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Methods for Calculating Interest on Loans: 360/365 vs. 365/365

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Because of the current state of the real estate industry, and in particular real estate finance markets, there are certain issues in loan documentation that have become even more relevant to borrowers as a means of controlling their costs of capital. The method used for interest rate calculations in promissory notes is one such issue. Following, we'll consider the Bank Method and the Stated Rate Method.

By way of example, often times borrowers will enter into a loan commitment with a bank which states an annual interest rate for the loan but not the method of computing such rate (*e.g.*, Interest Rate = 8% per annum). If the borrower was receiving a $10,000,000 interest-only loan at 8% interest, a reasonable interpretation of this loan commitment could be that the borrower should expect to pay $800,000 in interest per year (*e.g.*, $10,000,000 x 0.08). However, as demonstrated below, the actual interest paid is oftentimes more than the borrower expected because of the method employed to calculate interest in the loan documentation.

Traditionally, there are two common methods used for calculating interest: (i) the 365/365 method (or Stated Rate Method) which utilizes a 365-day year; and (ii) the 360/365 method (or Bank Method) which utilizes a 360-day year and charges interest for the actual number of days the loan is outstanding. (Drafter's Note: The use of the 360-day calendar dates back to ancient Egyptian times and is based on the lunar calendar rather than a deliberate attempt to confuse).

As shown below, the Stated Rate Method results in a borrower paying yearly interest equal to the $800,000 anticipated by the above loan commitment example (or 8% annual interest). While, the Bank Method results in the borrower paying an additional $11,111 in interest (*e.g.*, five days of additional interest) due to the fact that the $800,000 is accrued on day 360 of the Bank Method with 5 days remaining in the actual year still to be paid (or 8.11% annual interest).

The following are two typical provisions which employ the Bank Method and the Stated Rate Method:

- **Bank Method:** "The annual interest rate for this Note is computed on a 365/360 basis; that is, by applying the ratio of the annual interest rate over a

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year of 360 days, multiplied by the outstanding principal balance, multiplied by the actual number of days the principal is outstanding."
- **Stated Rate Method:** "All interest calculated under this Note shall be computed based on the actual number of days elapsed in a year consisting of 365 days."

The below calculation demonstrates the difference between the Bank Method and the Stated Rate Method:

Stated Rate Method (365/365)

Principal Loan Amount = $10,000,000
Stated Rate = 8% per annum (interest-only/non-amortizing)
Daily Interest = $2,191.78 (($10,000,000 x 0.08)/365)
Annual Interest = **$800,000** ($2,191.78 x 365)
Actual Yearly Interest Rate = 8%

Bank Method (360/365)

Principal Loan Amount = $10,000,000
Stated Rate = 8% per annum (interest-only/non-amortizing)
Daily Interest = $2,222.22 (($10,000,000 x 0.08)/360)
Annual Interest = **$811,111** ($2,222.22 x 365)
Actual Yearly Interest Rate = 8.11%

Of course, this difference in interest payments will be compounded for as long as the loan is outstanding. Accordingly, it is critically important for a borrower to understand these calculations to more effectively compare loan proposals and control their capital costs. A financially prudent real estate investor will have their loan commitments and subsequent legal documentation diligently reviewed as another means of controlling their costs of capital. The Reinhart team is ready to assist with these needs.

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