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**Best's**  
Methodology and Criteria

# Evaluating US Surplus Notes



Greg Williams  
908 882 2434  
Greg.Williams@ambest.com

Matt Tuite  
908 882 2403  
Matt.Tuite@ambest.com

Sean Lynch  
908 882 2078  
Sean.Lynch@ambest.com

Hope Farrell  
908 882 1763  
Hope.Farrell@ambest.com



# Evaluating US Surplus Notes

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## Outline

- A. Market Overview
- B. Balance Sheet Strength
- C. Rating Surplus Notes

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of AM Best's rating process.

## A. Market Overview

Surplus notes, also referred to 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 issuance of surplus notes and the interest payments are generally subject to respective state insurance statutes or regulations. Surplus notes' legal characteristics vary slightly from state to state; however, most state regulations mandate that such capital instruments are 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. The notes also are part of an insurer's total adjusted capital under risk-based capital ratio calculations.

Generally, US statutory accounting principles 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).

Given the historical context of surplus notes and their unique place in an insurance company's capital structure, this criteria procedure highlights both the considerations that determine the treatment of surplus notes within the balance sheet strength assessment and AM Best's approach to rating surplus notes issued by insurance companies.



# Evaluating US Surplus Notes

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## B. Balance Sheet Strength

### Considerations of Surplus Notes

The evaluation begins with an examination of 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 that can be evaluated include, but are not limited to, the following:

- Term: Scheduled maturities/time remaining to maturity
- Call provisions
- Subordination
- Step-up rates
- Deferral features: Optional/mandatory payment of interest or principal
- Cumulative/non-cumulative coupon payments
- Replacement language
- Alternative payment mechanisms
- Conversion features
- Default event language
- Other investor/creditor covenants

AM Best considers these features of the surplus notes in a collective way to assess the equity content of the issue including:

- Permanency: Is the note available to pay losses when needed? Is it held to maturity?
- Servicing: Are interest payments deferrable in general or when a company is in distress?
- Structure & Subordination: Is loss protection provided to policyholders and other creditors?

Surplus notes that AM Best typically views as equity-like have the following characteristics:

- Long-term (typically has a remaining maturity of more than 10 years)
- Subordinate to policyholders, claimants, beneficiary claims, and other classes of creditors, other than surplus note holders
- Interest payments and principal repayments subject to regulatory approval

### **Regulatory View**

AM 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. AM Best considers the following:

1. Whether regulatory approval is sought before the issuance of the surplus notes
2. The amount of surplus notes allowed as policyholders' surplus by the regulator
3. The provisions for regulatory approval of interest and principal payments

## Evaluating US Surplus Notes

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4. The provisions for regulatory approval to redeem and replace surplus notes.

AM Best takes a positive view of the above items when they are reflected in state insurance statutes of the issuer's domicile. There is a history of regulatory actions during a period of insurance company stress/default in which surplus notes performed the role of equity capital with respect to priority of claims during liquidation and also served as a form of loss-absorbing capital.

### **Management Intent**

AM Best examines both management intent and the intended use of funds in evaluating surplus notes. Management should intend that the surplus notes will be part of the company's long-term capital used to satisfy policyholder and other senior claims during a stress period. They should also make the surplus noteholder aware that the note may be subject to potential loss.

### **Quality of Capital**

AM Best looks more favorably upon surplus notes when the notes are issued 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. Conversely, a troubled company using the proceeds of surplus notes to repair an unprofitable book of business could create further problems for the insurer even when capital has improved in the short run, since the inherent defects in the book of business remain unaddressed and there is now an added interest obligation.

While there is no stated limit for surplus notes in the capital structure, and some regulators view the use of surplus notes as favorable, excessive reliance on surplus notes may be viewed as a weakness in the balance sheet strength (quality of capital) analysis.

### **Treatment of Surplus Notes in BCAR**

The baseline Best's Capital Adequacy Ratio (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, AM Best determines 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. AM 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 recognized 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. The reduction in credit is recognition of 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.

# Evaluating US Surplus Notes

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## Treatment of Surplus Notes in the Financial Leverage Calculation

### Operating Insurance Companies

Financial leverage for 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 in an amount up to 20% of a firm's total capital and the credit may be equal to the credit amount 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.

### Non-Operating Holding Companies

When financial leverage is evaluated on a consolidated (non-operating) holding company basis, surplus notes receive no equity credit because assets at a US 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 the overall balance sheet strength assessment.

## C. Rating 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 noteholders to the most senior creditors of the insurance company, the policyholders. The regulatory framework and control that insurance regulators have over surplus notes is viewed positively in terms of strengthening an insurer's capital position in a time of stress. The determination of the surplus note rating may encompass an evaluation of other factors, which could 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.

For higher rated insurers, surplus note ratings are typically rated two 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 (**Exhibit C.1**).

# Evaluating US Surplus Notes

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**Exhibit C.1: Guidelines for Notching From Operating Company Issuer Credit Rating to Surplus Note**

Issuer Credit Rating	Surplus Note Notching
bbb- or higher	2 or 3
bb+ or lower	3 or more



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**PRESIDENT James Gillard**

**EXECUTIVE VICE PRESIDENT & COO Stefan W. Holzberger**

**EXECUTIVE VICE PRESIDENT & CSO Andrea Keenan**

**EXECUTIVE VICE PRESIDENT & CIO James F. Snee**

**SENIOR MANAGING DIRECTOR & CHIEF RATING OFFICER Kenneth Johnson**

**SENIOR MANAGING DIRECTOR Edward H. Easop**

**AMERICAS**

**WORLD HEADQUARTERS**

A.M. Best Company, Inc.

A.M. Best Rating Services, Inc.

1 Ambest Road, Oldwick, NJ 08858

Phone: +1 908 439 2200

**MEXICO CITY**

A.M. Best América Latina, S.A. de C.V.

Av. Paseo de la Reforma 412, Piso 23,

Col. Juárez, Alcaldía Cuauhtémoc, C.P. 06600, México, D.F.

Phone: +52 55 1102 2720

**EUROPE, MIDDLE EAST & AFRICA (EMEA)**

**LONDON**

A.M. Best Europe - Information Services Ltd.

A.M. Best Europe - Rating Services Ltd.

12 Arthur Street, 8th Floor, London, UK EC4R 9AB

Phone: +44 20 7626 6264

**AMSTERDAM**

A.M. Best (EU) Rating Services B.V.

NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands

Phone: +31 20 308 5420

**DUBAI\***

A.M. Best Europe - Rating Services Ltd. - DIFC Branch\*

Office 102, Tower 2, Currency House, DIFC

P.O. Box 506617, Dubai, UAE

Phone: +971 4375 2780

\*Regulated by the DFSA as a Credit Rating Agency

**ASIA-PACIFIC**

**HONG KONG**

A.M. Best Asia-Pacific Ltd

Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong

Phone: +852 2827 3400

**SINGAPORE**

A.M. Best Asia-Pacific (Singapore) Pte. Ltd

6 Battery Road, #39-04, Singapore

Phone: +65 6303 5000

**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.

**Best's Issue Credit Rating (IR):** an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

**Best's National Scale Rating (NSR):** a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global ICR using a transition chart.

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