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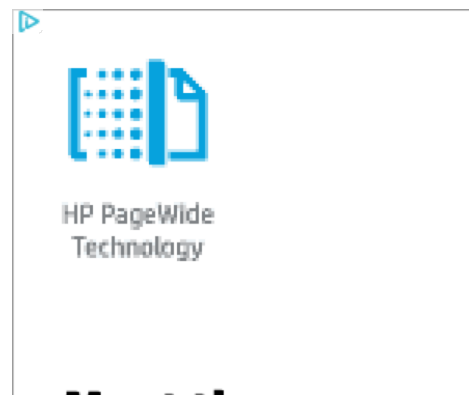
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What Are the Treatments for Surplus Notes for Statutory Accounting Principles?

By Grant Houston, eHow Contributor

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Issuing surplus notes became popular in the early 1990s to provide small- and medium-sized insurance companies access to capital. These notes are investment-grade subordinated debt instruments, similar to a bond, that offer a coupon (interest rate of return) and have a maturity date. Capital raised using surplus notes is classified as "equity" because surplus notes pay investors last in the event of liquidation, which is similar to equity investors.



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Rating Agency Treatment of Surplus Notes

Essentially, surplus notes are a hybrid investment vehicle because notes are considered bonds in function and payout structure, but are accounted for as equity. In 2010, Fitch Ratings agency concluded that the U.S. insurance regulatory system, operated by state insurance regulators, affords policy holders "strong" oversight and control over the financial stability of mutual insurance companies. Therefore, based on Fitch's assessment, surplus notes are debt instruments that protect policyholders from downside liquidation risk.

Accounting for Surplus Notes and Rule 144A

Surplus notes are assets of the company even though they are a debt instrument. According to the Society of Actuaries, surplus notes need to be clearly identified and disclosed in the footnotes of financial statements. Also, investment income generated from the notes cannot be accrued until payment by the issuer has been approved by the company's state of domicile insurance commissioner. Under the Securities Act of 1933, the Securities and Exchange Commission, following rule 144A, permitted mutual insurance companies to make a "private



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offering" of their surplus notes using existing statutory-basis financial statements, which differs from the traditional requirement of securities offerings in following generally accepted accounting principles.

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Contingent Surplus Notes

A contingent surplus note is a capital funding mechanism in case of a catastrophic event that would require an insurance company to increase capital requirements, whereupon the insurance company establishes a trust that sells its own promissory notes (contingent surplus note trust notes) to investors. The capital is then used to acquire Treasury bonds or other liquid assets. When the company needs cash, it issues surplus notes to the trust in return for the securities in the trust and then sells the securities. Hence, the Treasury notes and surplus notes are assets, instead of liabilities, on the company's balance sheet under statutory accounting principles.

CDOs and Surplus Notes

Collateralized Debt Obligations (CDOs) are structured investment vehicles designed by combining different types of stock and/or debt instruments to create a particular type of investment, composed of surplus notes and Insurance Trust-Preferreds (long-term subordinated notes). This capital structure is a newer version of the surplus notes, which allows small- and medium-sized insurance companies access to capital markets. These securities provide investors insurance coupled with bank collateral, because the trust component of the CDOs consists of Treasury bonds or other liquid assets. Issuers prefer surplus notes because the interest paid is tax deductible and it usually increases surplus. Issuers also find insurance trust-preferreds beneficial due to the equity credit they receive and the tax deductibility of dividends.

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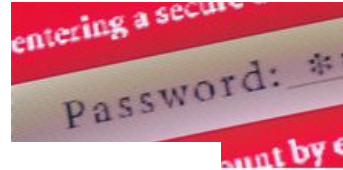
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