

*Our Insight, Your Advantage®*Financial Review  
March 20, 2025

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

## Hard Reinsurance Market Makes Surplus Notes Attractive for Some

### 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

#### Analytical Contacts:

Jason Hopper, Oldwick, NJ  
+1 (908) 882-1896  
jason.hopper@ambest.com

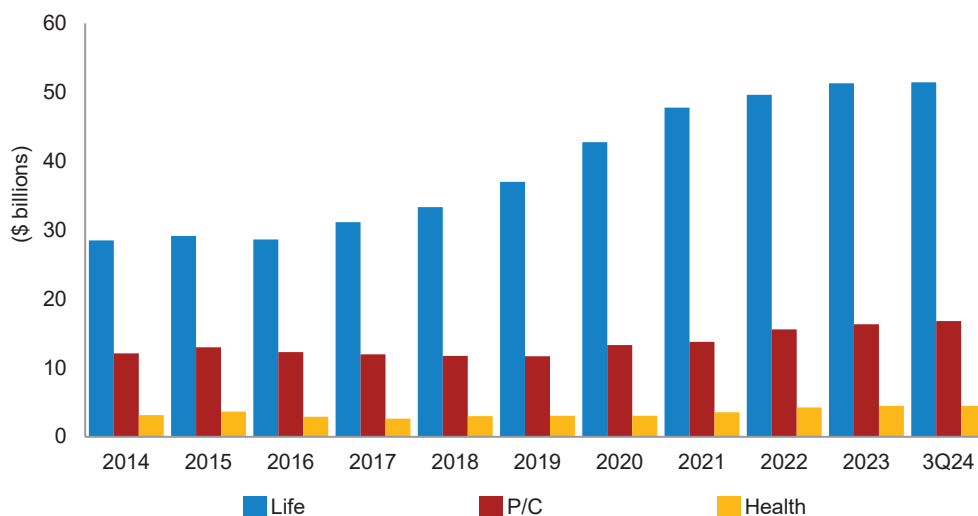
Daniella Pliss, Oldwick NJ  
+1 (908) 882-2245  
Daniella.Pliss@ambest.com

#### Contributor:

Jacob Conner, Oldwick

2025-020

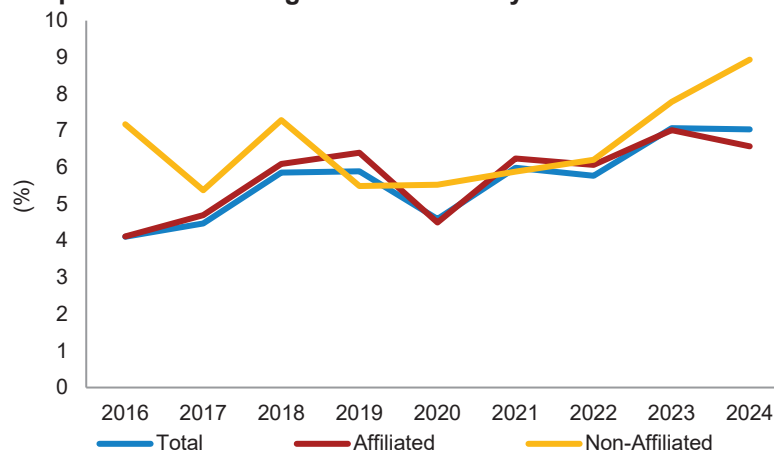
Exhibit 1  
**Outstanding Surplus Notes by Insurance Segment**



Source: **BESTLINK**

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.

Exhibit 2  
**Surplus Notes: Average Interest Rate by Issue Year**



Source: AM Best data and research

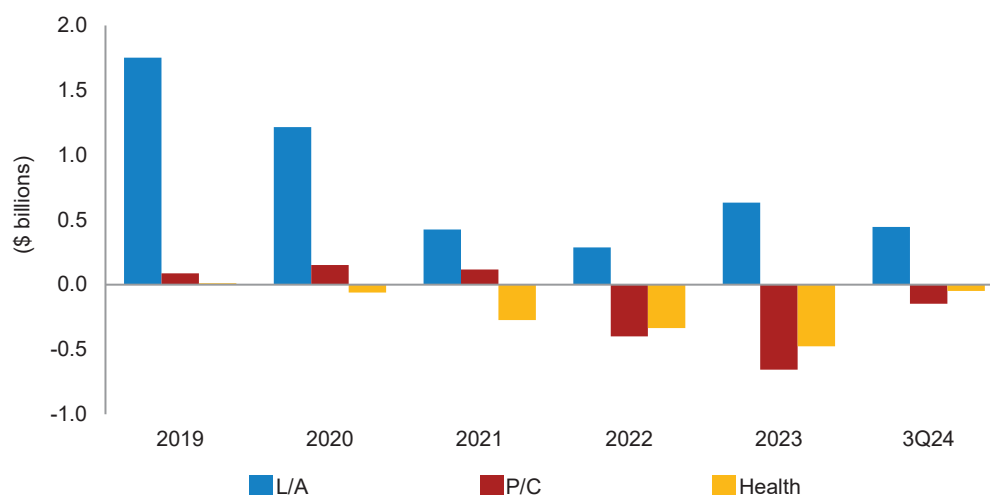
### Capital Relief for Premium Growth

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

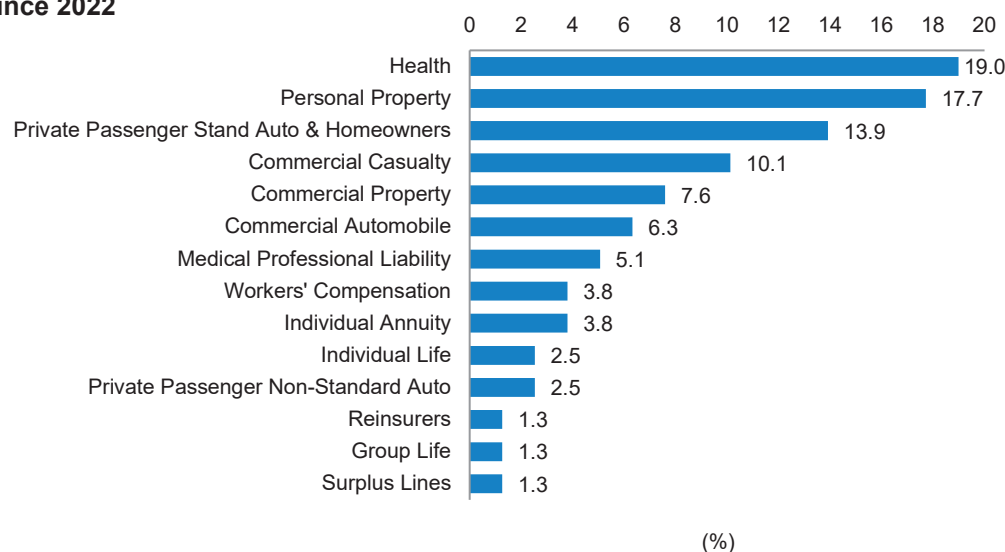
### Pretax Net Operating Gains for Companies With Surplus Note Growth >50% Since 2022



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

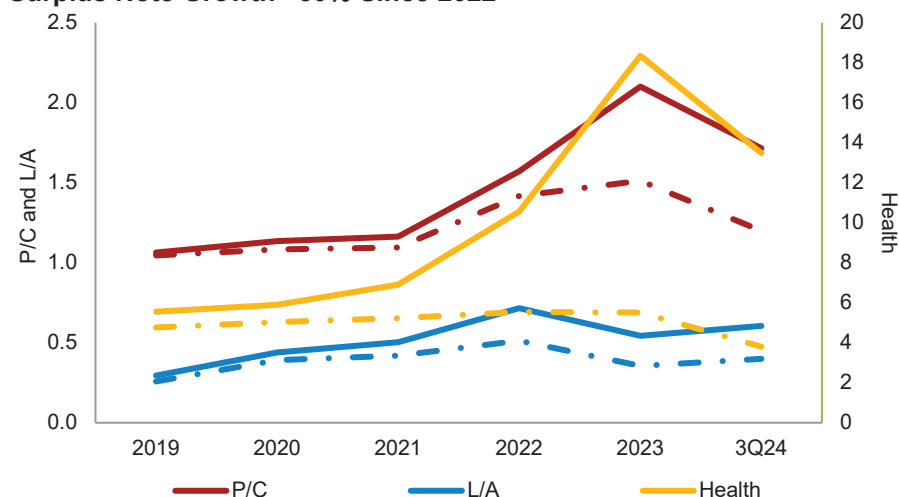
growth. However, AM Best believes that surplus notes are not a replacement for reinsurance and insurers need to perform appropriate risk/reward analysis to find optimal capital raising strategies. The ability of a company to issue surplus notes is viewed as a sign of financial flexibility, but excessive 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.

Published by AM Best  
**BEST'S SPECIAL REPORT**

**A.M. Best Company, Inc.**  
 Oldwick, NJ

**CHAIRMAN, PRESIDENT & CEO Arthur Snyder III**  
**SENIOR VICE PRESIDENT & TREASURER Cynthia Young**  
**SENIOR VICE PRESIDENT Lee McDonald**

**A.M. Best Rating Services, Inc.**  
 Oldwick, NJ

**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 credit-worthiness 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.

**Rating Disclosure: Use and Limitations**

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance, business profile, and enterprise risk management or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services, Inc. (AM Best) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AM Best.