

THE APPLICATION OF RULE 78 IN VEHICLE FINANCING BY ISLAMIC BANKS IN MALAYSIA



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**** This is a summary of an
article published in Arabian
Journal of Business and
Management Review (2017)**

Al-Ijarah Thumma al-Bay' (AITAB) is an innovative product designed for vehicle financing. Since its inception, AITAB has been a popular product due to the heightened demand by customers. Although AITAB is popular, it is not without condemn especially on the issue of using Rule 78, which is similar to conventional Hire-Purchase practise. This paper, attempts to address the issue of using Rule 78 which affects the customers in the case of default. A case study is used to compare the use of Rule 78 and simple profit rate methods on repaying the principal amount and the profit rate by the customer. The discussion is based upon the case on vehicle financing for three years and the impact on the defaulter on the thirteenth month of financing. The result shows the customer pays higher amount in the case of default using the Rule 78 in financing compared to simple profit rate method.



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Repayment Mechanism (Rule 78 vs Simple profit)

The mechanism of repayment of financing amount based on instalment payment is that the sum that is to be paid monthly is fixed every month, but the difference appears on the distribution of instalment paid into principal and profit, the commonly used method is Rule 78 and the other method is the simple profit rate.

The Rule of 78 is a method of allocating the profit charge on a loan across its payment periods. Under the Rule of 78, periods are weighted by comparing their numerical values to the sum of all the digits of the periods. The name of the rule came from the sum up of the digits from 1-12 ($1+2+3+4+5+6+7+8+9+10+11+12=78$).

Simple profit is the method of calculating the profit charge on a loan. This type of profit usually applies to vehicle loans. In repayment using Simple profit, the payment first goes towards that month's profit, and the remainder goes towards the principal. Each month's profit is paid in full so it never accrues. If the financing loan is for RM50,000, with profit rate 5% for five years. The payable amount for the 60 Month is RM62,500. Simple profit versus Rule 78 is that the amount paid is the same for both methods but the profit earns by the bank using Rule 78 is more in the early years compare to the profit rate.

Using Rule 78 the weights are applied in reverse, applying large weights to early periods. When paying off a loan, the repayments consist of two parts: the principal and the profit charge. The Rule of 78 weights earlier payments with more profit than latter ones. If the loan is not terminated or prepaid early, the total profit paid between simple profit and the Rule of 78 will be equal. However, because the Rule of 78 weights the earlier payments with more profit than a simple profit method, paying off a loan early will result in the customer to pay more in case

of default. This method of allocating profit was common in loans for consumer goods, such as automobiles. Apparently, this method penalises default customers.

Conclusion and Recommendation

In recent years, there has been an increasing concern over the sustainability of Islamic banking in Malaysia with regard to the banking practises. Hence, this research aids in filling the important gap to the present literature on issues related to AITAB financing.

This paper examines the empirical behaviour of Islamic banks providing vehicle financing. The paper uses a case study of AITAB financing for a duration of three years, when the customers default after having paid the twelfth instalment he faces financial difficulties as he lost his job and he cannot continue to pay the instalments from the thirteen month onward. Due to the use of Rule 78 in repayment customers has paid RM 882.20 more than he should if the bank uses the simple profit rate instead of Rule 78. In the case of complete transaction, the repayment amount is identical for both methods which is RM 44,080.00 the difference of the amount paid comes in the case of default, customer has to pay more relatively to simple profit rate method.

Islamic banks have been built up on two legs, which are the Islamic teaching and profit generation. It is reasonable that Islamic banks have their shareholders who would like to have returns on investment but not to forgo the Islamic teaching on exploitation. Thus, using Rule 78 in AITAB model practiced by Malaysian banks is constructed based on Shariah principles and needs to undertake the consideration of just and fair distribution aspects to all related parties without neglecting the profit factor.

It is also assumed that the goals of Islamic economics are thought to guide the objective of Islamic banking and Finance. With the actual practise of the Islamic banks in various jurisdictions, there seems to be a widening gap between the two Islamic disciplines in terms of their objectives and application. The implications of using the simple profit rate instead of rule 78 following a hire purchase application in the conventional banking sector, the customer would not pay more than what he has to pay.

****Notes:**

Babikir Mohamed, O., & Mohd Isa, M. (2017). The Application of Rule 78 in Vehicle Financing by Islamic Banks in Malaysia. *Arabian Journal of Business and Management Review* (Kuwait Chapter), Vol 6 (9),20-31.

