Relief for Early Calls on Debt

On March 30, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities,* addressing interest income recognition. Under current guidance, when a debt security or loan is purchased at a premium, the premium is typically amortized to the maturity date by adjusting the yield, despite the possibility that the borrower may prepay the debt instrument earlier than the contractual maturity date. The current interest income model may result in the recognition of too much interest income prior to prepayment and delayed recognition of a loss for the unamortized premium. (see Appendix A)

These amendments require the premium on certain debt securities to be amortized to the earliest call date. (see Appendix B)

> *This ASU may affect all entities but especially community banks; FASB research revealed 1,700 banks where these securities represented 10 percent of total assets.*

Scope

The scope is limited to securities that have explicit, noncontingent call features that are callable at fixed prices on preset dates. For instruments with contingent call features, once the contingency is resolved and the security is callable at a fixed price and preset date, the security would then fall within the ASU's scope. Securities that are immediately prepayable or where the prepayment date is not preset would be excluded from scope. The exclusion extends to securitized debt instruments with prepayment features.

The ASU applies to all premiums and not just purchase premiums, *e.g.*, deferred acquisition costs or cumulative fair value hedge adjustments that increase the amortized cost basis of a callable security above par.

> *There is no change for debt securities purchased at a discount; the discount will continue to be amortized to maturity.*

Transition

Entities should apply these amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in the year of adoption. There are no new disclosures required by this ASU; however, in the period of adoption, an entity would provide disclosures about an accounting principle change.

Effective Date

This ASU will be effective for public business entities for reporting periods beginning after December 15, 2018. All other entities will have an additional year for adoption. Early adoption is permitted for all entities, including in interim periods.

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Appendix A – Current Guidance

A community bank purchases a newly issued bond on July 1, 2012, for $1,350. The bond will mature June 30, 2024, pays 5 percent interest annually and is callable at par on July 1, 2020. The bank is paying a $350 premium to receive the above-market annual coupon of $50, which equates to a 1.74 percent yield on the bond. The bank will amortize the premium down to par over the bond's life so that on maturity, the cost basis will adjust to $1,000. If the bond is called, the bank would recognize a loss on any unamortized premiums.

Current Generally Accepted Accounting Principles					
Year	Adjusted Basis Beginning of Year	Current Year Amortization	Adjusted Basis End of Year	Net Interest Income	Yield
2012	1,350.00	13.23	1336.77	11.77	1.74%
2013	1,336.77	26.69	1310.07	23.31	1.74%
2014	1310.07	27.16	1282.91	22.84	1.74%
2015	1282.91	27.63	1255.28	22.37	1.74%
2016	1255.28	28.12	1227.16	21.88	1.74%
2017	1227.16	28.61	1198.56	21.39	1.74%
2018	1198.56	29.10	1169.45	20.90	1.74%
2019	1169.45	29.61	1139.84	20.39	1.74%
2020	1139.84	30.13	1109.71	19.87	1.74%
2021	1109.71	30.65	1079.06	19.35	1.74%
2022	1079.06	31.19	1047.87	18.81	1.74%
2023	1047.87	31.73	1016.14	18.27	1.74%
2024	1016.14	16.14	1000.00	8.86	1.74%

Appendix B

Same facts as above. Under ASU 2017-08 less interest income is recognized before the call date. Therefore, if the bond is redeemed at the first call date as expected, there is no unamortized premium. If the bond is not called, *e.g.*, due to a rise in interest rates, the interest yield would be reset to the security's coupon rate. Resetting the interest rate to the coupon rate after the earliest call would reflect the rise in market interest rates. If the security contained additional future call dates, an entity would consider whether the amortized cost basis exceeded the amount repayable by the issuer at the next call date; the excess would be amortized to the next call date.

ASU 2017-08					
Year	Adjusted Basis Beginning of Year	Current Year Amortization	Adjust Basis End of Year	Net Interest Income	Yield
2012	1,350.00	21.79	1328.21	3.21	0.50%
2013	1328.21	43.62	1284.59	6.38	0.50%
2014	1284.59	43.66	1240.93	6.34	0.50%
2015	1240.93	43.71	1197.22	6.29	0.50%
2016	1197.22	43.75	1153.47	6.25	0.50%
2017	1153.47	43.79	1109.68	6.21	0.50%
2018	1109.68	43.84	1065.84	6.16	0.50%
2019	1065.84	43.88	1021.96	6.12	0.50%
2020	1021.96	21.96	1000.00	3.04	
2021	1000.00	n.a.	1000.00	50	5.00%
2022	1000.00	n.a.	1000.00	50	5.00%
2023	1000.00	n.a.	1000.00	50	5.00%
2024	1000.00	n.a.	1000.00	50	5.00%