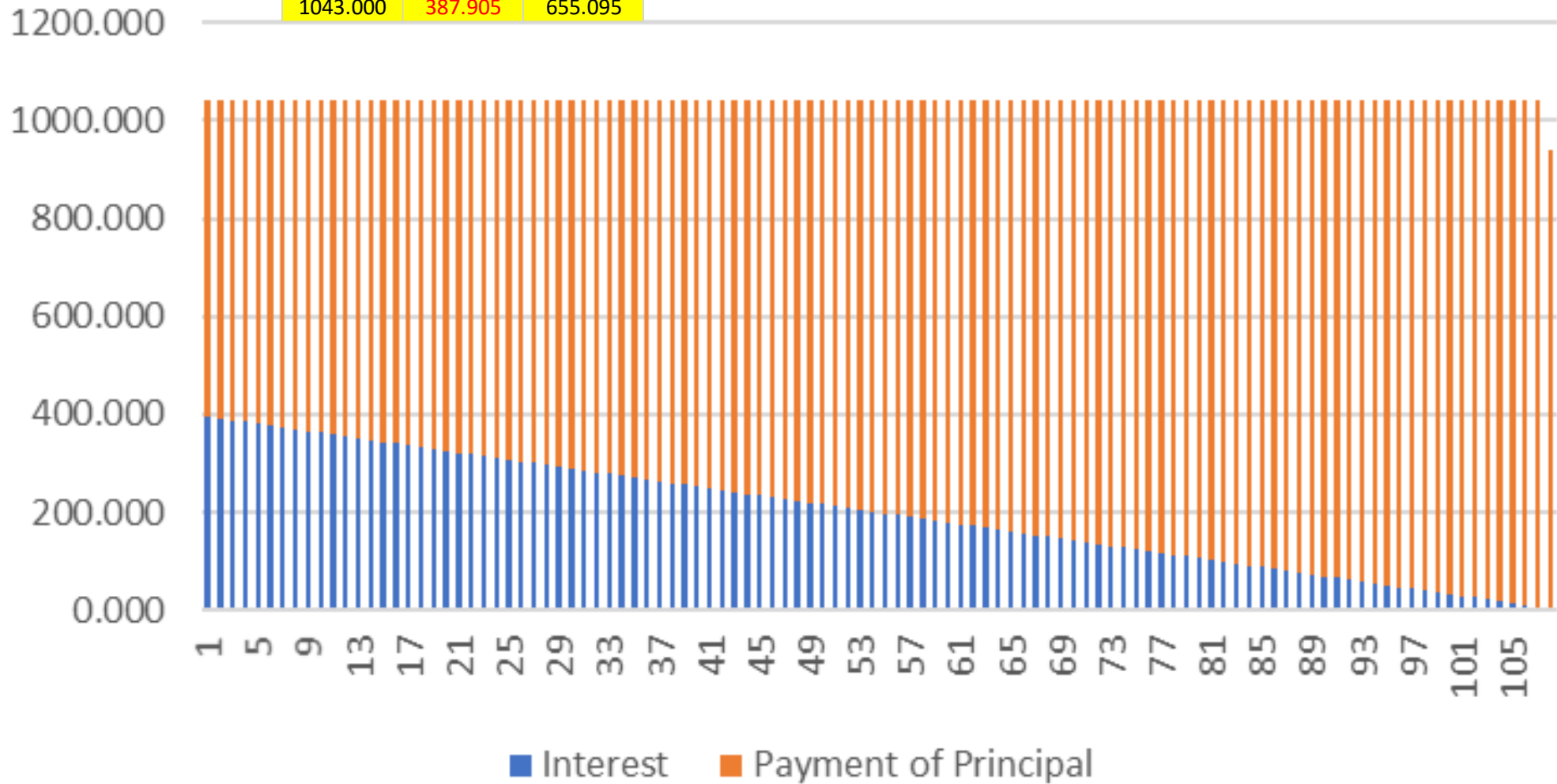
1 ■
 + 2 ■
 + 3 ■
 + 4 ■
 + 5 ■
 + 6 ■
 + 7 ■
 + 8 ■
 + 9 ■
 + 10 ■
 + 11 ■
 + 12 ■

78

Month	Nominator	Denominator	Profit Allocation
1	12	78	12/78
2	11	78	11/78
3	10	78	10/78
4	9	78	9/78
5	8	78	8/78
6	7	78	7/78
7	6	78	6/78
8	5	78	5/78
9	4	78	4/78
10	3	78	3/78
11	2	78	2/78
12	1	78	1/78
78			

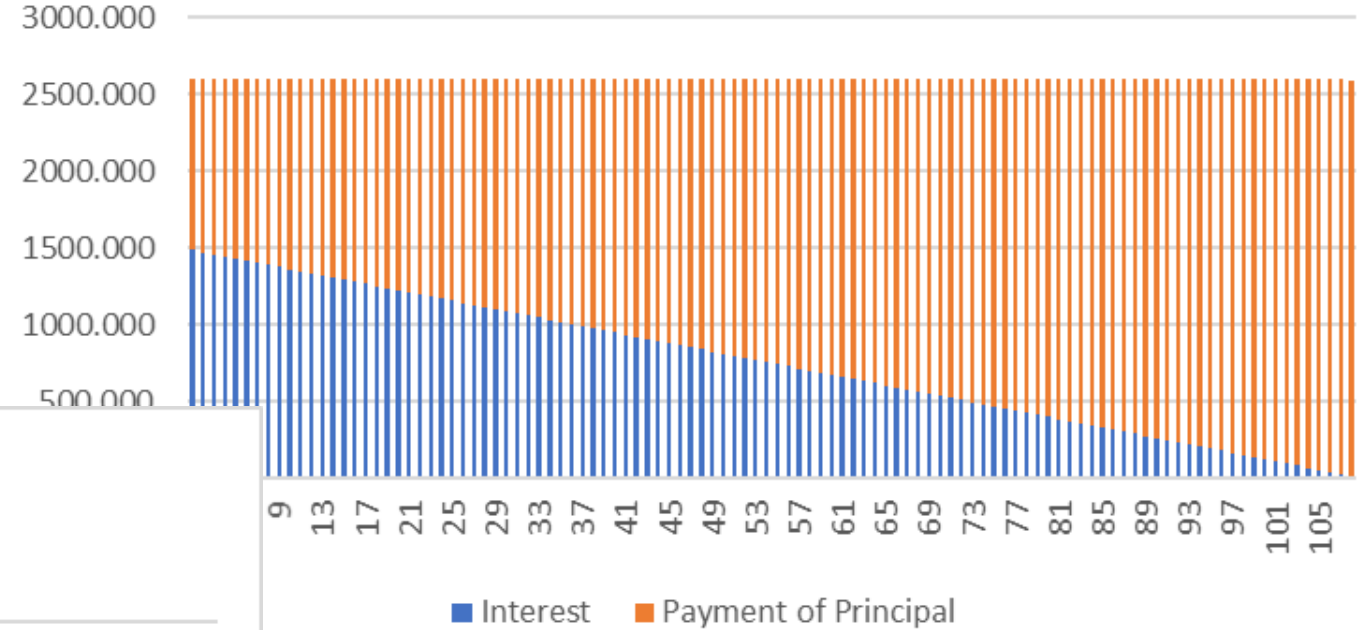
Rule 78

Instalment	Interest	Payment of Principal
1043.000	395.224	647.776
1043.000	391.564	651.436
1043.000	387.905	655.095



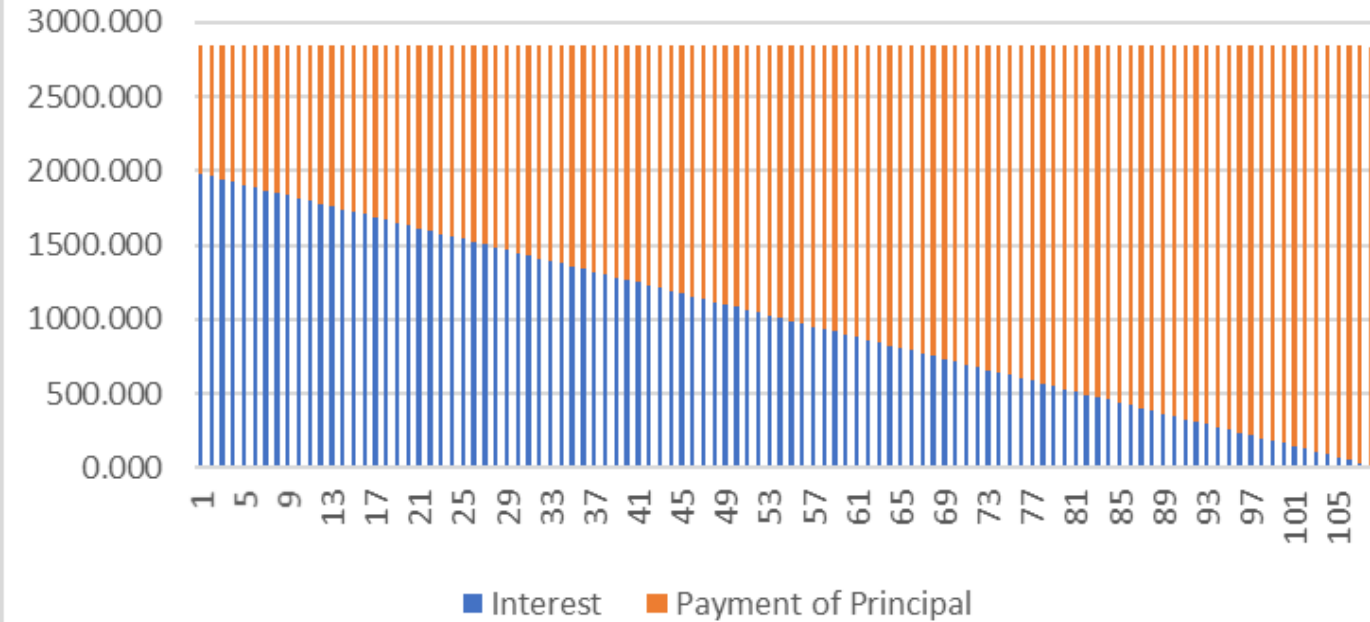
Instalment	Payment of Profit	Payment of Principal
2,602.00	1,330.37	1,271.63
2,602.00	1,321.91	1,280.09
2,602.00	1,313.39	1,288.61

Rule 78
Loan=200k Int=4.5%



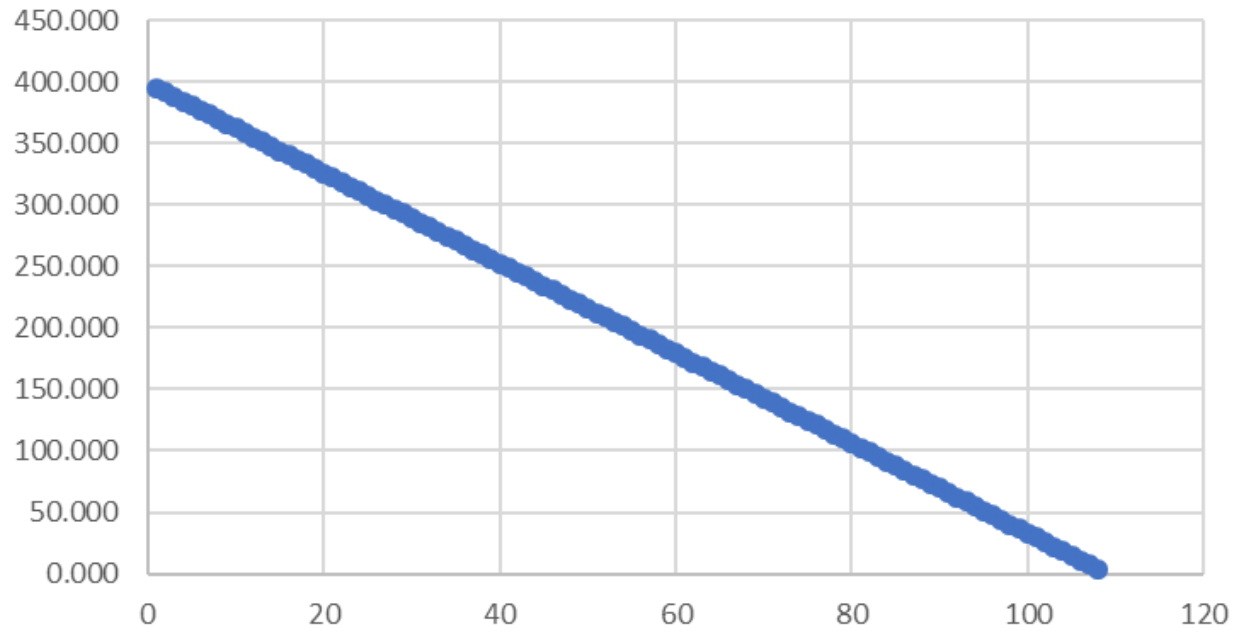
Instalment	Interest	Payment of Principal
2852.000	1981.651	870.349
2852.000	1963.303	888.697
2852.000	1944.954	907.046

Rule 78
Loan 200k Interest 6%



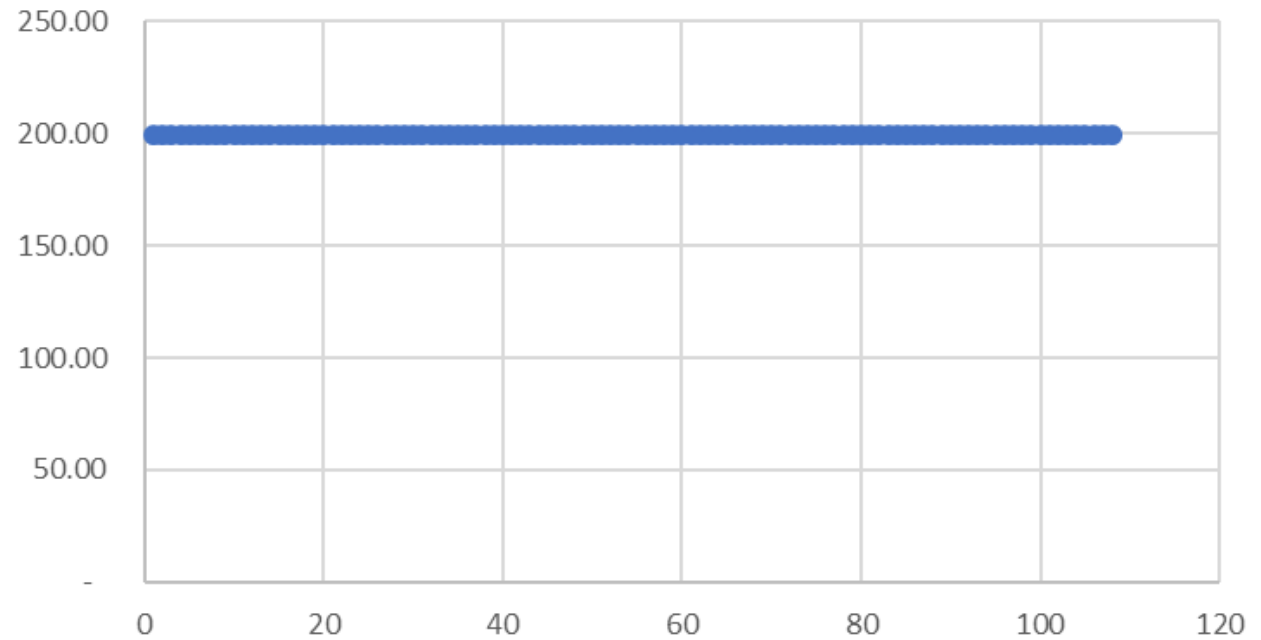
■ Interest ■ Payment of Principal

R78



See Excel File

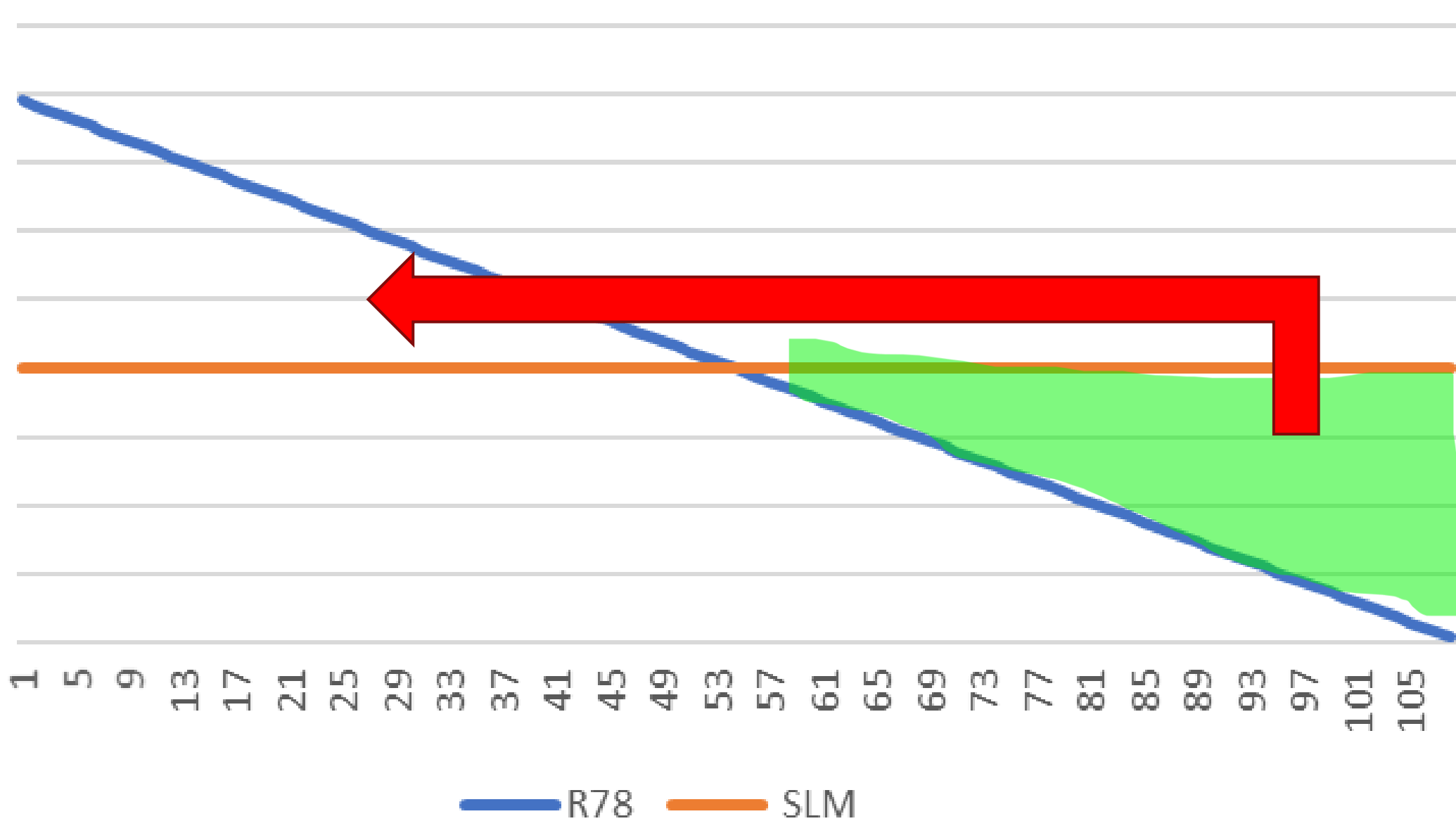
SLM



450.000
400.000
350.000
300.000
250.000
200.000
150.000
100.000
50.000
0.000

1 5 9 13 17 21 25 29 33 37 41 45 49 53 57 61 65 69 73 77 81 85 89 93 97 101 105

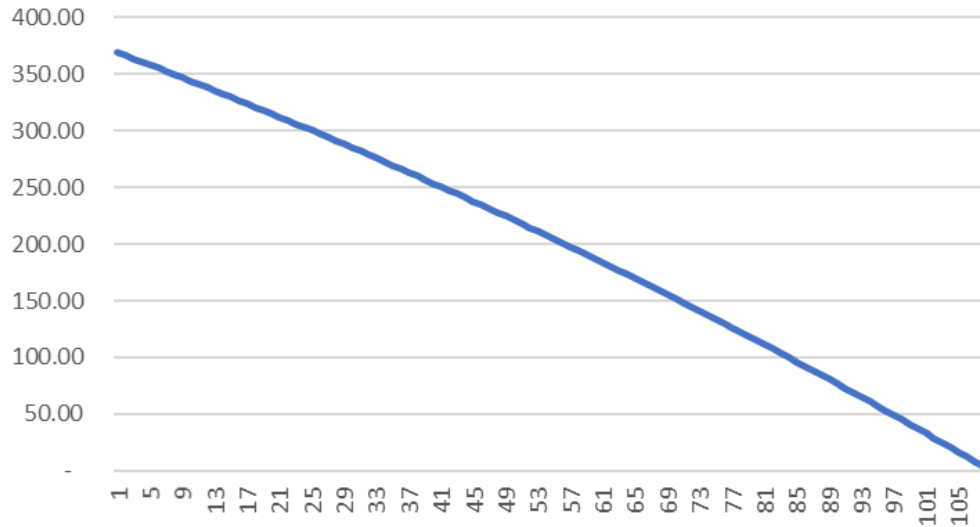
R78 SLM



Issues

1. Front-Loaded Interest Allocation
2. Penalizes Early Loan Payoff
3. Inconsistent with Modern Interest Practices
4. Regulatory and Legal Restrictions
5. Unsuitable for Long-Term Loans
6. Misalignment with Ethical and Fair Practices
7. Complexity and Lack of Transparency

EPRM



MFRS 9: Financial Instruments

Effective interest method

5.4.1 Interest revenue shall be calculated by using the *effective interest method* (see Appendix A and paragraphs B5.4.1–B5.4.7). This shall be calculated by applying the *effective interest rate to the gross carrying amount of a financial asset*

Income recognition

2. Income from financing and receivables

Income from financing and receivables are recognised in the income statement using the effective profit method. The effective profit rate is the rate that discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability to the carrying amount of the financial asset. The calculation of the effective profit rate includes all contractual terms of the financial instrument and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective profit rate.

Murabahah

Murabahah income is recognised on effective profit rate basis over the period of the contract based on the principal amounts outstanding.

Ijarah

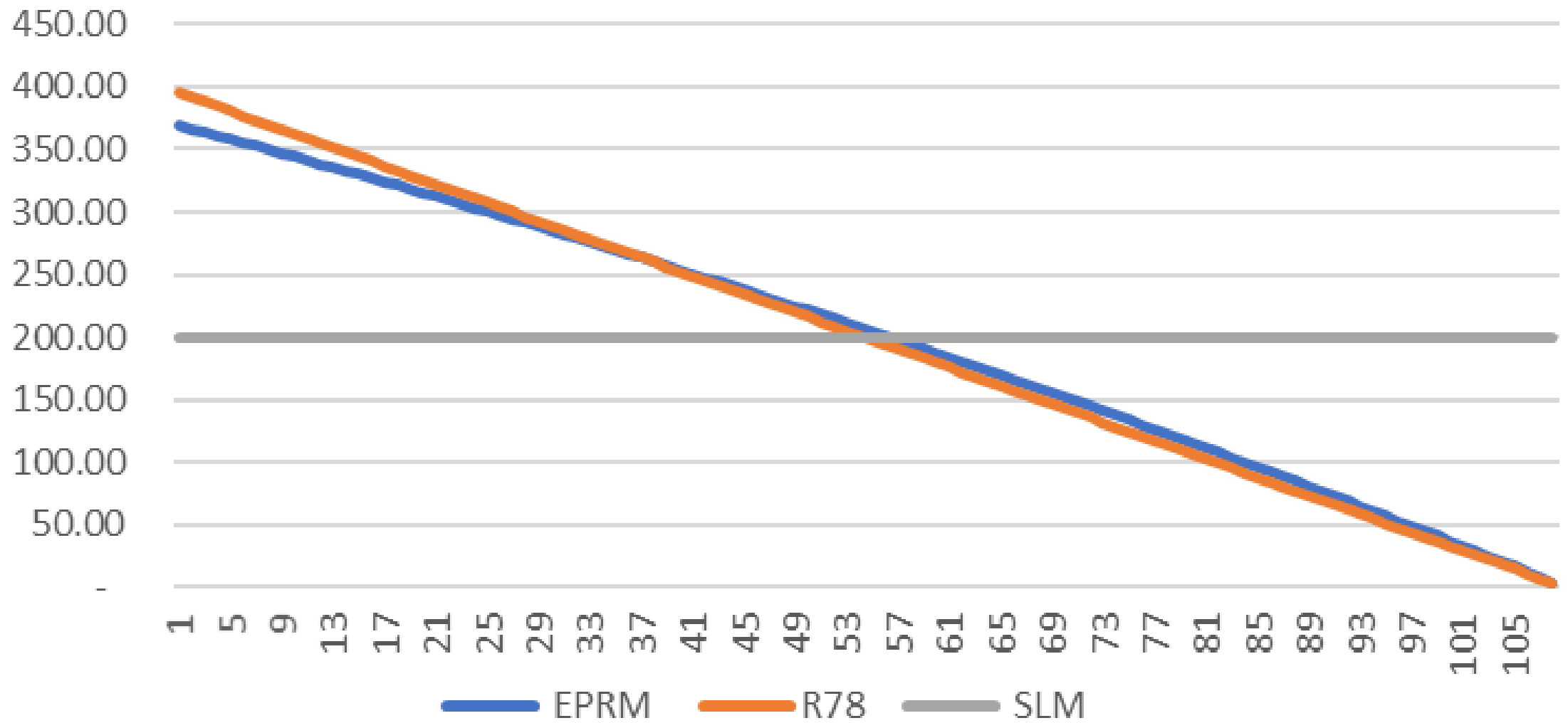
Ijarah income is recognised on effective profit rate basis over the lease term.

Musharakah

Income is accounted for on the basis of the reducing balance on a time-apportioned basis that reflects the effective yield on the asset.

NOW

Profit Allocation



Legal Frameworks

1.	US	Federal laws (e.g., 15 U.S.C. § 1615) prohibit its use in loans exceeding 61 months, mandating fairer methods such as the actuarial approach. Regulatory and judicial interventions emphasize the need for clear disclosures and equitable treatment of borrowers.
2.	UK	The UK abolished the Rule of 78 for new credit agreements after May 2005 through the Consumer Credit Act 2006. Paired with Office of Fair Trading guidance in 2005, these measures promoted fairer repayment practices, capped early repayment charges, and prioritized transparency and consumer protection, ensuring equitable treatment across financial products.
3.	Canada	The Supreme Court of Canada in <i>Bank of Montreal v. Innovation Credit Union</i> (2010) emphasized transparency in interest calculations, fair borrower treatment, and regulatory compliance. Legal critiques of the Rule of 78 highlight its disadvantages for consumers prepaying loans, reinforcing the need for equitable practices.
4.	Europe	The European Union Consumer Credit Directive (2008/48/EC) harmonized consumer credit laws across member states, emphasizing transparency and fairness. It mandated clear disclosure of credit terms, including interest calculation methods, enabling consumers to make informed financial decisions.

Legal Frameworks

5.	Australia and New Zealand	Australia reformed its Consumer Credit Code in the early 2000s, banning the Rule of 78 to ensure fairer loan practices. <i>Andrews v. ANZ Banking Group</i> (2012) scrutinized excessive fees, setting precedents for transparency and equitable financial practices. Both emphasized consumer protection and fairness in lending.
6.	UK	The Singapore Court of Appeal (2021) emphasized proportionality in penalty clauses, underscoring fairness and transparency in financial agreements. The ruling indirectly criticized disproportionate methods like the Rule of 78, reinforcing the judiciary's role in protecting consumers from unfair practices.
7.	Africa	South Africa's National Credit Act (2005) introduced reforms mandating transparent interest calculations and fair disclosure in credit agreements. By regulating interest and fee calculations, the Act protects consumers from overcharging and prevents unfair financial practices, ensuring fairness.
8.	Legal Literature	Legal literature has also critiqued the Rule of 78's. For example, an article titled "The Rule of 78, Hidden Penalty in Prepayment in Consumer Credit Transactions" provides a detailed analysis of how the Rule of 78's can disadvantage consumers who prepay their loans.

Thank You

For More Information and Working Paper

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