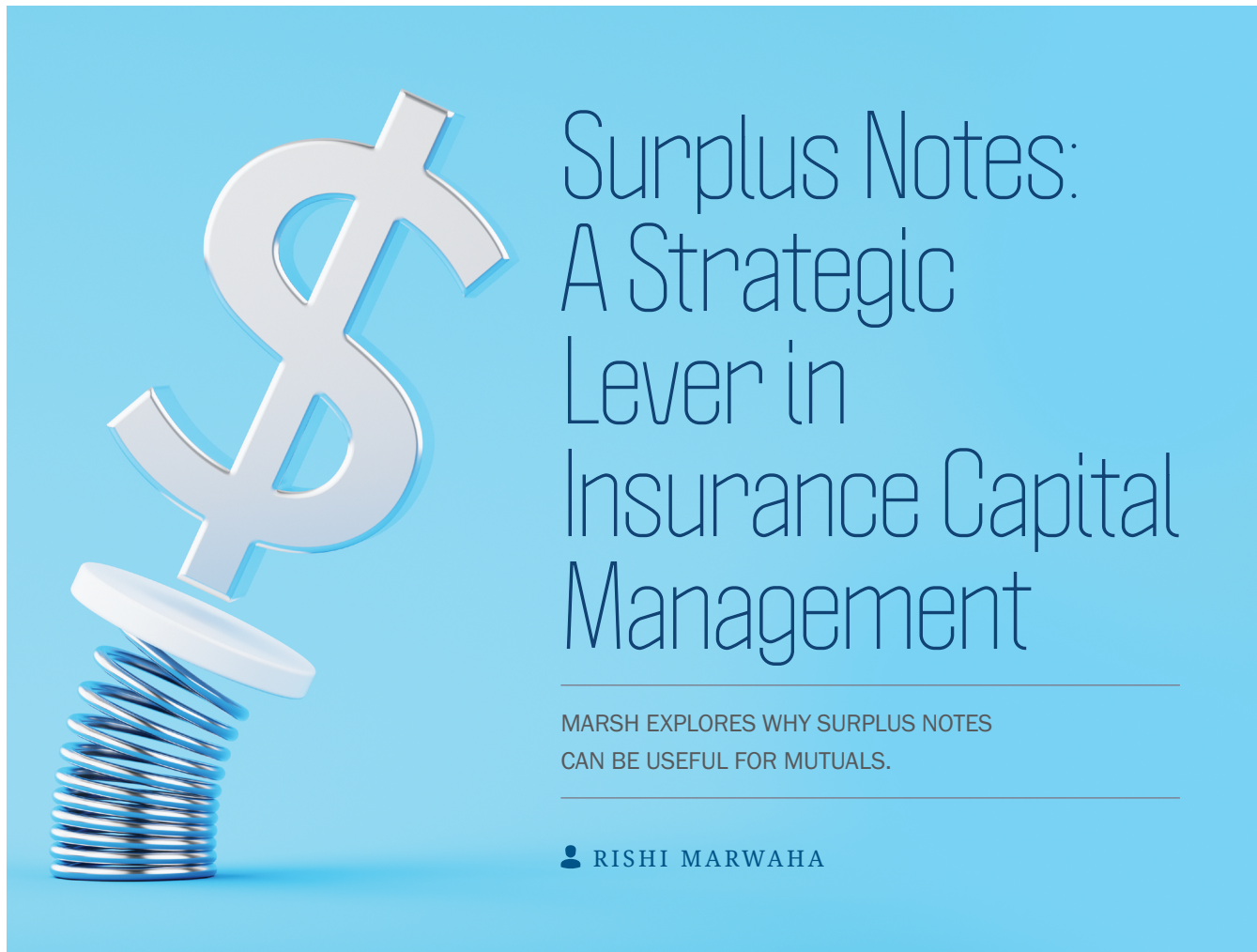




Property/casualty insurers are operating in one of the most challenging capital environments in decades. Elevated and unpredictable catastrophe losses, reserve pressure on select liability lines, reinsurance market disruption, and investment market volatility have forced management teams to rethink how they build and preserve capital resilience.

Against that backdrop, surplus notes have emerged as an increasingly important and prudent strategic capital tool, particularly for mutual insurers seeking flexible, long-term capital without sacrificing governance or strategic independence.

The market's growth reflects that shift. Since 2018, surplus notes outstanding across the property/casualty sector have increased by approximately 53 percent, including a 105 percent increase among small-to-mid cap issuers with statutory surplus levels below \$600 million, according to S&P Global Market

Intelligence. Importantly, the expansion has been driven both by more issuers accessing the market and larger average program sizes.

What are Surplus Notes?

Surplus notes are hybrid capital instruments issued by insurance operating companies. They resemble debt in that investors provide capital in exchange for a coupon and repayment terms, but under statutory accounting principles, they generally receive treatment closer to equity.

Most importantly, proceeds are typically treated as statutory surplus rather than liabilities subject to regulatory approval. Because statutory surplus is foundational to insurer capital adequacy, this treatment can be highly valuable.

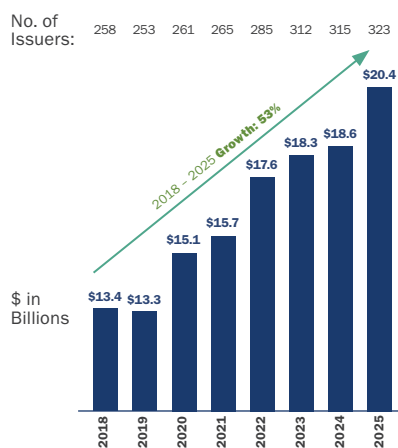
Surplus notes are deeply subordinated obligations. Policyholder claims and most other liabilities must be satisfied before

surplus note holders receive repayment. In addition, insurers generally require regulatory approval before making principal or interest payments — a missed coupon or principal payment due to regulatory disapproval does not typically constitute an event of default for surplus notes.

Surplus notes are generally viewed favorably by rating agencies because they possess many characteristics associated with permanent capital. From a ratings perspective, surplus notes often receive predominantly equity treatment within AM Best's Capital Adequacy Ratio and similar frameworks because of their permanence, subordination, and payment flexibility. Interest and principal payments typically require regulatory approval, enabling insurers to preserve liquidity and statutory surplus during periods of financial stress.

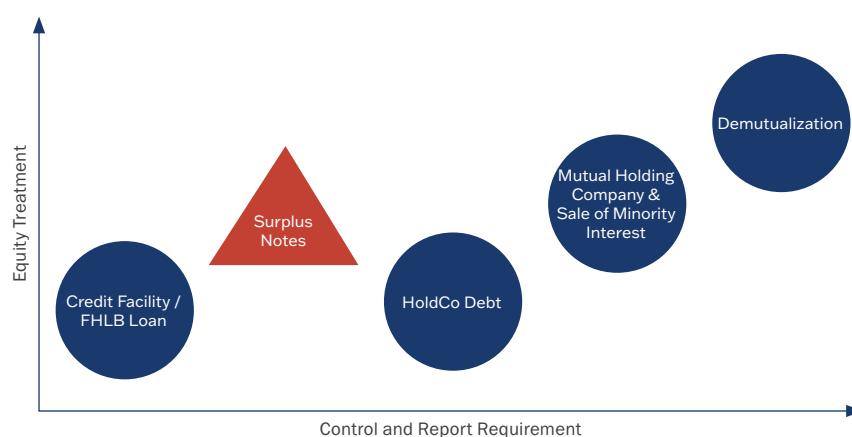
Rating agencies also consider surplus notes' long-dated tenor and their

U.S. P/C Surplus Notes Outstanding



Source: Marsh Securities proprietary database

Overview of Capital Options for Mutuals and Private Insurance Companies



Notes: Reinsurance and alternative capital (sidecars) are not included in the graph above as both provide capital relief in the form of a risk transfer product rather than a direct capital infusion.

deeply subordinated position relative to policyholder obligations and senior creditors. As a result, surplus notes can strengthen risk-adjusted capitalization metrics and support financial flexibility without materially increasing financial leverage in the same manner as conventional debt. However, treatment may vary depending on note structure, maturity profile, and refinancing expectations.

The result is an instrument that looks and feels like debt but delivers many of the balance-sheet benefits associated with equity capital.

Why Do Mutuals Use Them?

Surplus notes are particularly important for mutual insurers because they provide non-dilutive capital while preserving mutual governance and long-term policyholder alignment.

Unlike stock companies, mutuals do not have access to public equity and debt markets and are often reluctant to pursue structures that alter ownership or strategic control. Surplus notes allow carriers to raise long-term institutional capital while maintaining independence.

The instrument can also optimize cost of capital, diversify long-term funding sources, and provide greater flexibility than traditional corporate debt structures, which are often more covenant heavy.

Cost-Benefit Analysis: When Does a Surplus Note Make Economic Sense?

One of the most important considerations is whether a surplus note is economically accretive.

Credit spreads for privately placed surplus notes can vary significantly depending on market conditions and issuer-specific considerations, generally ranging from high-200-basis-points area to high-500-basis-points area over comparable treasuries. Key drivers include an insurer's underlying credit quality and ratings profile,

the intended use of proceeds, transaction size and structure, investor demand, and the overall quality of execution and market positioning during the placement process.

In many cases, a surplus note can be earnings accretive if the issuer's underwriting leverage multiplied by its operating ratio — taking into consideration the underwriting and investment income generated — exceeds the coupon of the instrument.

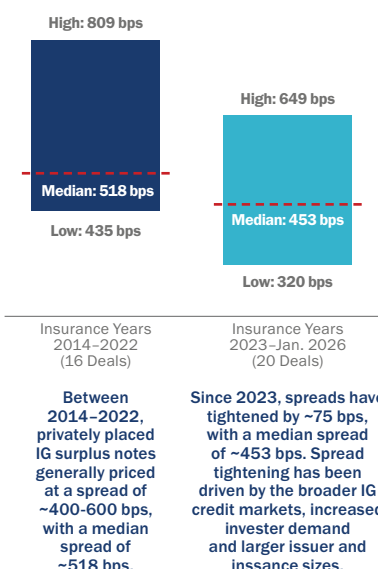
For example, consider an insurer with a 1.25x underwriting leverage and a 92 percent operating ratio. In this scenario, the implied return on incremental capital is approximately 10 percent.

Theoretically, in this example, issuing a surplus note at a coupon below 10 percent would, therefore, be earnings accretive if the proceeds support incremental underwriting activity.

The analysis changes somewhat when proceeds are being used primarily to bolster the balance sheet rather than support new premium growth. In those cases, the economic cost is better viewed as the "net spread" — the difference between the surplus note coupon and the investment yield earned on duration-matched securities purchased with the proceeds.

For investment-grade issuers, that net spread is often in the low single-digit range, making surplus notes a relatively efficient

Selected Privately Placed P/C 4(a)(2) Surplus Note Deals Spreads over Benchmark Rate



U.S. Investment-Grade Corporate Index Option-Adjusted Spread



Source: Ice Data Indices, LLC, ICE BofA US Corporate Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis; June 5, 2026.

form of contingent balance sheet capital, even when underwriting deployment is delayed.

Importantly, the current market backdrop is particularly constructive for issuers. As of the drafting of this article in June 2026, investment-grade credit spreads remain near historic lows, allowing insurers to lock in long-duration capital at exceptionally tight spreads relative to treasuries. While absolute coupons may appear elevated because benchmark Treasury rates remain higher than the ultra-low-rate period that followed the pandemic, the composition of the coupon matters economically.

For insurers investing proceeds into duration-matched fixed-income portfolios, the Treasury component of the coupon is largely offset by investment income earned on those assets. In effect, the benchmark rate is close to a wash economically while the true incremental cost of capital is more appropriately viewed as the delta in the credit spread between that of the issuer and the fixed-income portfolio in which the proceeds are invested.

That dynamic is highly favorable in today's environment because spreads — not Treasury yields — represent the permanent economic cost associated with financing. With spreads currently near cycle tights for investment-grade issuers, many insurers are finding that the all-in economics of surplus notes are more attractive than headline coupon levels alone would suggest. With capital markets remaining receptive, insurers are increasingly pursuing opportunistic surplus note issuance,

reinforcing the idea that the best time to raise capital is when you do not need it.

Key Considerations and Issuance Format

Despite their advantages, surplus note transactions require careful planning.

Regulatory approval: Issuance and debt-service payments generally require approval from the domiciliary regulator, making early engagement essential. Running a competitive issuance process helps streamline the regulatory approval process.

Rating agency treatment: While rating agencies generally provide favorable equity credit, they evaluate surplus notes in the broader context of leverage, reserve adequacy, earnings quality, and catastrophe exposure.

Investor perception: Investors closely evaluate underwriting performance, reserve history, reinsurance protections, governance, and strategic rationale. Clear communication around the use of proceeds and long-term capital strategy is critical.

Signaling risk: As with any capital raise, execution and messaging matter. Transactions tied to growth or strategic resilience are often viewed positively; poorly positioned transactions may create unnecessary concerns around reserve adequacy or capital stress.

One of the key structural decisions is issuance format. Section 4(a)(2) offerings are privately negotiated transactions sold directly to accredited investors and

TYPICAL SURPLUS NOTES USE CASES

- ▶ **Post-event recapitalization:** Restoring statutory surplus after catastrophe losses or reserve strengthening.
- ▶ **Bolstering balance sheet resilience:** Strengthening capital adequacy and ratings flexibility during periods of elevated uncertainty.
- ▶ **Managing underwriting cycles:** Preserving underwriting flexibility during periods of elevated volatility.
- ▶ **Growth initiatives:** Supporting expansion into new geographies, products, or distribution channels.
- ▶ **Optimizing cost of capital:** Accessing long-duration capital at attractive rates with favorable regulatory and rating agency treatment.
- ▶ **Diversifying sources of capital:** Expanding beyond retained earnings and traditional bank or reinsurance/risk transfer solutions.
- ▶ **Acquisitions and affiliations:** Financing strategic combinations while maintaining capital adequacy.
- ▶ **Reciprocal exchange formations:** Providing critical initial capital to launch new reciprocal exchanges, supporting the formation of more than 35 reciprocals since 2017.

qualified institutional buyers. These deals are generally more targeted, flexible, and efficient, making them particularly attractive for mutual insurers and mid-sized transactions.

Rule 144A offerings involve broader institutional distribution and greater secondary-market liquidity, but also require more extensive disclosure, syndication, and execution complexity.

In practice, 144A transactions tend to make the most sense for larger issuances — generally those exceeding \$300 million. [IN](#)