Office of the Superintendent of Financial Institutions Canada | Bureau du surintendant des institutions financières Canada

Guideline

Subject: **Accounting for Structured Settlements**

Category: **Accounting**

No: **D-5** **Date:** **April 1998**
Revised: **October 2006**

Introduction

This guideline addresses the accounting and reporting by a property and casualty insurance enterprise (P&C insurer) of an annuity when purchased for a structured settlement contract and of the associated financial liability. The main issues relate to whether the P&C insurer (a) continues to recognize a financial liability to a claimant and (b) recognizes a financial asset as a result of purchasing the annuity. The guideline also provides guidance with respect to the application of the presentation and disclosure standards in Section 3861 of the CICA Handbook to structured settlements.

The Canadian Council of Insurance Regulators (CCIR) currently provides direction for the reporting of structured settlements in Section IV of its Annual Return Instructions. This guideline provides guidance to P&C insurers in applying that direction within the context of these new accounting rules.

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Definition of a structured settlement:

The term "structured settlement" as used by a P&C insurer refers to a contractual arrangement whereby a third party makes periodic payments to a claimant of the P&C insurer. The periodic payments are normally funded through purchase by the P&C insurer of an annuity from a life insurance enterprise and are usually arranged so that the payments are tax free in the hands of the claimant. Structured settlements have been used to pay claimants pursuant to both tort actions and no-fault claims.

There are essentially two types of structured settlements. They are defined as follows:

Type 1:

Type 1 structured settlements have the following characteristics:

a) An annuity is purchased by a P&C insurer who is named as the owner. There is an irrevocable direction from the P&C insurer to the annuity underwriter to make all payments directly to the claimant.
b) Since the annuity is non-commutable, non-assignable and non-transferable, the P&C insurer is not entitled to any annuity payments and there are no rights under the contractual arrangement that would provide any current or future benefit to the P&C insurer.
c) The P&C insurer is released by the claimant to evidence settlement of the claim amount.
d) The P&C insurer remains liable to make payments to the claimant in the event and to the extent the annuity underwriter fails to make payments under the terms and conditions of the annuity and the irrevocable direction given.

Type 2:

Type 2 structured settlements differ from Type 1 in that:

a) The annuity is commutable or assignable or transferable, that is, there is some form of reversionary interest or continuing right to a benefit for the P&C insurer.
b) A legal release is not necessarily obtained from the claimant.

The commutation rights of the P&C insurer have the potential for terminating the claimant's right to future payments in advance of the annuity being exhausted.

The extent of the rights held by the P&C insurer sometimes indicates the P&C insurer has contracted with the annuity underwriter to provide only administrative services with respect to the periodic payments.

Type 2 structured settlements have typically been arranged to pay no-fault benefits, such as weekly disability payments. Descriptions used in the market place include "pure no-fault annuities" and "reinsurance annuities." However, the terminology "reinsurance" does not appropriately convey the nature of the contractual arrangement.

Financial reporting implications

Type 1: Derecognition of financial liability and annuity

Under a Type 1 structured settlement arrangement, a P&C insurer should not continue to recognize an insurance liability to the claimant once the P&C insurer purchases a non-commutable, non-assignable and non-transferable annuity to settle the liability and obtains a release from its direct (primary) obligation to the claimant. The irrevocable direction of the annuity cash flows to the claimant and the legal release extinguish the liability.

Accordingly, the P&C insurer should not recognize the annuity as a financial asset. The P&C insurer who is the named annuitant has no rights to any of the benefits from the annuity since these rights including the cash flows have been irrevocably transferred or assigned to the claimant. The release and irrevocable direction counters and negates any argument based on the legal ownership of the annuity.

The P&C insurer, however, assumes a financial guarantee obligation of the annuity underwriter in the event of any default or other failure of the annuity underwriter to make contracted payments to the claimant. It is therefore secondarily liable to the claimant for the annuity payments.

Any gain or loss should be recorded in income as an adjustment of incurred claims expense.

The P&C insurer also should not recognize a financial asset at time of purchase where the terms of the annuity make it commutable in the event the liability to the claimant becomes fully settled or otherwise discharged, e.g., the claimant dies and the annuity residual reverts to the P&C insurer. In these circumstances, a gain could subsequently arise to the extent there is residual value after the liability is fully settled. However, at the time of purchasing the annuity, no value should be ascribed to the contingent gain in its note disclosure since the annuity presumably would have been appropriately underwritten and priced.

Paragraph 16 of FASB Statement No. 140 supports derecognition of the insurance claim liability.

Type 2: Recognition of financial liability and annuity

Under a Type 2 structured settlement arrangement, the financial liability balance should continue to be recognized on the balance sheet. The financial liability of the P&C insurer to the claimant has not been extinguished legally or in substance since the annuity is commutable or assignable or transferable. Furthermore, a legal release from being the primary obligor is not necessarily obtained from the claimant. There is no irrevocable direction, as exists in Type 1, given by the P&C insurer to the annuity underwriter to make all payments directly to the claimant.

The structured settlement is effectively a temporary arrangement with the annuity underwriter to conduct administrative services on behalf of the P&C insurer.

Correspondingly, the P&C insurer should recognize the annuity as a financial asset on its balance sheet since it retains the right to commute, assign or transfer the benefits of the structure. The insurer has not surrendered control of the benefits since there is a reversionary interest or continuing right to a benefit from the annuity.

The annuity should be carried initially at its cost to the P&C insurer and the liability balance should be measured in the same manner as other outstanding claim liabilities of similar type.

The asset and liability balances should not be offset since these balances do not meet the offsetting standards in paragraph 3861.27(a) in the Handbook that require the existence of a legally enforceable right to set off the recognized balances.

The treatment accorded to the annuity asset is similar to that of a reinsurance recoverable. For the Minimum Asset and Deposit Adequacy Tests, annuities purchased from licensed Canadian life insurers will be considered as assets available for test purposes. However, in the case of foreign P&C insurers, these assets will need to be vested to be considered as assets available for test purposes.

Disclosure

Type 1: Financial guarantee representing an unrecognized financial liability

Under a Type 1 structured settlement, the claimant's recourse to the P&C insurer represents a guarantee of the annuity underwriter's obligation to make payments to the claimant pursuant to the terms and conditions of the structured settlement. Guaranteeing the obligation of another party exposes the P&C insurer to credit risk.

The P&C insurer should disclose in the notes to the financial statements the terms and conditions, the credit risk and the fair value of this financial guarantee (unrecognized financial liability). The disclosure should be based on the requirements of paragraphs 43, 58 and 69-70 of Handbook Section 3861.

Type 1: Contingent gain

The existence of a contingent gain in the case of a Type 1 structured settlement that is commutable should be assessed for disclosure in the notes. With respect to the amount, the disclosure should be based on the requirements of paragraph 3290.22(b) of the Handbook. The nature, terms and conditions of the contingent gain should be disclosed based on the standards set out in Handbook paragraphs 3290.22(a) and 3861.43.

Type 2: Annuities recognized on balance sheet as assets

In the case of Type 2 structured settlements, there should be disclosure in the notes relating to the terms and conditions, credit risk and fair value of the annuities that are recognized as financial assets on the balance sheet. This disclosure should be based on the requirements of paragraphs 43, 58 and 69-70 of Handbook Section 3861.

Transitional provisions

All federally regulated P&C insurers should apply the provisions in this guideline for fiscal periods commencing on or after January 1, 1998 if they have not already done so for earlier fiscal periods. The standards outlined in Section 1506 of the Handbook, *Accounting Changes*, with respect to a change in accounting policy should be followed.

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