A Guide to

Discretionary Mutuals

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What are they?

Used in Australia for many years, discretionary mutuals are an acceptable form of alternative risk transfer for large corporate groups and local government authorities. They can be used for a myriad of risks including property, liability, medical, as well as accident and health.

Discretionary protection is similar to insurance because both offer protection against a certain event or risk (for example, damage to crops from hail). However, the key difference is:

- Under an insurance policy, the protected person (the insured) has the contractual right to have their claim paid (if the claim meets all the policy terms and conditions);
- Under a discretionary risk product, the protected person has the right to have their claim considered and for a decision to be made about paying the claim (the exercise of discretion).

Why use them?

By the people, for the people

Discretionary mutuals are usually set up by industry or professional groups, or by businesses or corporate groups, to cover common or similar property and liability risks.

This is because:

- Discretion to pay claims is often exercised by people with industry experience, who may be sympathetic to the person making a claim;
- Discretionary risk products can be tailored by the mutual to provide industry-specific coverage quickly and easily, and may provide more extensive benefits than would be available from the traditional insurance market;
- Mutuals are often able to influence the risk management behaviour of their members in a positive way; and
- Depending on the membership size, the board may be able to consult the mutual members before they make a decision or have members sit on the board.

Increasingly, mutuals are being used for 'hard to place' risks or uninsurable risks, or to improve the buying power of particular groups such as:

- Industry participants who are not able to obtain insurance for their risks (for example, farmers in the agricultural industry);
- Buying groups who are being charged high premiums but can demonstrate a low loss ratio and good claims history;
- Buying groups with the technology to assess their risk and develop innovative and responsive products (which the traditional insurance market may be slow to embrace);
- Buying groups who are eager to manage their liability on a community basis and support their participants; or
- Government or large corporate groups who want a high level of control over their protection and the ability to customise their program by increasing discretionary layers and decreasing insurance and changing this from year to year to take advantage of the insurance cycle.

In June 2021, the Australian Small Business & Family Enterprise Ombudsman commenced a review of discretionary mutual funds in the context of feedback from the Australian Amusement, Leisure and Recreation Association (**AALARA**) on behalf of its members - many of which faced imminent closure without adequate insurance coverage.

The Ombudsman independently examined AALARA's proposal to establish an industry-owned and operated discretionary mutual fund as the most effective and durable solution to the sector's insurance crisis. In December 2021, the Ombudsman handed down his report[1] endorsing the proposal to establish a discretionary mutual fund as the only current workable solution to the immediate need for coverage in the sector. This was driven by the increasing crisis for that industry in securing appropriate insurance from the insurance market. Essentially, insurers did not have the appetite to provide public liability insurance to many of the operators in Australia.

It is likely that more stakeholder groups with 'hard-to-place' insurance risks will explore the merits of using a discretionary mutual to protect their sector and to ensure the commercial viability of their industry.

Some commercial businesses also use discretionary mutuals to protect their customers and to offer highly tailored or innovative risk protection products.

[1] 'The Show Must Go On' Report
<https://www.asbfeo.gov.au/policy-advocacy/reports/discretionary-mutual-fund-review>

Why use them?

As an Insurance Alternative

Discretionary mutuals can be a viable alternative because:

- Discretionary mutuals are generally simpler and less expensive to set up and capitalise, and have a lower tax burden than an insurance company or captive;
- The discretionary power means that the mutual can manage its exposures in terms of structuring the program to maximise its buying power for excess of loss and stop loss/reinsurance;
- There are tax advantages because GST is payable but income tax and insurance taxes like stamp duty are not; and
- Mutuals can raise equity by issuing Mutual Capital Instruments (which are similar to shares) to investors.

This model is also popular because it is more flexible and allows for innovation:

- The mutual doesn't have to be fully funded: claims can be partly paid, or even completely denied, due to lack of funds.
- The mutual can arrange alternative payment methods: for example, Aussie Farmers Mutual, a mutual covering multi-peril crop risks for Australian farmers, allows contributions to be paid partly in cash and partly by way of grain contracts.
- A discretionary mutual can utilise a number of other innovative solutions, e.g. the discretionary mutual may have a parametric trigger and payment structure providing a truly bespoke product for its members.

As an alternative to insurance, discretionary mutuals are often overshadowed by captives and other offshore arrangements. However, they are a worthwhile alternative to purchasing insurance from traditional markets in Australia and overseas or using a captive – especially if the insurance buyer is being charged high premiums but can demonstrate a low loss ratio.

A well-capitalised mutual will use a combination of discretionary protection and insurance funded by member contributions. Discretionary mutuals will only be a credible alternative to insurance if they are well-funded, i.e. the aggregate liability of the fund is capped and supported by an 'excess of loss insurance' program. This effectively reinsures the exposure of the mutual to a high volume and high value of claims which could wipe out the retained aggregate in any one year.

Contributions collected from the buying group must meet the costs of claims up to the aggregate level plus the cost of excess of loss insurance. This should be fully investigated before establishing a mutual and invariably this will involve an actuarial analysis to set the pricing.

Are they lawful?

Discretionary mutuals are not the same as insurance companies and are not subject to regulation under the Insurance Act 1973 (Cth).

The key difference between insurance and discretionary protection is that:

- An insurance policyholder has an absolute contractual right to have their claim paid if it is covered under the terms and conditions of the insurance policy.
- A person protected by a discretionary mutual has the right to have their claim considered and for a decision to be made about the exercise their discretion - either in favour or against the payment of a claim.

Both products offer a legitimate way of protecting someone against the occurrence of an event or risk.

Discretionary protection is recognised by case law as a valid legal alternative to insurance.[2]

Although it is not necessary to have an insurance licence from the Australian Prudential Regulation Authority to issue or offer discretionary risk products, because discretionary risk products are a facility for managing financial risk, they are regulated as financial products under Chapter 7 of the *Corporations Act 2001* (Cth). In most cases, this means an Australian financial services (AFS) licence will be required.

Mutual Structures

Discretionary protection businesses can use a number of different structures.

Company

A public company limited by guarantee is useful where membership will be offered to the same group of people. Instead of issuing shares, members apply for membership. Their rights are contained in a Constitution and/or a set of Rules.

This structure is particularly efficient where the group membership will not change regularly or if the mutual is being operated by a not-for-profit entity. There can also be taxation advantages to structuring the mutual in this way due to the operation of the principles of mutuality.

However, there is considerably more administration involved in this structure than through the structures commonly used by commercial enterprises.

Typically, the directors at Board level have the discretion to decide whether a claim will be paid. They must follow the guidelines in the Constitution and/or Rules when exercising the discretion.

Rules are not necessary if the Constitution sets out the terms on which members can access the discretionary protection. The advantage of having these terms in separate Rules is that they can be changed more easily than a Constitution.

Other Structures

Unit or discretionary trust or proprietary limited company structures are more commonly used by commercial discretionary risk product providers as there is no need for their customers to have ownership.

[2]Medical Defence Union Ltd v Department of Trade [1980] 1 CH 82. This English case was confirmed and considered in the Australian decisions of Bailey v Medical Defence Union (1995) 184 CLR 399 and The Barclay MIS Group of Companies v ASIC [2002] FCAT 606.

Regulatory requirements

The establishment costs for a discretionary mutual can be significant so it is not a short-term alternative, and it requires absolute commitment from the buying group.

Because discretionary mutuals require an AFS licence to advise on and deal in miscellaneous risk products, it is important to assess whether the buying group could successfully apply for an AFS licence or will need to partner with a professional mutual manager that has its own AFS licence.

If the discretionary mutual takes the structure of a managed investment scheme, it may be necessary to seek ASIC relief to avoid further regulation under Chapter 5C of the Corporations Act 2001 (Cth). Regardless of the structure, an AFS licence is required. Discretionary mutuals offer a regulated financial product and the product issuer must have a 'miscellaneous financial risk product' authorisation on their AFS licence. It is possible to employ a professional mutual manager who has the expertise and skills to manage the mutual for the buying group and the appropriate licence authorisation.

Regardless of whether the members of the buying group are 'retail' or 'wholesale' clients, a Product Disclosure Statement and Target Market Determination will be required.[3]

A feasibility study is important prior to establishment because this is a long-term solution for buying groups and needs to operate for 5 to 10 years for the true benefit to be experienced by the group.

Establishment costs in the first year of operation can be substantial, but maintenance of compliance requirements is substantially less after the first year.

Tax advantages

A different tax treatment applies to discretionary mutuals than in relation to insurance contracts or insurance companies. GST is payable on member contributions, but no stamp duty or emergency services levy applies to contributions paid by member to the mutual (if insurance is not offered to members).

Importantly, the Australian Tax Office has confirmed that it treats the mutual's income from contributions paid by members as tax exempt and not included in the mutual's assessable income.[4] Tax advice at the time of establishment is recommended.

Mutuals as an investment vehicle

Mutuals, including those structured as a company limited by guarantee, that meet certain criteria have the ability to raise equity by issuing Mutual Capital Instruments (MCIs) to investors. Upon receipt of MCIs, investors are entitled to dividends and other distributions (subject to the terms of the Constitution) while holding limited voting rights.

MCIs are ideal for small mutuals focusing on larger sophisticated and wholesale investors who can use MCIs as a less onerous way of raising capital than other alternatives such as crowdfunding, provided that investors are open to a different form of investment that has different rights attached.

The Constitution will need to be drafted so it meets the legal requirements for the mutual to validly issue MCIs.

[3]Regulation 7.9.07CA of the *Corporations Regulations 2001* (Cth).

[4]ATO ID: Income tax: application of section 121 of the Income Tax Assessment Act 1936 to a mutual discretionary fund (ATO ID 2005/98).

Conclusion

The regulatory requirements attached to establishing a discretionary mutual can be very complex and time consuming, but this can be minimised to a degree by partnering with a professional mutual manager and seeking out the expertise and skills of an insurance broker who can place an appropriate insurance program.

Discretionary mutuals take time and are not an option for the faint-hearted. This is a long-term strategy to protecting a buying group - not a quick fix in response to higher premiums in any one policy year.

The benefits do outweigh the costs if the mutual is operated for a long term (5 to 10+ years at a minimum) and the mutual is able to influence the risk management behaviours of the insurance buying group in a positive way. It can also over time offer more extensive benefits to members than would be available from the traditional insurance market.

Discretion exercised in the right hands with the right resources and expertise can be a very effective risk transfer option for buying groups with a vested interest in managing their risk and supporting their buying group - not simply paying premiums.

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