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Evaluating U.S. Surplus Notes

Surplus notes, also referred as surplus debentures, contributed certificates or capital notes, are unsecured indentures that may be issued directly by insurance operating companies domiciled in the United States. Surplus notes are closely regulated and deeply subordinated to policyholder claims, and therefore are reported as part of policyholders' surplus despite their debt-like features.

The authority to issue surplus notes and make interest payments is generally part of state insurance statutes or regulations. Although surplus notes' legal characteristics vary slightly from state to state, most state regulation provides that such capital instruments be reported as policyholders' surplus and not debt only if the surplus note is subordinate to policyholders' claims, other claimants and all other classes of creditors other than surplus note holders in the event of liquidation. In addition, interest payments and principal repayments require prior regulatory approval in the insurer's state of domicile. Generally, U.S. statutory accounting principles (SAP) allow insurers' investments in surplus notes to be treated as admitted assets, with their value determined by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC). They also are part of an insurer's total adjusted capital under risk-based capital ratio calculations.

Given the historical context of surplus notes and their unique place in an insurance company's capital structure, this criteria procedure highlights:

I. Considerations in determining the equity and debt characteristics of surplus notes issued by insurance companies;

II. Treatment afforded to surplus notes in Best's Capital Adequacy Ratio (BCAR);

III. Treatment of surplus notes in A.M. Best's financial leverage calculations; and

IV. A.M. Best's approach to rating surplus notes issued by insurance companies.

I. Considerations

Surplus Notes Features

The starting point in the process is to evaluate the specific terms and conditions of the surplus notes. This entails comparing the surplus note features to the characteristics of pure equity and debt instruments. The features and provisions evaluated include but are not limited to the following (See **Exhibit 1**):

- Term – Maturities/scheduled maturities
- Call provisions
- Subordination
- Step-up rates
- Deferral features – Optional/mandatory payment of interest or principal
- Cumulative/non-cumulative coupon payments
- Replacement language
- Alternative payment mechanism
- Conversion feature
- Default event language

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- Other investor/creditor covenants

A.M. Best will review the above features of the surplus notes in a collective way to assess the equity content of the issue. This is dictated by:

- Permanency of capital – is the note available to pay losses when needed?

- Ability to defer interest or dividend payment – are payments deferrable when a company is in distress?

- Subordination in an issuer's capital structure, i.e., loss protection provided to policyholders and other creditors.

Surplus notes that A.M. Best typically views as equity-like based on characteristics are:

- Long term, typically with a remaining maturity of more than 10 years;

- Subordinate to policyholders, claimants, beneficiary claims and other classes of creditors, other than surplus note holders; and

- Subject to regulatory approval of interest payments and principal repayments.

Regulatory View

A.M. Best recognizes the regulatory view and environment of the issuer's domicile as part of the assessment of the equity content of the surplus notes. A.M. Best will take into account: a) whether regulatory approval is sought before the issuance of the surplus notes; b) the amount of surplus notes allowed as policyholders' surplus by the regulator; c) provisions for regulatory approval of interest and principal payments; and d) provisions for regulatory approval to redeem and replace surplus notes. A.M. Best takes a positive view where the above items are reflected in state insurance statutes of the issuer's domicile. Also viewed positively is a history of regulatory actions during a period of an insurance company stress/default, where the surplus notes performed the role of equity capital with respect to priority of claims during liquidation, and served as a form of loss-absorbing capital.

Management Intent

A.M. Best will examine both management intent and the intended use of funds in evaluating surplus notes. It should be management's intent that the surplus notes will be part of the company's long-term capital to be used to satisfy policyholder claims and other senior claims during a stress period, and that the surplus note holder may be subject to potential loss. A.M. Best will look more favorably at surplus notes issued as part of available capital by a new company with a clean balance sheet – a start-up with no business activity – or by an active company to fund profitable business while maintaining conservative underwriting leverage, as opposed to a troubled company using the proceeds of surplus notes to repair an unprofitable book of business. The rationale for this is that although capital has improved in the short run, the inherent defects in the book of business, if unaddressed, plus the added interest obligation, could create further problems for the troubled insurer.

Financial Guarantors

Surplus notes have been issued by new and active financial guaranty insurance companies, making the ratio of outstanding surplus notes to policyholders' surplus higher than

Exhibit 1

Surplus Notes Features

Feature	Description	Comments
Term	The remaining time to maturity or scheduled maturity period of the issue.	Notes with remaining time to maturity of 10 years or more, and notes with no stated maturity create more financial flexibility with minimal refinancing risk. Thus they act more like equity capital.
Call Provisions	The option but not the obligation to redeem the outstanding note balance by the issuer at some point in time.	Call provisions with call periods five years or more after issuance may provide financial flexibility depending on the issuer's financial position and the financial environment. Issues with longer call periods provide more equity characteristics compared with those having shorter call periods after issuance.
Subordination	Determines the payment priority of the notes. Generally payment of principal and interest is subordinate and junior to policyholder claims, other beneficial claims and other issuer's liability at liquidation.	Subordination of notes to policyholder claims and other senior creditors, and interest and principal payments subject to regulatory approval, make the notes loss absorbing during liquidation. Note holders then are subjected to losses like equity holders before policyholders and other senior creditors.
Step-up	The number of basis points that the security coupon increases over the initial credit spread if the note is not called at a predetermined date, usually the first call date.	Step-up rates usually are capped at a level with regulatory approval. The step-up provision by itself generally will not impact the equity-like nature of the notes. Step-up provisions subject to regulatory approval and not legally binding may allow for some financial flexibility.
Deferral – Optional/ Mandatory	May be optional, which gives the issuer the option to defer interest payments on the notes, or mandatory where certain triggers will force deferral of interest payments or distributions.	The option to defer interest and principal payments, subject to regulatory approval, without triggering a default provides flexibility for the issuer. Mandatory deferral of interest payments and principal does not necessarily impact the equity-like characteristics, especially in cases where the issuer is in financial distress and has to maintain some form of minimum regulatory capital.
Cumulative/ Non-cumulative	*Cumulative:* Arrangements where coupon payments that have been accumulated can be paid at a later date. *Non-cumulative:* Arrangements where skipped coupon payments are canceled and not paid.	Non-cumulative provisions are more equity like compared with cumulative provisions. Cumulative notes based on the issuer's discretion and subject to regulatory approval provide issuers with flexibility and the ability for long-term planning.
Replacement Language	Generally describes how the note will be replaced at the call date. A more binding replacement language is the use of a replacement capital covenant by which the issuer is legally obligated to replace the notes with similar equity-like features to the benefit of senior creditors.	New instruments replacing the original issued notes should maintain the same equity characteristics as the replaced notes in terms of being permanent capital and being subordinated to policyholders' claims, other beneficial claims and other senior debt. The dollar amount of the replacement instrument should equal that of the initial outstanding notes.
Alternative Payment Mechanism	Specifies how the issuer will settle omitted coupon payments – generally through the market issuance of securities (common stock, preferred shares, etc.).	Generally, alternative payment mechanisms may be positive, negative or neutral, depending on the new security type; time period; issuer's ability to control the issue date; and impact on default of the original issue.
Conversion	Specifies how the note will be converted to some form of equity, generally at a premium. This is generally at the option of the note holder. If converted to common stock, it increases the equity amount in the issuer's capital structure. Conversion may be optional or mandatory.	Notes with the option to convert into common stock at some future time simply become the equity of the issuer, and thus increase the equity amount in the capital structure. This may be viewed as a positive factor.
Default Event Language	Determines what constitute the occurrence of a default event, the issuer's obligations, and note holders' remedies during and after a default event.	Generally default event language, which covers interest and principal payments and is subject to regulatory oversight and force majeure situations, may provide some direction and flexibility. The impact of this provision may be neutral in most cases as to the equity features of the note.

for other property/casualty insurance issuers. The financial guaranty insurance business is characterized by upfront, nonrefundable premium, generating sizable unearned premium due to bonds/instruments with long-dated maturities (20-30 years); no loss payment acceleration – only interest and amortized principal payments are made; and high leverage reflecting the low-frequency/high-severity nature of the risks, with policyholders' surplus components being a backstop for periods of extremely high losses.

In addition to the unearned premium reserves and liability of the unpaid losses and loss-adjustment expenses, financial guaranty insurers are required by law to maintain a liability referred to statutory contingency reserves. The purpose of these reserves is to protect policyholders during periods of extreme economic contraction. Regulators generally have allowed surplus notes to be part of a financial guarantor's available capital, but with restrictions on interest and principal repayments because of the unique nature of this line of business. Historically, surplus notes have performed the role of equity capital with respect to permanence, with regulators stepping in to determine when interest and principal repayments can be made by the insurer, as well as subordination to policyholder claims for financial guarantors during both regular business cycles and stress periods. Start-up financial guarantee insurers with clean balance sheets and active financial guaranty insurers with profitable books of business can expect favorable treatment compared with active financial guaranty insurers that have deteriorating books of business.

II. Treatment of Surplus Notes in BCAR

The baseline BCAR model initially deducts all surplus notes from the operating insurer's reported statutory surplus. After reviewing the surplus note's features and other qualitative considerations mentioned earlier, A.M. Best will determine how much capital credit should be given for the surplus note in the BCAR analysis. The maximum amount of capital credit that can be given in BCAR is 90% for third-party (externally held) notes and 95% credit for notes held by affiliates. The higher credit for notes held by affiliates is based on the assumption that affiliated companies would be more willing to modify the terms of the original surplus note to prevent a credit event. A.M. Best views surplus notes as a permanent form of statutory capital, recognizing the regulatory protection in the event of adverse conditions. The maximum amount of capital credit granted in BCAR will be allowed for up to five years before the surplus note's stated maturity. Credit then will be reduced 20% per year on a straight-line basis until the surplus note reaches its maturity date. Reduced credit recognizes the fact that as maturity approaches, the notes represent less of a company's surplus as they must be repaid in full or substituted with other forms of capital at that time.

While the surplus note may receive substantial capital credit in the BCAR analysis of the operating insurer, the actual rating of the operating insurer may be limited by the evaluation of a number of factors, including volatility of earnings, financial leverage, financial coverage, operating performance, business profile and risk management. However, poor or negative coverage ratios would be reflected in the ratings of the operating insurer rather than the amount of credit the surplus note receives in BCAR.

III. Treatment in the Financial Leverage Calculation

Operating Insurance Companies

Financial leverage at an operating insurer is evaluated on an adjusted and unadjusted basis. On an adjusted basis, surplus notes in the operating company financial leverage calculation may receive equity capital credit equal to the credit the surplus note received in the BCAR calculation. The portion of the surplus note considered debt, plus preferred stock, plus any other borrowed money, is evaluated relative to capital. **Exhibit 2** illustrates A.M. Best's typical tolerance levels for adjusted financial leverage at an operating company. On an unadjusted basis, the entire amount of the surplus note, plus preferred stock, plus any other borrowed money, is evaluated relative to capital.

Exhibit 2

Guidelines for Operating Company Financial Leverage

Issuer Credit Rating	(Borrowed Money + Preferred Stock + Surplus Notes (Debt Portion))/Capital
aaa	<25%
aa+	<35
aa/aa-	<50
a+/a/a-	<65
bbb+/bbb/bbb-	<80
bb+/bb/bb-	>80

However, due to the regulatory framework and control that insurance regulators have over surplus notes, the determination of the rating will encompass an evaluation of other factors, which may supersede the adjusted and unadjusted leverage guidelines. These factors include interest coverage, quality of capital (recognizing the deep subordination and the regulatory control of surplus notes compared with straight debt), financial performance, business profile and risk management.

Non-Operating Holding Companies

When financial leverage is evaluated on a consolidated (non-operating) holding company basis, surplus notes receive zero equity credit because assets at a U.S. insurance operating company are not readily available to fulfill holding company obligations, given the control exercised by the insurance company's regulator.

Additionally, surplus notes held at an operating company within a holding company structure may be eliminated when consolidating financial data up to the holding company. However, any obligations to service surplus notes anywhere within the organization need to be reviewed as part of overall balance sheet strength.

IV. Rating the Surplus Notes

Ratings of surplus notes are notched from the published Issuer Credit Rating (ICR) of the operating company. The notching reflects the subordination of the surplus note holders to the most senior creditors of the insurance company, the policyholders. For higher rated insurers, surplus note ratings are typically rated two or three notches below the operating company ICR. However, for issuers at the lower rating levels, notching between policyholder and surplus note obligations may be expanded as the ICR moves farther down the rating scale. The increase in notching at the lower ICR levels reflects the generally increased probability for regulatory intervention. (see **Exhibit 3**).

Exhibit 3

Guidelines for Notching From Operating Company Issuer Credit Rating to Surplus Note

Issuer Credit Rating	Surplus Note
aaa/aa/a/a-	2 or 3
bbb+/bbb/bbb-	3 or 4
bb+ and below	5 or more

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Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

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