

Structured Settlement Annuities

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This report was prepared for use in the educational curriculum of the Society of Actuaries. It describes the main features of structured settlement annuities in North America and current actuarial practices and issues related to this product. It draws upon a study note on the same topic authored by Roger Harbin, FSA in 1991. Perspective on the Canadian structured settlement market was provided by Robert (Bob) Nigol, B.A., M.A., Managing Partner of EPS Settlements Group of Canada.

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Section 1: Overview of Structured Settlements

A structured settlement annuity is a contract that provides periodic benefits to a plaintiff, stemming from tort settlements of various types of claims. These annuities are used to settle personal injury or wrongful death claims arising from accidents, medical malpractice, workers' compensation cases, and other causes. Structured settlements take their name from the fact that the payment streams are frequently customized to fit the circumstances of the injured party and/or the injured party's dependents. For example, they can provide regular income streams to meet ongoing medical or care needs to egregiously injured plaintiffs, or deferred payments over four years to provide college education funding for minors in wrongful death claims where a parent's life was lost. These contracts are financed through a single premium amount funded by the defendant or their insurance company. The benefit payments that the plaintiff receives under a structured settlement are not subject to personal income taxation.

Structured settlements have received increased recognition over time for the advantages they present to both plaintiffs and defendants, as well as constituting good public policy. Periodic and deferred payments have been encouraged and even mandated in some states as a means of controlling costs under malpractice claims and ensuring that the monies would be available in future years and not squandered as could happen with lump sum payments. In addition, such payment arrangements can relieve the plaintiff from the need to invest and manage the proceeds of a large settlement. For these reasons, structured settlements are credited with reducing encumbrances on government benefit programs and are generally viewed very positively by policymakers.

Structured settlements are often the result of a pre-trial settlement. They also may come about during the appeals process, when an initial court verdict is being challenged. In some instances, especially in cases involving minors, structured settlements are imposed by statute or by judicial authority.

Structured settlement annuities are marketed through a very specialized field force. Consultants for the firms that specialize in this field help negotiate tort settlements and work with insurance companies to provide the annuities that fund such settlements. These consultants normally work closely with the defendants or their insurers and are compensated only through commissions earned on the sale of the annuity contracts.

A structured settlement arrangement has been consummated when the defendant (or their casualty insurer) agrees to pay the plaintiff/annuitant a stream of specified benefit payments in return for releasing the defendant from the tort claim. In order to fund the benefit stream, the defendant purchases an annuity contract from a life insurer. Many times, the arrangement will then include what is known as a "qualified assignment", where the defendant (or their casualty insurer) transfers the liability for the future payments to a third party, the "assignee." The assignee company will then own the right to the annuity payments, together with the obligation to make the specified benefits payments to the plaintiff/annuitant. The assignee company is often a subsidiary of the life insurer providing the structured settlement annuity. Assignments of this nature allow the defendant (or casualty insurer) to close their books on the settled claim.

Note that the discussion here on the structured settlement market and practices is primarily focused on the United States. Any reference to Canadian practices is specifically noted, and primarily occurs at the end of the paper in the [Other Considerations](#) section.

1.1 HISTORY OF STRUCTURED SETTLEMENTS

The earliest recorded use of structured settlements is believed to have occurred in Canada in the 1960's. The drug Thalidomide was associated with birth defects, and when the drug's manufacturer exhausted its insurance coverage, it started to settle cases through agreements to make lifetime payments rather than through one-time lump sum settlements. In the United States, uncertainty over the tax treatment of the payments limited the market until the Internal Revenue Service issued a favorable revenue ruling in 1979. In the [Other Considerations](#) section below, more information is provided on the taxation of structured settlements.

The structured settlement market has grown considerably since those early days. Courts have increasingly realized the societal good provided by settlements that provide money over time to best match a plaintiff's ongoing needs. Judges have become more active in encouraging or in some cases requiring the use of periodic payment settlement in lieu of one-time lump sums.

1.2 FORMS OF BENEFIT PAYMENTS UNDER A STRUCTURED SETTLEMENT

There are several different modes of benefit payment that are used to provide the desired flexibility when structuring the settlement of a personal injury claim.

Annuity Certain: a stream of specified benefit payments made at periodic intervals over a predetermined number of years. These payments are not dependent on the survival of the annuitant and will be made to the annuitant's estate or named beneficiary if the annuitant should die prior to the end of the certain period.

Single Life Annuity: a stream of specified benefit payments made at periodic intervals over the duration of an annuitant's lifetime.

Temporary Life Annuity: a stream of specified benefit payments made at periodic intervals only if the annuitant is alive, with such payment stream having a specified end date.

Lump Sum: a single payment made at a specified future date, can be either life contingent, which means that it is only paid if the annuitant is alive on the future date, or certain. Many times, the settlement may call for a series of lump sums, such as payments to be made every five years for a certain period of time.

While the annuity types above are not typically indexed to cover actual emerging inflation, they may be specified to increase at a fixed rate (such as 2% or 3%) annually as a way of providing coverage for future inflation.

Additionally, it is common for a single life annuity to have a certain period attached to it. As an example, a single life annuity with a 10-year certain period would guarantee payments for the first 10 years, and benefit payments after that time would be dependent on the annuitant's continued survival.

Section 2: Pricing Considerations

The pricing framework for a Structured Settlement Annuity must take into account multiple considerations. There are several significant assumptions that are needed, such as interest rates, mortality, and expenses. The framework must take into account reserve levels and required capital, which will likely result in a phenomenon known as surplus strain, along with profitability targets. Finally, the insurer's practice around the communication of rate changes and guarantee periods to the specialized consultants who operate in this market is an important consideration.

2.1 MORTALITY

Mortality assumptions will be necessary to generate the expected benefit cash flows whenever there are life contingent payments. As discussed earlier, life contingent cash flows can take the form of a life annuity, a temporary life annuity, or life contingent lump sums.

Developing appropriate mortality assumptions can be a real challenge for structured settlements. The annuitant population tends to be dramatically different than that for any insured population, including annuities intended to fund retirement income. Structured settlement annuitants tend to be much younger when the annuities are issued. Since the annuities are used to fund a tort settlement, there isn't the type of longevity-related anti-selection that exists with other life annuities. Structured settlements are a niche market, making it unlikely that any single company will have sufficient credibility based on their own experience. The Society of Actuaries (SOA) conducts industry mortality studies which most companies find helpful in complementing their own emerging experience.

If the plaintiff/annuitant has significant injuries or a medical condition which will result in a reduced life expectancy, underwriting will be necessary. When underwriting annuities, the age used to determine the purchase price is adjusted. This will likely result in an age “rate-up” to reflect the biological or physiological age of the plaintiff at the time of underwriting, as compared to their chronological age. Unlike life insurance, such a substandard designation will be favorable in the pricing of life contingent payments, as the impairment will reduce the expected cash flows. The substandard structured settlement will then be priced based on the rated age instead of the annuitant’s actual age. While this method may lack precision, it is a widely used simplification that is convenient in communicating with the specialized consultants and other participants involved in arranging structured settlements.

Substandard underwriting is a complicated area for companies in this market. Many companies use their life underwriters to assign the rated age. However, the type of impairments that they need to rate for structured settlement cases present a very different profile than those typically experienced with life insurance applicants. By the nature of the causes of the tort actions that lead to structured settlements, many of the annuitants being underwritten have experienced physical trauma such as brain injuries and spinal cord injuries. The more traditional life underwriting issues of obesity, cardiovascular disease, diabetes, and so on make up a very small percentage of structured settlement cases being underwritten. Often the underwriters will look to determine a future life expectancy for the impacted annuitant, and then translate that into a rated age.

The pricing actuary must also consider, however, that even if the underwriter has successfully assessed the remaining life expectancy of the substandard annuitant, the mortality curve will likely be different than that for an average person whose chronological age is the same as the annuitant’s rated age. For example, a 20-year-old who receives a 30-year age rate-up will be rated age 50 at issue. If such person is still alive in 40 years, at their chronological age of 60 at that point they will likely have much lower mortality going forward than someone who is actually 90 years old.

The mortality considerations above help establish the base mortality assumption, but don’t account for expected mortality improvement over time. For structured settlement annuities, it is common practice to use a one-dimensional mortality improvement scale (i.e. only differs by age and gender, not year of issue cohort). Many companies use an existing industry improvement scale, such as G2, perhaps with some adjustments that reflect their individual views of future mortality improvement.

2.2 INTEREST RATES

A crucial step in pricing structured settlements is developing a discount curve to calculate a net present value of the projected benefit cash flows. The interest rates used in the discount curve are based on the yields a company can attain on newly purchased assets. In order to construct such a curve, company actuaries must work closely with portfolio managers to determine appropriate asset types.

The benefit payments under a structured settlement are fixed and determinable, with the only uncertainty being variation in actual mortality compared to expected for life contingent payments. For this reason, companies can safely invest in less liquid asset types, such as private placements and mortgage loans. These asset types are only typically available for short and intermediate maturities. Publicly traded fixed income securities, such as Treasuries and corporate bonds, are commonly available for up to 30 years.

Companies can choose to invest a certain portion of their portfolio in “high yield” bonds, generally referring to bonds of credit qualities rated BB and below. However, investing in lower grade bonds will result in a higher margin necessary for the risk of default, and will also increase the required capital the company must hold. Nevertheless, a prudent allocation to lower quality assets may prove advantageous in pricing.

Structured settlements are known as “long-tail” liabilities, meaning that the benefit stream can extend over a very long timeframe. Take the example of a life annuity on a 20-year-old, where some level of expected benefit payment

will be due for more than 60 years. The investment horizon extends for only around 30 years, so there will be substantial liability cash flows due beyond that period. For this reason, it will be necessary to make an interest rate assumption to discount liability payments beyond 30 years. This inability to match all the projected cash flows creates “reinvestment risk”. There are various strategies that companies can use in an attempt to match the long duration of structured settlement benefit cash flows, including investing in derivative instruments like futures and swaps. These reinvestment risk mitigating strategies will be discussed further in the [Risk Considerations](#) section below.

A gross yield curve results from the above process, reflecting different yields available at different maturities based on a company’s investment strategy. Margins will then need to be deducted from those gross yields to reflect asset-related items such as investment-related expenses and expected defaults. Liability-related margins can be used to factor in expenses, but there are also other ways to provide for expense coverage in pricing (see below). Finally, an additional margin is deducted from the gross yield to provide for a target level of profitability.

2.3 EXPENSES AND PREMIUM TAXES

The expenses that the insurer incurs when initiating and maintaining the structured settlement annuity will need to be incorporated into the pricing. Also, as is the case with all product lines, the expense structure will need to factor in a portion of the writing company’s overhead. Expenses can be covered in pricing in several ways. It may seem like a best practice to attempt to do so in a manner that can accurately reflect the dynamics of the various expense types, but this must be balanced with practical considerations involving the marketplace.

The costs associated with the commissions and any other acquisition expenses that vary by premium amount can be covered by adding a fixed percentage to the net premium (the premium prior to the addition of such a factor). Since part of the initial set up expense is administrative and likely does not vary by the size of the annuity, this can be covered by adding a fixed dollar per contract fee to the annuity. While a fixed dollar amount may better reflect the economies of scale that exist with larger annuities, the downside is that they will result in pricing that isn’t proportional, which may be an undesirable complexity when settlement arrangements are being negotiated. Ongoing maintenance and overhead expenses can be covered by adding a fixed percentage to the benefit payments, or through an interest rate margin.

A handful of states levy a premium tax on non-qualified annuities. If an annuity contract covers a risk in one of those states, premium taxes may be due, and an insurer would want to factor that into their pricing.

2.4 POST-TAX RETURN ON INVESTED SURPLUS

An insurer who writes structured settlement annuities is likely to incur statutory surplus strain whenever they issue new business. The statutory reserving methodology, discussed in the [Reserving / Valuation Methodology](#) section below, includes inherent conservatism designed to assure solvency. In addition, there is an amount of required capital that also must be held to support the insurer’s book of business. This conservatism in reserving together with the capital requirements will tie up funds the insurance company won’t be able to use elsewhere until they are released over time. When modeling a target level of profitability for their structured settlement business, the actuary would be prudent to factor in the level of excess reserves and capital into their internal rate of return calculation. Federal and any applicable state income taxes should also be accounted for in the profit targets.

2.5 ADMINISTRATION OF PRICING AND RATE CHANGES

Most insurers provide pricing software to structured settlement consultants that can be easily updated when interest rates change. A common administrative practice in the industry is for a company to guarantee that any set of newly established prices will be good for a certain amount of time. This usually includes a period of overlap, where the current rate basis will be honored by the company for a period of time following a pricing update. This type of concession is necessary to accommodate the settlement negotiation process but poses risks to insurers

during falling interest rate environments. Companies usually attempt to price for this “ratebook guarantee” risk by holding an additional interest rate margin.

Section 3: Risk Considerations

The primary actuarial risks associated with Structured Settlement Annuities are mortality and interest rate risk.

3.1 MORTALITY RISK

As mentioned above, mortality assumptions even for standard cases (i.e., no age rate-up) can be challenging due to limited experience in this niche market. While companies can look to use industry experience produced by the SOA, even that poses challenges. The SOA tends to look at much longer experience periods (as compared to other product lines) to compensate for the limited amount of annual experience, which introduces another source of noise. Because the industry experience can be very sparse at certain age and gender combinations, there is not really an expected basis to weight with the experience either if using credibility theory.

Substandard mortality poses even greater risks than standard business. The challenges that life underwriters face in assessing the impairments common in the structured settlement market were noted above. An additional challenge is the delay that will occur before an assessment of mortality outcomes can be achieved. Unlike life insurance, where the anti-selection occurs mostly in early durations and the effect of underwriting wears off quickly over time, many of the impairments with substandard structured settlements may not result in an immediate elevation of mortality.

The SOA also includes substandard annuities in its industry mortality studies. While they should be helpful in assessing substandard mortality overall, one must keep in mind that different companies have different underwriting standards. Also, even within one company, it is very possible that underwriting standards have changed over time. Upon close inspection, the substandard experience is much more granular than standard cases since each rated age presents a combination of actual age plus rate-up. Additionally, the experience covers a wide range of different impairments.

The workings of the structured settlement marketplace also pose risk for writers of these annuities. The market is very competitive, underwriting is far from an exact science, and brokers will place substandard annuities with the most aggressive rated ages in most cases. Underwriters must remain disciplined, or risk “selling their mistakes”.

Additionally, recall that the base mortality assumption is representative of current levels of mortality. Mortality improvement assumptions play a crucial role in pricing, especially given the long duration of the benefit cash flows. Mortality improvement in the United States population has varied significantly over time and remains a very subjective assumption. Since the ages of structured settlement annuitants tend to be much younger than purchasers of annuities used to provide retirement income, the risk of outsized mortality improvement is much more material.

Mortality improvement assumptions also get applied when projecting the expected mortality on substandard lives. Here, there is the additional risk that certain impairments may be cured someday, such as spinal cord injuries. Even something as basic as improvements in feeding tube technology can have a significant impact on future mortality. While any enhancements in treatment or cures for such conditions will be a great thing for humanity, they can also result in substantially underpriced annuities if substandard risks start living as long as their brethren who share a similar chronological age.

3.2 INTEREST RATE AND ASSET / LIABILITY MISMATCH RISK

As mentioned above, the long-tail nature of structured settlements can lead to significant reinvestment risk. Usually for fixed payout annuities, insurers will look to cash flow match asset and liability flows. However, if they attempt

that strategy for their structured settlement business over the entire 30 year or so investment horizon, they will be left with substantial reinvestment risk for the liabilities coming due after 30 years. For this reason, many insurers will cash flow match for a limited number of years, and then duration match their liabilities in total. They may use derivative securities, such as futures and swaps, or long maturity zero-coupon bonds, to help extend their asset duration. Some companies have even used equities to back their long-tail liabilities, since average returns over such a long period can be reasonably expected to exceed returns on fixed income securities. However, investing in equities will subject a company to higher capital requirements.

Insurers which back structured settlements with assets that have prepayment risk, such as callable bonds and mortgage-backed-securities, need to be aware of the additional reinvestment risk that such optionality poses on their portfolio returns.

An additional element of interest rate risk involves the administrative practices involving pricing changes. “Ratebook guarantee” risk exists due to the way pricing is updated in the face of changing interest rate markets, as described in the [pricing](#) section. Companies risk getting inundated with less profitable business when interest rates fall and defendants and their consultants rush to close cases to take advantage of the lower prices. A mitigation strategy that companies often use is to impose dollar limits on their published rates, and individually price cases over a \$1 million (for example) with much shorter rate guarantee periods. This custom treatment also allows a company to better reflect economies of scale in the pricing of larger cases.

3.3 CREDIT RISK

This risk is not in any way unique to structured settlement annuities, so it won’t be covered in detail here. Suffice it to say that there is a trade-off between higher yields and credit quality, and a company that buys a higher percentage of lower rated bonds will be more impacted by economic cycles.

3.4 IMPACT OF BENEFIT ESCALATORS ON RISK

It was mentioned above that some of the annuity types available with structured settlements include benefits that increase at a fixed annual percentage, such as 2% or 3% per year. While these percentage escalators don’t present a new risk per se, they serve to magnify the existing mortality and interest rate risks under a structured settlement annuity. For instance, the mortality risk with payments of a level amount is mitigated to a certain degree by the discounting, which translates into lower present value for longer duration payments that extend beyond the annuitant’s life expectancy. However, when a percentage escalator is built into the benefit, the increasing benefit payments may partially or fully offset the discounting function. Additionally, if the increasing benefit payments are due beyond the investment horizon, such an escalator can compound the degree of reinvestment risk.

3.5 RISK-BASED CAPITAL

There is an existing risk-based capital (RBC) framework in place which determines the amount of statutory capital a company must hold to support their structured settlement business. As for other insurance liabilities, the framework consists of the four “C” risks, C-1 (Asset Risk), C-2 (Insurance Risk), C-3 (Interest Rate Risk), and C-4 (Business Risk). A full discussion of this statutory capital framework is beyond the scope of this paper.

Section 4: Reserving / Valuation Methodology

Both Statutory and GAAP financial statements are produced by most companies for their structured settlement product line. Statutory accounting is required by state regulators, and since one of its purposes is to assess solvency, it tends to have some conservative elements. GAAP accounting is more on a “best estimate” basis, meaning that it generally does not include margins for conservatism, and it is a required framework for publicly traded insurers. Many mutual insurers will also look to produce GAAP-like financial statements to better assess the financial performance of their various product lines.

4.1 STATUTORY RESERVING

The statutory reserving rules for structured settlements generally follow the methodology used for payout annuities but have some unique aspects that reflect the nuances of the structured settlement product line. Since payments under a structured settlement are guaranteed, the reserve is the present value of the income payments based on an appropriate annuity mortality table and the valuation rate of interest in accordance with the Standard Valuation Law, as will be explained in further detail below. VM-22 prescribes a maximum discount rate for all payout annuities (including structured settlements) issued in 2018 and later. VM-22 may be modified in the future to reflect a principles-based reserving approach, using the average of the results from the worst 30% of scenarios based on company specific assumptions.

Actuarial Guideline IX-A provides the ground rules for establishing reserves for substandard cases. It establishes what is known as the “constant extra death” methodology, where a number of extra deaths per thousand is added at each duration so that the resulting life expectancy matches that assigned during the underwriting process. Because the number of extra deaths is constant, and it is being added to an increasing number of expected deaths with advancing age, the effect is to grade reserves to a standard basis by the end of the valuation table. This seems appropriate, because over time a cohort of substandard lives will gradually become more like a standard one as the most severely impaired die and the more robust lives continue to survive. However, experience suggests that Guideline IX-A produces mortality rates that are too high in early durations with significantly higher margins in later durations.

The valuation rate of interest is based on the issue year method and a guarantee duration based on the number of years from the date of issue to the date the first payment begins, similar to other payout annuities. Actuarial Guideline IX-B provides clarification on the use of the various durational interest rates with regard to projected structured settlement benefit streams. A company can aggregate the expected cash flows for each one-year block of business, and all benefit amounts due each year that do not exceed the prior year by 10% can be considered a single series of benefits for purposes of assigning a durational based interest rate. Amounts in excess of 10% more than the prior year must be valued as though they were lump sum payments due in that year, based on the associated durational interest rate.

Structured settlements are subject to regulatory cash flow testing (i.e., Asset Adequacy Testing), and the testing outcomes may result in a company having to increase reserves over what is required by base statutory valuation.

4.2 GAAP RESERVING

GAAP accounting for structured settlements is similar to the methodology used for other payout annuities, with the exception that most companies use the rated age assigned for pricing purposes to project mortality for substandard annuities.

Section 5: Other Considerations

5.1 TAXATION

Structured settlements are not subject to personal income taxes in compliance with Internal Revenue Code (IRC) Section 104(a)(2) and Revenue Ruling 79-220. While lump sum awards under personal injury lawsuits would similarly not be subject to taxation, any subsequent interest earned would be subject to income taxation. IRC Section 130 allows for the qualified assignment of structures involving physical injuries to a third party.

5.2 ATTORNEYS' FEES

Sometimes attorneys representing plaintiffs in structured settlement actions may ask for their fees to be in the form of an annuity, which is perfectly acceptable in the United States. A couple of important points to note here. First,

insurance companies would usually use pricing consistent with their typical retirement annuities since attorneys requesting lifetime incomes would typically be more aligned with that demographic. Next, because these annuities are not structured settlements, they are not covered by IRC 104(a)(2) and would not receive tax free treatment.

5.3 FACTORING

In the United States, factoring has become increasingly popular. It was mentioned earlier that while the future benefit payments available under structured settlement annuities allow the annuity to be structured to meet the ongoing needs of the plaintiff/annuitant, there is no flexibility once a deal is finalized. The plaintiff/annuitants have no ability to accelerate payments under an established settlement. Sometimes, previously unanticipated liquidity needs arise for a plaintiff. Factoring companies can provide this liquidity by exchanging the rights to either a portion or the whole of the future settlement benefits in return for an immediate payment. Factoring is somewhat controversial, as such liquidity can come at a steep cost. Factoring companies typically use relatively high interest rates to discount the future payments, invoking a fear that many annuitants don't have a full appreciation for the time value of money.

5.4 INFLATION CONSIDERATIONS


A potential disadvantage of structured settlements is that the annuity benefits are generally fixed at issue and the future benefit payments could lose purchasing power due to inflation. There are a few product variations that could directly or indirectly address inflation concerns. Most popular are the benefit payments that increase at a stipulated rate, already discussed above. Some life insurers offer benefits that vary based on inflation indices, such as the Consumer Price Index. Additionally, a variable product known as the "Market Indexed" structured settlement calls for benefit payments that are indexed to equity market performance, such as the S&P 500. This product offers the certainty of a floor and the upside benefit of increased income based on market performance, and the possibility of an increasing stream of payments provides the annuitant with a degree of inflation protection.

5.5 CANADIAN MARKET

This paper has thus far focused on the United States market. Structured settlements are also popular in Canada, where they have similar favorable tax treatment through the Canada Revenue Agency.

There are a few notable differences between the US and Canadian markets:


- Even though the Canada Revenue Agency allows for qualified assignments, less than 50% of structured settlement contracts get assigned to third parties. In the United States, close to 100% of contracts use assignment arrangements.
- Canada has a less crowded marketplace, as only two or three insurers dominate the structured settlement annuity market.
- The plaintiff's right to receive payments is non-transferrable, which eliminates the possibility of factoring arrangements.



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