Surplus Notes: Debt that behaves like equity?

If you look at the trade off on debt versus equity, here is what you are offered as the pluses by each side. With debt, you get tax benefits, reflecting the fact that interest expenses are tax deductible. With equity, you get flexibility, since you are not bound to make dividend payments, unless you have the earnings to cover those payments. It is every company's dream to issue securities that offer all the flexibility of equity, while having the payments treated as debt by the tax authorities (thus giving you a tax benefit from any payments). If you are a regulated company, it is an even bigger bonanza if the regulatory authorities treat the financing as equity, since it allows you to meet regulatory capital requirements, while having equity research analysts not count the issuance as equity (with its consequent effects on per share earnings).

Can you actually issue a security that is debt to the IRS, equity with the regulatory authorities and with the company, and back to being debt, when viewed by analysts? Yes, and one example (among many) is surplus notes. Surplus notes are securities issues primarily by insurance companies, where the interest payments on the notes are made after all other contractual payments are made. If the insurance company does not have a surplus, it can defer payments on the surplus notes, without facing default. Here is how it is treated by the different entities:

1. Insurance regulators: Surplus notes, for the most part and in most states, is treated as regulatory equity capital. In return, the regulators can restrict or stock payments being made to surplus note holders, if they feel that an insurance company's solvency is at risk.
2. GAAP: GAAP accounting treats surplus notes as debt.
3. Ratings agencies: treat it as a hybrid and give "equity" credit to insurance companies for issuing surplus notes, though the rules have been tightened since 2008.
4. Equity research analysts: consider only shares outstanding when they consider equity and do not count surplus notes as part of shares outstanding.
5. IRS: The tax authorities continue to treat it as debt and the payments on surplus notes are treated like interest expenses, saving you taxes.

In effect, an insurance company that issues surplus notes is getting the tax benefit of debt, without many of the normal consequences (lower ratings, regulatory disapproval and analyst backlash for having too much debt).

Questions

1. Based upon the way surplus notes work, do you think that they are more akin to debt or to equity?
2. Assume that the current split treatment (equity by the regulatory authorities and ratings agencies, debt by the accountants, IRS and analysts) of surplus notes continues into the future. How would you differentiate between two insurance companies that look similar in terms of operations and other

funding but vary on one dimension: one company has borrowed $10 billion in conventional debt and the other has issued $10 billion in surplus notes?

3. Pick a company (perhaps the one that you were doing your project one). Can you construct a security that behaves like equity (in terms of offering you flexibility) while retaining enough characteristics of debt to give you a shot at getting your payments to be tax deductible?