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SEC Objects to Prospective Unlocking of LTC Reserves

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Earlier this year, the Securities and Exchange Commission (SEC) informed one of its registrants that prospective unlocking of benefit reserves for long-term care (LTC) insurance was not an acceptable practice under current US GAAP. The purpose of this article is to make actuaries aware of this action and provide some additional context.

Recall that under FAS 60, the assumptions used for benefit reserves on long-duration insurance contracts are locked-in at policy issuance. US GAAP accounting literature specifies two situations where these reserve assumptions can be unlocked. One situation, addressed in FAS 60, is when a premium deficiency exists, in which case the reserve is re-calculated using current assumptions. The second situation, addressed in AICPA SOP 05-1, is when an internal replacement is deemed to occur. In this case, reserve assumptions are updated on a prospective basis only, meaning that the current reserve is unchanged but the future pattern of reserve changes is altered.

This latter concept is variously referred to as prospective unlocking, the prospective revision methodology, or pivoting. Although the issuance of AICPA SOP 05-1 in 2005 represented the first time that this concept appeared in U.S. accounting literature, the prospective unlocking concept has a long history in actuarial circles. Many actuaries have believed that prospective unlocking is an acceptable GAAP practice with respect to benefit reserves for long-term care, issue-age-rated Medicare Supplement, and other long-duration health contracts for which the timing and magnitude of actual premium increases (as well as changes in morbidity levels) may differ from the assumptions made at policy issuance. Prospective unlocking has been referenced in the SOA's US GAAP for Life Insurers textbook, as well as in ASOP 10.

Until this year, standard-setting bodies had not taken any known position on whether or not prospective unlocking is an appropriate GAAP practice. That changed during the first quarter of 2008. In March 2008, an SEC registrant filed a 2007 Form 10-K that included the following language:

In the critical accounting policies section of our 2006 Form 10-K, we disclosed that we used a

prospective revision methodology (also known as pivoting) to account for premium rate increases on long-term care policies. Under this accounting policy, we prospectively changed reserve assumptions for long-term care policies when premium rate increases differed significantly from our original assumptions. We based the use of this accounting policy on our interpretation of GAAP. ... In accordance with the request of the SEC staff, we prepared a document which summarized our use of the prospective revision methodology and the authoritative guidance we followed in determining our accounting policy. On February 28, 2008, the SEC staff informed [the Company] that the use of this method is not consistent with the guidance of FASB Statement of Financial Accounting Standards No. 60, "Accounting and Reporting by Insurance Enterprises."

In light of this new SEC stance, companies that issue long-duration health insurance contracts and report under US GAAP should strongly consider discussing this situation with their audit firm prior to year-end 2008.

The Actuarial Standards Board is in the process of determining whether any changes are warranted in light of this situation to the existing guidance in ASOP 10. However, as of this writing we are not aware of any plans by the Financial Accounting Standards Board to promulgate any authoritative accounting literature relating to prospective unlocking. ■



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