

RULE OF 78s

The Rule of 78s (also known as the sum-of-digits method) is a method of allocating the interest charge on a loan across its payment periods. The name comes from the total number of months' interest that is calculated in a year (the first month is 1 month's interest, whereas the second month contains 2 months' interest, etc.).

This is an accurate interest model only when based on the assumption that the borrower pays only the amount due each month. If the borrower pays off the loan early, this method maximizes the amount paid (interest paid) by applying funds to interest before principal. In other words, in comparison to a simple interest loan, a rule of 78s loan will charge more interest if the loan is paid early.

For short term loans, the Rule of 78s is used to mitigate the risk to the lender of a loan being paid off before the costs of making the loan have been recouped.

Precomputed Loans

The Rule of 78s applies to precomputed loans - whose total finance charge is calculated before the loan is made. Finance charge, which includes charges, interest costs and any other loan costs, can be calculated with simple interest equations, add-on interest, an agreed upon fee, or by any disclosed method.

Once the finance charge has been identified, the Rule of 78s is used to calculate the amount of the finance charge to be rebated (forgiven) in the event that the loan is repaid early, prior to the agreed upon number of payments.

With precomputed loans, a borrower owes the lender the principal amount borrowed, plus the finance charge. For example, if \$5,000 is lent and the precomputed finance charge is \$1,000, the borrower owes the lender \$6,000 at the time the loan is made, whereas a simple interest borrower owes the lender only the \$5,000 principal and monthly interest on the unpaid principal.

Further Information:

Wikipedia: https://en.wikipedia.org/wiki/Rule_of_78s

Investopedia: <http://www.investopedia.com/terms/r/ruleof78.asp>