Financial Review
March 20, 2025

Hard Reinsurance Market Makes Surplus Notes Attractive for Some

Rapid premium rate increases, along with higher reinsurance pricing, creates demand for higher capital needs

Principal Takeaways

- Surplus note issuance has been fairly steady since the end of 2022, after exhibiting consistent growth between 2014-2020.
- Nearly half of the companies that have seen notable growth in surplus notes outstanding since 2022 are in health, personal property, and standard auto/home composites.
- The average interest rate of surplus notes exceeded 7% in each of the last two years, with the divergence in rates widening between unaffiliated and affiliated notes.
- The issuance of affiliated surplus notes continues to trend upward. AM Best views notes issued to affiliated parties more favorably, because affiliated companies may have more flexibility to adjust the terms of the notes if conditions warrant.

Higher interest rates, as well as higher pricing in the reinsurance market over the last several years are affecting the investing and operating environments for insurers. Some insurance lines have been impacted by operating losses, resulting in more moderate capital growth than expected. Several property/casualty lines have also seen higher reinsurance pricing in recent years. As interest rates remained higher through 2024, some companies seeking greater financial flexibility are weighing cost-benefit analysis for the most efficient strategy to fulfill their needs.

Interest Rates Elevated the Last Two Years

While the growth in surplus notes has been more muted the last two years in total, the P/C and health segments have seen an uptick of 8%-9% since 2022, compared to less than 4% for the life/annuity segment. Surplus notes totaled $16.8 billion for the US-domiciled P/C insurance segment as of 3Q24, while L/A insurers have over $51 billion in surplus notes outstanding (**Exhibit 1**). Life insurers require higher levels of absolute capital due to their larger scale, and 15 companies account for roughly three-quarters of L/A outstanding surplus notes, many of which are larger mutual organizations. The median ratio of surplus notes to capital & surplus (C&S) for companies with notes outstanding remains varied across the insurance segments: 26% for P/C companies, 18% for L/A, and 46% for health, the latter of which has the largest share of affiliated surplus notes. Even though surplus notes outstanding is the highest for life insurers--$51 Billion as of 3Q24-- the ratio of surplus notes to C&S is lower than other segments. During 2023 and 2024, there were 46 companies that entered or reentered the surplus notes market. Doing so has been more costly than previous years, as the average interest rate of surplus notes exceeded 7% in each of the last two years, with the divergence in rates widening between unaffiliated and affiliated notes (**Exhibit 2**).

Operating Losses Limit Capital Growth

The need for financial flexibility is driven by several factors. Financial losses, primarily generated on the underwriting side, slowed down the expectation of capital growth. Nearly 80 companies have grown their surplus notes outstanding by more than 50% since year-end 2022. Of these

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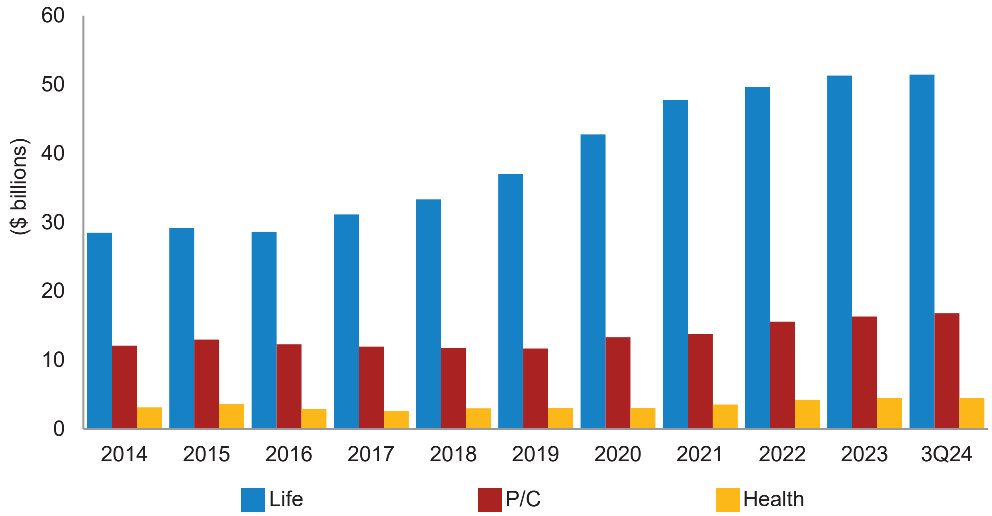
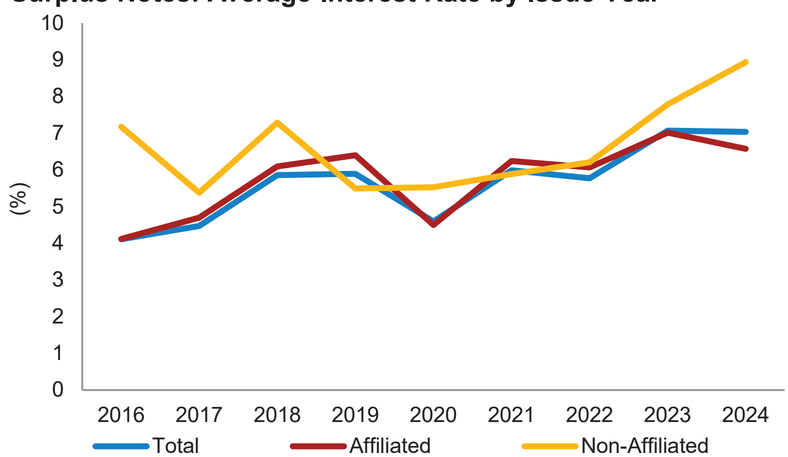
Exhibit 1
Outstanding Surplus Notes by Insurance Segment



Source: BESTLINK

Exhibit 2
Surplus Notes: Average Interest Rate by Issue Year



Source: AM Best data and research

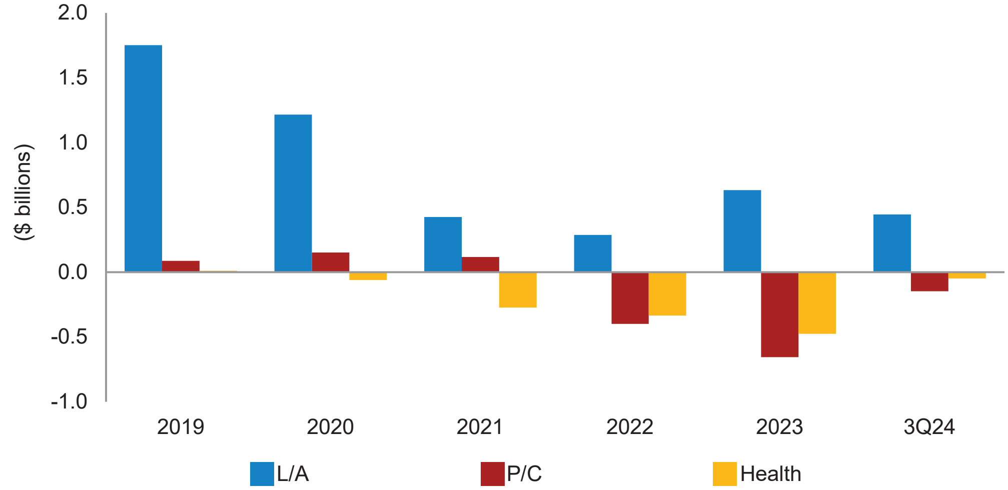
80 companies, those in the P/C and health segments have reported aggregated pretax operating losses in both 2023 and 2022, as well as through third quarter 2024 (**Exhibit 3**). These losses create a need for bolstering capital cushions and additionally, loss affected insurers are the ones most likely to face reinsurance rate increases and increases in attachment points which causes the need for even more capital. Most of these P/C companies write less than $500 million of direct premiums. Over half of these companies are in health, personal property, and auto/home (**Exhibit 4**). The Medicare Advantage and Managed Medicaid lines of business have seen margins tightened over the last two years, and many of the health companies are provider-owned plans. Both the personal property and auto/home lines have had difficult recent years as well.

Capital Relief for Premium Growth

As operating losses have impeded capital growth, surplus notes have provided capacity for continued premium growth. Rapid premium rate increases can also result in higher capital requirements, and the need to improve risk-adjusted capitalization. For those companies that saw surplus note growth over 50% since 2022, the premium leverage (ratio of DPW to C&S) excluding surplus notes doubled for the P/C companies since 2019 and tripled for the health companies (**Exhibit 5**).

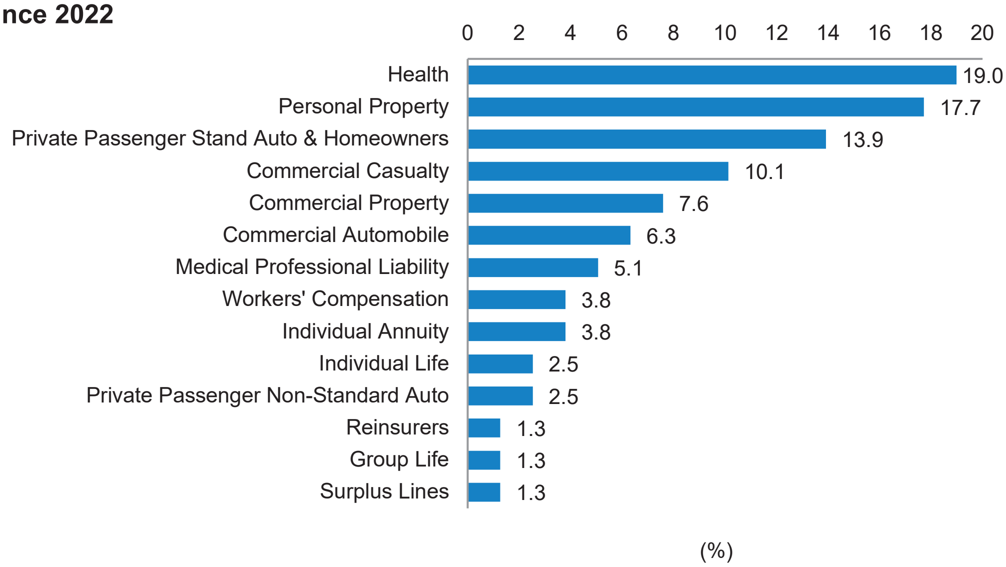
Although improved from several years ago, P/C reinsurance markets can still be difficult and obtaining necessary limits at reasonable rates can be challenging. When considering a surplus note,

Exhibit 3
Pretax Net Operating Gains for Companies With Surplus Note Growth >50% Since 2022



Source: AM Best data and research

Exhibit 4
Business Line Composites for Companies with Surplus Note Growth >50% Since 2022



Source: AM Best data and research

some companies find that in addition to more traditional results of increasing capital and enhancing financial flexibility, higher capital reduced the need for reinsurance. Surplus notes can partially fill the capacity created by rising secondary perils and social inflation amid the need for increased risk-adjusted capital.

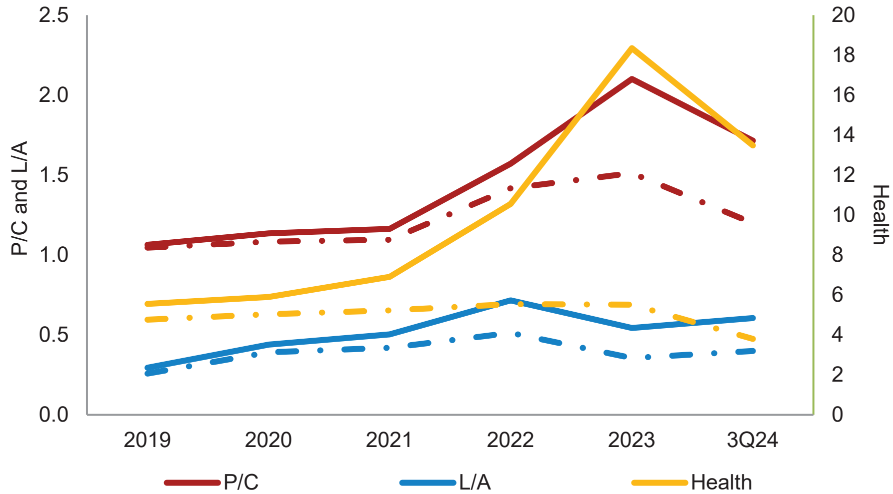
Additionally, interest rates on surplus notes can be partially offset by investing proceeds in investment grade fixed income where yields on new issuances are relatively high. Furthermore, writing more business due to surplus notes issuance can bring additional earnings further offsetting the cost of the note interest expense. As a result, some companies may find that surplus notes can provide a better economic solution compared to additional reinsurance when companies are seeking to support growth. However, AM Best believes that surplus notes are not a replacement for reinsurance and insurers need to perform appropriate risk/reward analysis to find optimal capital raising strategies. The ability of a company to issue surplus notes is viewed as a sign of financial flexibility, but excessive reliance on surplus notes may result in negative assessment of capital quality.

Increase in Surplus Note Issuance to Affiliated Companies

The issuance of affiliated surplus notes continues to trend upward. AM Best views notes issued to affiliated parties more favorably, because affiliated companies may have more flexibility to adjust the terms of the notes if conditions warrant. Over 90% of notes outstanding for

Exhibit 5

Surplus Notes Impact Direct Premium Leverage for Companies with Surplus Note Growth >50% Since 2022



Solid Line excludes surplus notes from C&S; Dash line includes surplus notes
Source: AM Best data and research

AM Best's Treatment of Surplus Notes

AM Best looks at surplus notes in several areas of its rating process. Surplus notes are treated as capital on a US statutory basis. When determining the Best Capital Adequacy Ratio (BCAR) based on statutory filings, surplus notes are initially deducted from a company's reported capital. For surplus notes maturing in five or more years, a 90% credit is added to capital for notes issued to unaffiliated third parties and 95% credit for notes issued to affiliated companies. Affiliated notes may have more flexibility with regard to terms and conditions, allowing for higher credit. For notes maturing in under five years, capital credit is decreased 20% per year on a straight-line basis, reflecting a less permanent form of capital.

Surplus notes are also part of AM Best's financial leverage analysis at both the operating company and the non-operating holding company level, if applicable. GAAP-reporting companies are required to report surplus notes as debt rather than as equity. On an adjusted basis, surplus notes at the operating company level may receive equity capital credit up to 20% of total capital and equal to the credit received in the BCAR calculation. When determining financial leverage for non-operating holding companies, surplus notes receive no equity credit due primarily to regulatory control of the operating insurance company.

Surplus notes are also reviewed from a quality of capital perspective. Companies that rely heavily on surplus notes may be viewed as having a weaker balance sheet profile, especially if the terms of the notes create a burden on earnings. Management's intent and use of surplus note funds is also reviewed.

health companies are affiliated, compared to 41% for L/A, and 35% for P/C. Affiliated surplus notes are used frequently by special purpose captives and risk retention groups in the P/C segment, because the notes are issued to members or subscribers as part of their funding. With the increase in affiliate surplus note issuance, it is important to monitor the balance sheet strength of affiliate companies and their ability to pay back issuers.

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