

Surplus Notes

During the first two decades of the *Forum* I made occasional references to what are called surplus notes in most states. They are called contribution certificates in California and surplus debentures in Texas. The most significant references in those early days were in some of my articles about the financial condition of Executive Life Insurance Company, as discussed in chapter 7. In 1993, two years after the collapse of Executive Life, surplus notes became a topic of major attention for me, for reasons explained in this chapter.

What Is a Surplus Note?

I have referred to a surplus note as a bizarre financial instrument and as an accountant's nightmare. A surplus note is a promissory note that represents debt; that is, an insurance company issuing a surplus note thereby borrows money from the purchaser of the surplus note. The money received from the purchaser increases the insurance company's assets. However, unlike an ordinary promissory note, issuing a surplus note does not require the insurance company to establish a liability. Consequently the surplus note increases the insurance company's net worth, since net worth is the company's assets minus its liabilities.

A surplus note increases an insurance company's net worth because state insurance laws allowing the issuance of surplus

notes say the insurance company is not required to establish a liability in connection with the issuance of a surplus note. The original purpose of such laws was to provide a mechanism through which mutual insurance companies, which do not have shareholders, may increase their net worth from external sources. The early laws were enacted many years ago because of the dire financial condition of some mutual insurance companies at the time. Some of the laws have been amended, after effective lobbying by stock (shareholder-owned) insurance companies, and now allow stock insurance companies to issue surplus notes even though stock companies can increase their net worth by selling shares to investors.

State surplus note laws say an insurance company is allowed to issue a surplus note only with the prior approval of the insurance commissioner in the insurance company's state of domicile. The laws also say payments of interest and repayments of principal on a surplus note are allowed only with the prior approval of the insurance commissioner.

A surplus note does not provide permanent net worth because the issuing insurance company promises to repay the borrowed money. However, the theory behind the laws is that a surplus note is treated appropriately as part of an insurance company's net worth because the surplus note is subordinated to all the company's other liabilities, and because interest payments and principal repayments on a surplus note are made only when the company is in satisfactory financial condition as determined by the insurance commissioner. As discussed later, I believe that the theory is open to question.

Podunk Mutual

An anecdote illustrates the original purpose of surplus notes. Paul is the president and chief executive officer of Podunk Mutual Life Insurance Company, a small, fictional company with inadequate net worth. Indeed, the company is perilously close to financial collapse.

Mary is Paul's mother-in-law. She wants Podunk to survive because she wants Paul to remain employed for the sake of her

daughter and the grandchildren. Mary is willing to put \$1 million into Podunk to increase its net worth, but a mechanism is needed. Podunk cannot increase its net worth by issuing shares of stock to Mary in exchange for the \$1 million because a mutual insurance company has no shares of stock and no shareholders. Nor can Podunk increase its net worth by issuing an ordinary promissory note to Mary in exchange for the \$1 million because issuing an ordinary promissory note would increase Podunk's assets and liabilities but would not increase its net worth.

Enter the surplus note, an instrument that is allowed under the surplus note law in Podunk's state of domicile. With the prior approval of the insurance commissioner there, Podunk can issue a surplus note to Mary in exchange for the \$1 million. Although the surplus note would be evidence of debt, the law says Podunk is not required to establish a liability. Thus Podunk's issuance of a \$1 million surplus note would increase Podunk's assets by \$1 million and would increase Podunk's net worth by \$1 million.

The Tax Angle

As will be seen, income tax considerations now play a major role in the decisions of insurance companies to issue surplus notes. The key point is that interest payments on a surplus note are treated in the same manner as interest on debt and therefore are deductible by the insurance company. On the other hand, if interest payments on a surplus note were treated in the same manner as cash dividends paid on shares of stock, the interest payments would not be deductible by the insurance company.

A surplus note is often described as tax effective. I think it is more accurate to describe a surplus note as providing the issuing insurance company with a subsidy from U.S. taxpayers.

The situation has not been ignored by the Internal Revenue Service (IRS). Several court cases addressed the question of whether interest payments on a surplus note should be treated as interest on debt and therefore deductible, as argued by the insurance companies, or whether those interest payments should be treated as cash dividends paid on shares of stock and

therefore nondeductible, as argued by the IRS. I think the cases could have gone either way, but the courts decided the cases in favor of the insurance companies.

I think those court decisions are regrettable for three reasons. First, the decisions provide insurance companies with an advantage over competitors in the financial services business. Second, the decisions cause those competitors to push for enactment of similar laws to level the playing field, thereby shifting to other taxpayers the burden of paying for vital government services. Third, the decisions tempt insurance company executives to borrow money and thereby threaten the long-term financial strength of insurance companies.

Traditional Surplus Notes

As mentioned above, surplus notes originally were designed to be issued by mutual insurance companies that were in poor financial condition. Indeed, the very existence of a surplus note in an insurance company's financial statement was a red flag indicating that the insurance company was in financial trouble. A surplus note issued by a mutual insurance company in poor financial condition is called a traditional surplus note.

Intercompany Surplus Notes

Surplus notes sometimes are used to transfer funds from one member of an insurance company group to another member of the group. For example, an insurance company may issue a surplus note to its parent company in exchange for funds provided to the insurance company by the parent company. Such surplus notes played a prominent role at Executive Life Insurance Company, as discussed in chapter 7. A surplus note issued by one member of an insurance company group to another member of the group is called an intercompany surplus note.

Investor Surplus Notes

In April 1993 Prudential Insurance Company of America (Newark, NJ) became the first financially strong insurance company to issue a surplus note to sophisticated investors through

a private offering. Prudential issued a \$300 million, 10-year surplus note at an annual interest rate of 6.875 percent. A surplus note issued to sophisticated investors through a private offering is called an investor surplus note.

I was surprised by the issuance of a surplus note by a financially strong insurance company. Also, I expected that other financially strong insurance companies would promptly copy Prudential's action.

Therefore I called a Prudential senior officer I knew and asked for an explanation. He said he would call back in an hour, and he did so. He said two company executives wanted to come to Indiana to meet with me personally rather than discuss the matter by telephone or letter. I agreed to the meeting. The reason for the unusual nature of the response was clear: the company was concerned that I would view its issuance of a surplus note as a sign of financial weakness.

In our meeting the executives said Prudential issued the surplus note for two reasons. First, they cited court rulings that interest payments on a surplus note are deductible for income tax purposes in the same manner as interest payments on debt. Second, they said the company created a voluntary employee benefit association (VEBA) to provide post-retirement medical and other benefits for certain unionized employees. The company used the \$296 million of net proceeds from the surplus note offering to prefund the VEBA. The prefunding generated about \$100 million of income tax savings for the company in 1993. The executives emphasized that the company was not in any kind of financial difficulty.

Goldman, Sachs & Co. was Prudential's adviser on the surplus note offering and the VEBA project. Prudential submitted to the New Jersey insurance commissioner a Goldman report that included an interesting chart. It showed that 62 percent of the initial contribution to the VEBA came from Prudential and that the other 38 percent came from the IRS. Goldman could have said the 38 percent came from other taxpayers.

The New Jersey surplus note law allowed the issuance of a surplus note only for a few specified purposes, none of which struck

me as applicable in this case. I therefore wrote to the insurance commissioner inquiring about the authority to allow the issuance of a surplus note in the Prudential case. I received a lengthy and reasonable response from Asutosh Chakrabarti, the New Jersey commissioner's chief actuary.

The Revolution of 1993

As I expected, Prudential's action was copied in a wave of surplus note offerings by financially strong insurance companies. In October 1993 Metropolitan Life Insurance Company (New York, NY) issued two surplus notes. One was a \$400 million, 10-year surplus note at an annual interest rate of 6.3 percent. The other was a \$300 million, 30-year surplus note at an annual interest rate of 7.45 percent. The net proceeds of \$691 million were to be used "for general corporate purposes, including the conduct of [Metropolitan Life's] business." The New York insurance superintendent authorized the issuance of the surplus notes under the New York surplus note law.

In November 1993 Massachusetts Mutual Life Insurance Company (Springfield, MA) issued a \$250 million, 30-year surplus note at an annual interest rate of 7.625 percent. The net proceeds of \$246 million were to be used "for general corporate purposes." This sentence was in the confidential private offering circular: "In Massachusetts, there is no statute that specifically authorizes the issuance of surplus notes or addresses their accounting treatment or repayment terms." Since the offering circular said nothing further on the matter, I wrote to the Massachusetts insurance commissioner inquiring about the authority for approving issuance of the surplus note. In response, an attorney in the Division of Insurance said "there are no existing public documents which address this question." Later I wrote again. In March 1994 I received this letter from the deputy commissioner and general counsel of the Division:

The Division has broad supervisory powers over insurance companies doing business in Massachusetts. This is especially true of those insurers domiciled in the Common-

wealth. The Division's chief responsibility is the protection of both policyholders and the public, and the Massachusetts General Court has granted the Division broad statutory authority over the financial condition and transactions of our domestic insurers, including the obligation to monitor and to periodically examine their financial status.

Approval of surplus note transactions by Massachusetts domestic insurers is within the General Court's broad grant of authority to the Division and is consistent with the legislative charge.

In response I asked the Division's deputy commissioner for the precise language of the "broad grant of authority" and the "legislative charge." I received no reply.

In December 1993 New York Life Insurance Company (New York, NY) issued two surplus notes. One was a \$150 million, 10-year surplus note at an annual interest rate of 6.4 percent. The other was a \$300 million, 30-year surplus note at an annual interest rate of 7.5 percent.

The flurry of surplus note offerings that followed Prudential's action is discussed in my February 1994 issue. Also, the subsequent "reshuffling of capital" through surplus notes issued by insurance companies and purchased by other insurance companies is discussed in the September 1994 issue. By the end of 1994 surplus notes were a heavily used financial instrument. Life insurance companies had issued a total of \$6.6 billion of surplus notes, in contrast to only \$400 million at the end of 1981. Among the many strong life insurance companies that issued large amounts of surplus notes, in addition to the four already mentioned, were General American Life Insurance Company, John Hancock Mutual Life Insurance Company, Mutual Life Insurance Company of New York, National Life Insurance Company (VT), New England Mutual Life Insurance Company, Northwestern National Life Insurance Company, Ohio National Life Insurance Company, Pacific Mutual Life Insurance Company, Principal Mutual Life Insurance Company, Security Life of Denver Insurance Company, and Sun Life Assurance Company of Canada (U.S.).

After the emergence of the surplus note as a popular financial instrument, I began publishing every year in the *Forum* a tabulation of all insurance companies with appreciable amounts of surplus notes outstanding at the end of the previous year. In my final tabulation, in the August 2013 issue, I reported that life insurance companies had \$28 billion of surplus notes outstanding at the end of 2012, or 5 percent of the industry's net worth, and that property insurance companies had \$14 billion of surplus notes outstanding, or 2 percent of the industry's net worth.

Maturities of Surplus Notes

Prudential's first surplus note matured in ten years. Subsequent surplus notes issued by Prudential and other companies had longer maturities, often 20 or 30 years. At the extreme, Liberty Mutual Insurance Company and Lumbermens Mutual Casualty Company issued 100-year surplus notes. In recent years most maturities have not exceeded 30 years.

Ratings of Surplus Notes

Although traditional and intercorporate surplus notes are not rated, investor surplus notes are rated. For a highly rated insurance company, surplus notes usually are rated two notches below the company's financial strength rating. For example, a company with financial strength ratings of AA+ by Standard & Poor's and Aa1 by Moody's Investors Service usually receives ratings of AA- and Aa3 on a surplus note. For a lower-rated company, a surplus note usually is rated at least three notches below the financial strength rating.

The Disasters

In recent years, regulators have found it necessary to take the disastrous step of denying some insurance companies permission to pay interest on surplus notes. One notable case was Lumbermens Mutual Casualty Company, one of the companies that had received permission to issue a 100-year surplus note only a few years earlier. The Lumbermens incident is discussed in the November 2003 issue.

Another notable case was Atlantic Mutual Insurance Company. The company was later taken over by its state insurance regulator. The Atlantic Mutual incident is discussed in the March/April 2007 issue.

Still another notable case was Shenandoah Life Insurance Company, which also had to be taken over by its regulator. Later the regulator arranged for the company to be sold to United Prosperity Life Insurance Company, and an existing \$20 million surplus note became a roadblock to completion of the sale. Ultimately the unfortunate surplus note investors were forced to accept \$4 million in exchange for the \$20 million surplus note, thus taking a \$16 million loss. In other words, the surplus note investors were forced to make a \$16 million uncompensated contribution to Shenandoah on top of the \$60 million United Prosperity paid to acquire the company. The Shenandoah case is discussed in the August 2012 issue.

The Last Holdouts

New York-based Teachers Insurance and Annuity Association of America (TIAA) and Wisconsin-based Northwestern Mutual Life Insurance Company long held top ratings for financial strength. They were the last major holdouts against the tidal wave of surplus note offerings following the 1993 revolution inspired by Prudential. I thought TIAA and Northwestern would never issue surplus notes, but I was wrong.

In December 2009 TIAA issued \$2 billion of 30-year surplus notes at an annual interest rate of 6.85 percent. In March 2010 Northwestern issued \$1.75 billion of 30-year surplus notes at an annual interest rate of 6.063 percent. The net proceeds were for general corporate purposes. The TIAA and Northwestern surplus notes are discussed in the August 2010 issue.

Northwestern has a large field force to which the company had long promoted the absence of debt in its financial statements. Thus the company needed to address the concerns of its field force about the company's massive departure from tradition. A newsletter for the field force contained an edited segment of a conversation between a company executive and

a member of the field force. The executive said the company had an “opportunity” to obtain “access” to net worth, the company had no plans to use the funds for any specific purpose, the company might want to have additional net worth on hand if the economy went through another event similar to what happened in September 2008 through March 2009, interest rates were as low as they probably will go, the company should be able to invest the funds at a rate equal to or higher than the after-tax cost of the funds, it is better to borrow when funds are not needed, and the company concluded that “accessing” the net worth was in the best interest of the policyholders.

I am not persuaded. Surplus notes are tempting because they increase net worth and enjoy income tax advantages. However, they are also addictive. There can be no assurance that the company will be able to keep the funds invested at an interest rate higher than the company is paying for the funds, there can be no assurance that the company will be able to refinance the surplus notes at maturity on favorable terms, and repaying the borrowed money will decrease the company’s net worth.

In September 2014 TIAA issued another \$2 billion of surplus notes: \$1.65 billion of 30-year surplus notes at an annual interest rate of 4.90 percent and \$350 million of 40-year surplus notes at an annual fixed-to-floating interest rate of 4.375 percent. The net proceeds of the new surplus notes were for general corporate purposes and to fund a portion of the cost of acquiring Nuveen Investments, Inc., a diversified investment management company, for \$6.25 billion. Moody’s responded by lowering its Aaa top rating of TIAA one notch to Aa1. A. M. Best, Fitch Ratings, and Standard & Poor’s did not lower their ratings of TIAA. I wrote about TIAA’s new issuance of surplus notes in blog no. 68 (September 22, 2014).

My Watch Lists

As discussed in chapter 22, for many years I published in the special ratings issues watch lists of life insurance companies with a vulnerable financial strength rating from at least one major rating firm. I also included in the watch lists each

company whose surplus notes were large relative to the company's total adjusted capital. (Total adjusted capital, which is similar to net worth, is discussed in chapter 31.) In the September 2013 special ratings issue, for example, I showed 26 companies whose ratios of surplus notes to total adjusted capital were at least 50 percent.

The Bottom Line

Those responsible for issuing surplus notes are insurance company executives who decide to issue the surplus notes and state insurance regulators who grant permission to issue the surplus notes. Those executives and regulators will be long gone when the consequences of issuing the surplus notes will have to be faced, especially where maturity dates are more than ten years in the future. Thus surplus notes are a classic example of a WWNBA transaction: We Will Not Be Around.

Issues and a Blog Item Mentioned in This Chapter

February 1994, September 1994, November 2003, March/April 2007, August 2010, August 2012, August 2013, and September 2013, and blog no. 68 (September 22, 2014).