Surplus Notes as a Source of Capital for P&C Insurers

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Property and casualty insurers faced heavy losses in 2024, as the severity and frequency of natural catastrophe events continued to rise. The United States experienced 32 events causing economic losses of over $1 billion, 21 of which resulted in over $1 billion in insured losses. Among others, hurricanes, wildfires and severe convective storms contributed to total losses amounting to approximately $190 billion, of which $108 billion were insured. [1] In addition, in January 2025, the Los Angeles-area wildfires resulted in insured losses estimated to be in the range of $25 billion to $40 billion.

As a result, insurance companies in these markets may require additional financing to bolster their regulatory capital, finance the day-to-day operations of the business or pursue strategic opportunities. As we explain below, surplus notes may be an attractive alternative for these insurers looking to raise capital without increasing the liabilities reported on their statutory financial statements.

Surplus notes can be utilized by insurers in a variety of transactions, including capitalization of non-stock insurers, capital infusions from parent companies (insurers and non-insurers) to insurer subsidiaries, private placement capital raisings, reserve financings and contingent capital facilities.

SURPLUS NOTES

Surplus notes are instruments unique to U.S.-domiciled insurance companies. A surplus note differs from a "vanilla" senior debt security in three important respects. First, regulatory approval is required prior to the issuance of or payment of principal and interest on a surplus note. Second, to be treated as a surplus note, the instrument must be expressly subordinated to all policyholder, beneficiary and creditor claims. Third,

[1] See Gallager Re, *Natural Catastrophe and Climate Report: 2025* (January 2025), available at https://www.ajg.com/gallagherre/-/media/files/gallagher/gallagherre/news-and-insights/2025/natural-catastrophe-and-climate-report-2025.pdf.

surplus notes are reported as equity on the issuer's statutory financial statements. Key features of surplus notes include:

Regulatory Approval. Both the initial issuance of a surplus note and any payment of interest or principal on a surplus note must be approved by the relevant state insurance regulator. Payments on the notes may be approved by the regulator only if it deems the surplus to be sufficient to safely do so. Further, the form of the agreement under which a surplus note is issued (*e.g.*, a fiscal agency agreement) and the form of the note itself must be approved by the relevant state insurance regulator.

Covenants and Defaults. Surplus notes typically have few, if any, covenants; and the failure to obtain regulatory approval for the payment of interest or principal is not typically a default or event of default.

Maturity. The maturity of a surplus note can vary from a relatively short-term tenor of five to 10 years to a tenor as long as 50 to 60 years.

Optional Redemption. An optional redemption feature is common, with the notes optionally redeemable at a make-whole prior to a par call date, which is typically one to six months prior to maturity, depending on tenor. Surplus notes are also regularly structured to include a tax event optional redemption at par. This type of redemption provision typically dictates that a tax event occurs when there is a change in the tax law such that there is more than an insubstantial increase in the risk that interest payable on the surplus notes will not be deductible for U.S. federal income tax purposes.

Offering Document/Marketing. Insurance companies commonly issue surplus notes to investors in a Rule 144A/Regulation S marketed offering or in a one-off privately negotiated transaction with institutional investors. Marketed offerings of surplus notes require the preparation of an offering memorandum that may include U.S. GAAP or statutory financial statements. The associated marketing effort may include a formal "roadshow" by senior management to investors and may include a pre-marketing "wall-crossing" process whereby institutional investors are subject to selective discussions under cover of confidentiality for a limited period of time to gauge potential interest. Surplus notes are also frequently issued in a directly negotiated private placement with one or more institutional investors and are regularly used by insurance companies to move capital internally, including between an unregulated holding company and a regulated insurance subsidiary.

Regulatory Capital. From a regulatory capital perspective, surplus notes are treated as surplus, or equity, and are included as part of the insurance company's total adjusted capital under risk-based capital ("RBC") calculations. Surplus notes are similarly treated as surplus or equity for statutory accounting purposes and the proceeds thereof are

treated as assets of the insurer. By contrast, under U.S. GAAP, these instruments are treated as debt and reported as a liability on the insurer's balance sheet. Surplus notes issued by an insurer to an upstream parent will ordinarily qualify for capital treatment even when the parent uses proceeds from a third-party financing to purchase the note.

Ratings. For higher rated insurers, surplus notes are typically rated two notches below the issuer credit rating of the operating company according to AM Best; whereas insurers with lower ratings may have surplus notes notched more than two levels below the operating company's issuer credit rating. Moody's may, depending upon the issuer, notch surplus notes only one notch below the issuer's senior debt rating.

Tax. While surplus notes are treated as equity from a regulatory capital perspective, they may be treated as debt for tax purposes (despite the requirement of regulator approval for payments), if they possess a sufficiently debt-like character under case law and Internal Revenue Service ("IRS") guidance. Debt treatment is typically desirable, as it allows for tax deductions on interest payments and generally permits interest payments to non-U.S. holders without withholding. A key distinction looks to whether the noteholder reasonably expects payment from the cash flows of the business as a lender would, or instead is taking on the entrepreneurial risk of the business in order to be repaid, as an equityholder would. While very long maturity dates can put pressure on this analysis, issuers have treated surplus notes with maturities as long as 50 or 60 years as debt where the maturities were tailored to the expected liability profile of the business and repayment expectations were considered strong.

FINAL THOUGHTS

Ultimately, the most appropriate means of raising additional capital will depend on a range of factors including the then-current composition of the company's capital structure, the intended use of proceeds, and regulatory and rating agency considerations. Although navigating the technical accounting and regulatory aspects of surplus notes can be complex, surplus notes can be an effective way to raise capital while maintaining the tax efficiency and cost of capital advantages of fixed-income debt instruments.

For more information on financing and capital solutions for insurance companies, see our Debevoise In Depth, available here.

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