Different Floors, Different Ceilings

By Kerry Pechter *Sun, Feb 3, 2013*

MetLife and Allianz Life have applied for SEC approval of annuity contracts that offer risk-return trade-offs similar to AXA Equitable Life's successful Structured Capital Strategies product.

Investors who seek both upside potential and downside protection on their tax-deferred savings can now find several types of annuity contracts to help them do precisely that. And the number of available choices appears to be growing.

Fixed index annuities, of course, preserve principal (if held long enough) while offering a taste of equity-linked gains during bullish markets. More recently, a spate of variable annuities has appeared that include performance-smoothing managed-volatility funds.

For investors who seek a different balance of risk and reward, there's a third possibility: Structured annuities where investors can increase their upside potential by sharing the downside risk with the product issuer.

The first product in this category was AXA Equitable Life's Structured Capital Strategies variable and index-linked deferred annuity. Launched in late 2010, the product features a design and a value proposition that initially baffled regulators when it was first submitted for approval.

For instance, a high-level SEC staff attorney said during a Practicing Law Institute meeting in New York last month that the new contract puzzled him on first reading. An AXA securities lawyer conceded at the same meeting that the SEC review process for the product took seven or eight months. "The terminology was new," the attorney said. "We wanted to call it Protected Capital Strategies but the SEC said no."

Sincerest form of flattery

What was so new about it? Structured Capital Strategies has an index-linked crediting method where gains are tied to the increases in several optional indices, up to a certain cap, over a one-year, three-year or five-year term. It can offer more generous caps than, say, index annuities in part because the issuer doesn't guarantee zero loss of principal.

Instead, the investor assumes the so-called tail risk by agreeing to absorb losses beyond a chosen downside buffer (-10% for one year, up to -20% over three years, or up to -30% over five years). In 2012, a year when rising equity markets made protection more costly than helpful, Structured Capital Strategies owners were in a position to earn more than most owners of managed volatility funds and much more than indexed annuity owners.

"We like the simplicity of the product," said Kevin Kennedy, head of new business for AXA Equitable's Retirement Savings division. "Traditional variable annuities solve a need but they're subject to the three Cs: cost, complexity and commitment. The nice thing about this product is that the costs are embedded in the caps, so there's no additional cost. It's simpler than traditional VAs: You just choose the index you want, the maturity and the amount of downside protection. And the commitment is as little as one year."

Last June, after about 18 months on the market, sales of Structured Capital Strategies surpassed the $1 billion mark. At least two other life insurers—MetLife and Allianz Life—have flattered AXA by filing prospectuses for SEC approval of more or less similar products. Bear in mind that these are all *contracts*—assets that are index-linked are not held in separate accounts (though assets in optional variable strategies are). The index-linked credits come from the issuers' investments in options and are backed purely by the claims-paying abilities of the issuers.

Flex Market Shield

MetLife Insurance Company of Connecticut filed a Form S-3 prospectus early this year for a proposed Flex Market Shield single premium deferred annuity. Where AXA's Structured Capital Strategies offers three downside buffer options, MetLife offers four "shields."

MetLife customers can take either a little risk or a lot. Pending SEC approval, owners of Flex Market Shield will be able to protect themselves from accumulated losses of up to 10%, 15%, 25% or even 100% over either a one-year, three-year or six-year term.

On the upside, owners can choose either a predictable "step rate" of return (credited only if the performance of the chosen index is equal or greater than zero) or opt for whatever net gain (up to a cap) the index achieved between the beginning and end of the chosen term.

Given the gaps in the current filing, it's difficult to evaluate this product yet. MetLife's preliminary prospectus did not name the indexes that contract owners would be able to tie their investments to. But it did say that there would be a choice among several securities indices and at least one commodity index.

The cap rates were not specified and, characteristically for this type of product, will not be fixed until the purchase date. The minimum purchase premium is $25,000 and the penalty in the first year of the six-year surrender period is 9%.

Index Advantage

On January 3, Allianz Life filed an N-4 form for a flexible premium deferred variable and index-linked annuity called Index Advantage. Contract owners can choose between three strategies, a conventional variable annuity strategy or either of two indexed strategies, the Index Protection Strategy or the Index Performance Strategy.

The Protection Strategy works like a traditional fixed indexed annuity. The contract owner is protected against loss of principal. The credited gains are tied to increases in the S&P 500 Index, up to a cap that's fixed at the time of purchase, depending on market conditions.

The second, or Performance Strategy, resembles the AXA and MetLife index-lined strategies described above. The credits are determined by gains in the S&P 500, the Russell 2000 Index or the NASDAQ 100 Index. For either strategy, there's a six-year surrender period with a maximum withdrawal charge of 8.5%.

Unlike the AXA or MetLife products, the Index Advantage doesn't appear to have fixed term options or fixed buffer options. Instead, it appears that Allianz Life will reset the caps and the buffer at the commencement of the contract and on every contract anniversary.

Competition welcomed

According to AXA Equitable's Kennedy, Structured Capital Strategies has sold well both to yield-starved fixed income investors and to cautious equity investors. "The B share is still the best-selling share class, mainly to financial planners, and sales in the bank channel run a close second," he told *RIJ* last week.

"In the banks you see more of the five-year product being sold, mainly as an alternative to fixed income products for people looking for better returns than they can get from a CD or money market fund. On the planner side, a lot of people are using our one-year product. It's for the equity investor who says, 'Why not protect my downside this year?'"

Although all annuities come with guaranteed payout options, AXA doesn't see Structured Capital Strategies as an income product. "We see it as a gateway to an income product," he said. You buy this today and use it as a capital appreciation product. And maybe in five years you have some growth and you move to an income type product." (For SCS index choices, see fact sheet.)

Structured Capital Strategies was a brainchild of necessity in the aftermath of the financial crisis. AXA sought to maintain sales volume without adding to the risk already incumbent in its large variable annuity book. AXA calculated a way to afford to offer clients higher caps by capping its *own* downside exposure and relying on the client to assume losses that exceeded their chosen buffer.

"We looked at a bunch of different alternatives, and asked, 'How do we give clients an upside that's attractive?' If you look at indexed annuities right now, the caps are down so low. That's because the cost of full protection against loss is so high right now," Kennedy said.

AXA also figured that advisors would not object to the tail risk exposure if wholesalers explained that such exposures were, historically, quite rare. Over the past 324 rolling five-year periods, he said, "the market was down more than 30% only once. If you can give people 99.7% certainty, that's a robust offer."

As for the prospect of competition from MetLife and Allianz Life, Kennedy welcomed it. "The category makes a lot of sense," he told *RIJ*. "We were the only player initially, and it's hard to be first sometimes. We think it's great that competitors are coming in because they help validate the product."

© 2013 RIJ Publishing LLC. All rights reserved.