Statutory Issue Paper No. 160

Structured Settlements Acquired as Investments

STATUS
Finalized April 6, 2019

Original SSAP: 21R; Current Authoritative Guidance: SSAP No. 21R

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper introduces substantive revisions to *SSAP No. 21—Other Admitted Assets* to explicitly include accounting guidance for an insurance reporting entity that acquires (directly or indirectly) structured settlement payment rights as a result of a structured settlement factoring transaction. This item is specific for transactions that only provide a reporting entity the right to receive payments under a structured settlement and does not address situations in which the reporting entity has acquired an insurance product (e.g., life settlement, annuity, etc).

2. The substantive revisions to SSAP No. 21 (illustrated in Exhibit A), reflect the following elements:

   a. Period-certain (non-life contingent) structured settlement income streams are admitted assets if the rights to the future payments have been legally acquired in accordance with all state and federal requirements.

   b. Life-contingent structured settlement income streams shall be nonadmitted regardless if legally acquired.

DISCUSSION

3. This issue paper intends to provide historical information on the consideration of revisions for structured settlements acquired as investments, as well as the initially adopted revisions.

Overview of Structured Settlements

4. Generally, structured settlements are settlements of tort claims involving physical injuries or physical sickness and workers' compensation claims, under which settlement proceeds take the form of periodic payments, including scheduled lump sum payments. Structured settlements are often funded by single-premium annuity contracts purchased by the obligor / defendant contractually obligated to make the future settlement payments. In these situations, the original recipient of the structured settlement payments does not own the insurance product (annuity); rather the recipient only has the contractual right to the future cash streams. Structured settlement cash flow streams, by design, include the time value of money, therefore the interest rate is embedded in the payment stream - (they do not pay separate interest). Structured settlement payments to the original recipient are tax-free, and may have tax advantages to subsequent holders.

5. Structured settlement payments are designed in accordance with the financial needs of the original recipient. As such, the amounts and timing of structured settlement income streams are situation specific, and can vary significantly from other structured settlements. As basic examples, cash flow streams can result with monthly payments for a set period of time, or can be designed to provide large cash payments every few years to match anticipated predetermined costs for the injured person. Once the terms of the

structured settlement are set, original recipients do not have the ability to renegotiate the settlement terms. Although they have different payment terms, structured settlements are broadly classified in two buckets:

a. Period Certain / Guaranteed Payments – These structured settlement payments are owed regardless whether the recipient is living at the time the payment is owed. As such, any subsequent purchaser of the income stream can expect to receive a set amount of future cash flow payments.

b. Life Contingent Payments – These structured settlement payments are owed only if the original recipient is living at the time the payment is owed. As such, the extent to which future cash payments will be required under the terms of the structured settlement is uncertain.

6. Original recipients of structured settlements may decide to sell their legal rights to future cash flows in exchange for lump sum payments on the secondary market through factoring companies. (These elections can include the entire future cash flows of the structured settlement, or partial amounts of future cash flows. As an example, if an original beneficiary had legal rights to 36 monthly structured settlement payments, they could elect to only sell one year of their cash flow payments (12 months) to the secondary market and retain the remaining 24 payments.)

7. Factoring companies sell the rights to future cash flows as "investment" products to unrelated third parties, either as individual items or as an interest in a securitized pool of structured settlements. As the original recipient receives a discounted lump sum payment from the acquiring factoring company, the ultimate holder of the future income stream may receive an attractive yield. For period certain structured settlements, the income streams are often considered low risk as they are generally backed by single-premium annuity products purchased by the original obligor from well-capitalized insurance companies that fund / administer the future income stream. (When the original obligor purchases an annuity to fund the payments, the obligor is released from future obligation, and the annuity insurer, which makes the payments as set forth in the structured settlement arrangement, assumes the liability to the beneficiary.)

Structured Settlement Transfer Requirements:

8. In order to protect the original recipients of structured settlements from exploitation, state and federal laws have strict requirements on the transfer of structured settlement cash flows and provide tax penalties if the provisions are not followed. Although states have varying additional restrictions (e.g., some prohibit the factoring of worker's compensation structured settlement benefits), all transfers are subject to the following provisions under the federal Structured Settlement Protection Act (SSPA) and IRS code:

a. All structured settlements must comply with the specific state's SSPA version, including the rule that the transfer had to be in the seller's best interest and the best interest of that person's family or dependents.

b. A 40% excise tax is to be applied to any transfer that was not court-approved. Absent an appropriate court or administrative authoritative order, a party acquiring structured settlement payment rights must pay, up front, a tax equal to 40% of its expected gross profit on the transaction. (This is the difference between the total undiscounted amount of future payments and the amount paid to acquire the cash flow stream.)

9. Risks to acquirers of structured settlement income streams include:

a. Future structured settlement income streams are illiquid and may be difficult to sell. If a subsequent holder needs to sell, it may be difficult to do so, and may result with the holder incurring a loss.

b. Acquirers of income streams that are not court approved and properly assigned may not be legal, and the acquirer may not be able to legally obtain the future income streams.

Existing Statutory Accounting Guidance:

10. Existing statutory accounting guidance for structured settlements is not intended to address insurer acquirers of structured settlement income streams as investments. Rather, existing SAP guidance addresses situations in which the insurer is the holder of an annuity that provides future structured settlement payments to the designated recipients. The existing SAP guidance, as it pertains to the use of annuities to fund structured settlements satisfying claim liabilities of the insurer, is adopted from U.S. GAAP. Under the existing statutory accounting guidance, these annuities are reported as "other than invested assets" outside of the investment schedules. As these items are reported as "other than invested assets," they are excluded from RBC charges and may be outside of state investment limitations.

11. Existing guidance in *SSAP No. 21—Other Admitted Assets*

Cash Value of Structured Settlements

5. The reporting of the present value of structured settlement annuities where the reporting entity is the owner and payee as described in SSAP No. 65, paragraph 17.a. shall account for the annuity an admitted asset at its net present realizable value. The annuity described is reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves.

12. Existing guidance in *SSAP No. 65—Property and Casualty Contracts*

Structured Settlements

17. Structured settlements are periodic fixed payments to a claimant for a determinable period, or for life, for the settlement of a claim. Frequently a reporting entity will purchase an annuity to fund the future payments. Reporting entities may purchase an annuity in which the entity is the owner and payee, or an annuity in which the claimant is the payee. When annuities are purchased to fund periodic fixed payments, they shall be accounted for as follows:

a. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves. The annuity shall be recorded at its present value and reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased; and

b. When the claimant is the payee, loss reserves shall be reduced to the extent that the annuity provides for funding of future payments. The cost of the annuities shall be recorded as paid losses.

18. Statutory accounting and Generally Accepted Accounting Principles (GAAP) are consistent for the accounting of structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the owner and payee and the reporting entity has been released from its obligation. GAAP distinguishes structured settlement annuities where the owner is the claimant and a legally enforceable release from the reporting entity's liability is obtained from those where the claimant is the owner and payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the claimant is the owner and payee yet the reporting entity has not been released from its obligation. Statutory accounting treats these settlements as completed

transactions and considers the earnings process complete, thereby allowing for immediate gain recognition.

19. The following information regarding structured settlements shall be disclosed in the financial statements:

a. The amount of reserves no longer carried by the reporting entity because it has purchased annuities with the claimant as payee, and the extent to which the reporting entity is contingently liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities; and

b. The name, location, and aggregate statement value of annuities due from any life insurer to the extent that the aggregate value of those annuities equal or exceed 1% of policyholders' surplus. This disclosure shall only include those annuities for which the reporting entity has not obtained a release of liability from the claimant as a result of the purchase of an annuity. The reporting entity shall also disclose whether the life insurers are licensed in the reporting entity's state of domicile.

20. Refer to the Preamble for further discussion regarding disclosure requirements.

Development of Statutory Accounting Guidance:

13. During the 2018 Summer National Meeting, the Statutory Accounting Principles (E) Working Group exposed proposed revisions to SSAP No. 21 to incorporate accounting guidance for structured settlement income streams acquired by insurers as investments. Elements in this exposure included the following concepts:

a. Structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, through acquisition of an interest in a securitized pool that meets the scope requirements of *SSAP No. 43R—Loan-backed and Structured Securities* shall follow the accounting and reporting guidance of that SSAP. (This is not a change from existing guidance.)

b. Period certain (non-life contingent) structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, as individual investments (not as securitizations), are considered other long-term investments, captured on Schedule BA, and permitted as admitted assets when the structured settlement income stream has been legally acquired in accordance with all state and federal requirements. These acquisition requirements include court-approval of the income stream transfer from the original beneficiary. If a structured settlement income stream has not been legally transferred from the original beneficiary to the insurer acquirer, the structured settlement shall be fully nonadmitted by the insurance reporting entity. (Unless there is legal transfer, nonadmittance is required as the acquirer may not be entitled to receive the future income streams.) In addition to nonadmittance, the insurer acquirer must also appropriately report the excise tax required under the IRS code.

c. Life contingent structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, as individual investments (not as securitizations), are considered other long-term investments, captured on Schedule BA, and shall be fully nonadmitted. (With life contingent income streams, nonadmittance is required as it is uncertain whether any future income streams will be received. As such, these items should not be considered admitted assets available for policyholder claims under *SSAP No. 4—Assets and Nonadmitted Assets*.)

d. The proposed guidance should not be inferred to "life settlement" acquisitions. Life settlements are not structured settlements. A life settlement transaction is when an investor purchases an insurance policy from an insured and continues to pay the premium payments so that when the insured event occurs (e.g., death of the insured), the investor receives the death benefit. In life settlements, the investor often pays the insured an amount greater than the cash surrender value of the insurance policy, with an expectation that the insured event will occur in a timeframe that the death benefit received is greater than the cost of the purchase price and the future premium payments to keep the policy active. As detailed in this agenda item, a structured settlement is the legal right to future cash flows, and does not reflect the acquisition of an insurance policy. Unlike life settlements, there is no cash surrender value to structured settlements, and payments under the structured settlement are not renegotiable once set.

14. With the noted elements for structured settlements, the following provisions for reporting structured settlement income streams as other long-term invested assets, were also exposed:

a. Structured settlement income streams shall be separately reported on Schedule BA, unless they can be aggregated with other structured settlements with similar terms and payout streams.

b. Structured settlement income streams may be submitted for a credit analysis to the SVO and reported on Schedule BA with an NAIC designation as a "fixed or variable interest rate investment that has the underlying characteristics of a bond, mortgage loans or other fixed income instrument." (These individual structured settlement income streams may not be reported with a CRP rating as filing exempt.)

c. Structured settlement income streams shall be initially reported at cost. This cost generally reflects the net present value of the future payment streams with an embedded fixed-rate yield. As the structured settlement income streams are received, reporting entities shall reduce the book adjusted carrying value to reflect the receipt of the income stream (partial payment on Schedule BA, Part 3) as well as corresponding investment income for the fixed rate spread.

15. In response to the exposure, comments from interested parties' were received stating support for the proposed accounting and reporting guidance. Additionally, the Valuation of Securities (E) Task Force and NAIC Investment Analysis Office (IAO) indicated support for the proposal to establish statutory accounting guidance for structured settlements. The information received from the NAIC IAO identified that purchases of cash streams by assignment of the right to payments due under structured settlements are already filed with, and designated for credit quality, by the SVO.

16. During the 2018 Fall National Meeting, after considering the interested parties' comments and the information from the Task Force and NAIC IAO, the Working Group adopted the exposed revisions to SSAP No. 21, incorporating explicit guidance for the accounting and reporting of structured settlements. As part of the adoption action, the Working Group identified the revisions as a substantive change, and designated a December 31, 2018 effective date for the revisions. With the substantive classification, the Working Group directed NAIC staff to prepare an issue paper for historical documentation. With the effective date in the SSAP, the substantive revisions will be effective prior to the availability of this issue paper.

17. As issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble), the subsequent consideration and adoption of this issue paper will not have any impact of the effective date of the substantive revisions adopted to SSAP No. 21 during the 2018 Fall National Meeting.

EXHIBIT A – Substantive Revisions to SSAP No. 21—Other Admitted Assets.

Note: These substantive revisions to SSAP No. 21 were adopted during the Fall National Meeting with an effective date of Dec. 31, 2018. This issue paper has been prepared strictly for historical documentation. Only paragraphs with noted revisions are captured below. All remaining paragraphs will be renumbered accordingly.

~~Cash Value of~~ Structured Settlements – Reporting Entity Owner and Payee of Annuity

5. The reporting of the present value of structured settlement annuities where the reporting entity is the owner and payee as described in SSAP No. 65, paragraph 17.a. shall account for the annuity an admitted asset at its net present realizable value. The annuity described is reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves.

Structured Settlements – Reporting Entity Acquires Legal Right to Receive Payments

6. A reporting entity that acquires (directly or indirectly) structured settlement payment rights[FN1] through a factoring company, excluding securitizations captured in SSAP No. 43R, shall report the acquisition as follows:

a. Period-certain (non-life contingent) structured settlement income streams shall be reported as other long-term invested assets[FN2], and are admitted assets if the rights to the future payments from a structured settlement has been legally acquired in accordance with all state and federal requirements. If the structured settlement has not met all legal requirements, including the court-approved transfer from the original recipient, then the reporting entity shall recognize the appropriate excise tax obligation and the structured settlement shall be nonadmitted.

b. Life contingent structured settlement income streams shall be reported as other long-term invested assets on Schedule BA and shall be nonadmitted. (Nonadmittance is required regardless if the right to future payments has been legally transferred.)

New Footnote 1: This guidance is specific to acquired structured settlement income streams (legal right to receive future payments from a structured settlement) and does not capture accounting and reporting guidance for the acquisition of any insurance product (e.g., life settlement, annuities, etc.).

New Footnote 2: Reporting entities that hold qualifying structured settlement payment rights shall report the security on Schedule BA either as an "any other class of asset" or as a "fixed or variable interest rate investment with underlying characteristics of other fixed income instruments" if the structured settlement payment right qualifies for reporting within that reporting line (e.g., NAIC designation).

7. Structured settlement income streams shall be initially reported at cost, including brokerage and other related fees. The cost generally reflects the net present value of the future payment streams with an embedded fixed-rate yield. Structured settlements income streams shall always be acquired at a discount, meaning the amount to be received shall be greater than the acquisition cost. As the structured settlement payments are earned, reporting entities shall reduce the book adjusted carrying value (BACV) to reflect the accrual of the income stream (proportionate payment of original cost on Schedule BA, Part 3) as well as corresponding investment income for the fixed rate spread. (For example, if a reporting entity acquires a structured settlement that equates to

three payments, as each payment is received, the BACV would be decreased proportionately, with the pay-down recognized as a disposal.)

a. Impairment—Determination as to the impairment of a structured settlement income stream shall be based on current information and events. When a reporting entity does not expect to receive a structured settlement payment, the structured settlement shall be considered impaired. Once a structured settlement income stream is impaired, the entire amount of the reported structured settlement investment (including subsequent rights to cash flows related to the impaired structured settlement) shall be written off in accordance with *SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*. If the structured settlement payment is not expected to be received due to the credit quality of the issuer (e.g., the insurer / obligor making structured settlement payments), all structured settlement income streams expected from that obligor shall also be deemed impaired and written off in accordance with SSAP No. 5R. (For example, if a reporting entity acquired the rights to receive three structured settlement payments in a single brokerage transaction, when the first payment is not expected to be received, then all three structured settlement payments related to this acquisition shall be written off. If the reason for the impairment is due to the obligor, and the reporting entity had acquired other structured settlement income streams that are due from that obligor, all structured settlement income streams due from that obligor shall also be written off as impaired.)

b. Investment Income – The discount on acquired structured settlements shall be recognized as an adjustment of yield over the period of time until the cash payments under the structured settlements are received to produce a constant effective yield each year.

Effective Date and Transition

22~~20~~. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors.* The guidance for structured settlements when the reporting entity acquires the legal right to receive payments is effective December 31, 2018.

