

# DISCRETIONARY MUTUALS.

Here's an explanation of why discretionary mutuals are an attractive alternative to insurance.

## 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.

## WHY USE THEM?

As an alternative to insurance, they are often overshadowed by captives and other offshore arrangements. However they are a worthwhile alternative to purchasing insurance from traditional markets here 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 'fully funded', i.e. the aggregate liability of the fund is capped and supported by an 'excess of loss insurance' programme. This effectively reinsures the exposure of the mutual to high volume and high value of claims which could wipe out the retained aggregate in any one year.

However, it does mean that the contributions collected from the buying group must meet the costs of claims up to the aggregate level plus the

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cost of excess of loss insurance. This should be fully investigated before establishing a mutual.

## 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 on the one hand and discretionary protection on the other 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 'insurable' event or risk.

Discretionary protection is recognised by case law as a valid legal alternative to insurance.<sup>1</sup>

Although it is not necessary to have an insurance licence from the Australian Prudential Regulation Authority, because a discretionary mutuals are a facility for managing financial risk, they are regulated as a financial product under Chapter 7

<sup>1</sup> *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



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.

### Member Mutuals

A company limited by guarantee structure is useful where membership is to 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.

### Commercial Mutuals

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.

## 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.

*Regardless of the structure, an Australian financial services licence is required.*

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*.

The buying group will need a senior manager who has managed discretionary mutuals in the past, who can be appointed as a 'Responsible Manager'.

Regardless of whether the members of the buying group are 'retail' or 'wholesale' clients, a Product Disclosure Statement will be required<sup>2</sup>.

## TAX ADVANTAGES

A different tax treatment applies to discretionary mutuals than in relation to insurance contracts or insurance companies. The Australian Taxation Office and the Actuaries Institute have published numerous resources.

Most importantly, the Australian Tax Office (ATO) has confirmed that it treats the mutual's income from contributions paid by members as tax exempt

<sup>2</sup> Regulation 7.9.07CA of the *Corporations Regulations 2001* (Cth).



and not included in the mutual's assessable income<sup>3</sup>.

### MUTUAL CAPITAL INSTRUMENTS

Mutuals, including those structured as a company limited by guarantee, who 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.

### IN 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.

However, the benefits do outweigh the costs if the mutual is operated for a long term (5-10 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.

*This is long-term strategy to insurance for a buying group - not a quick fix in response to higher premiums in any one policy year.*

## CAN WE HELP YOU.

The Fold Legal provides specialist legal and regulatory advice to financial services businesses, and has particular expertise in advising on and establishing discretionary mutuals.

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If you'd like our help, get in touch:

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<sup>3</sup> ATO ID: Income tax: application of section 121 of the Income Tax Assessment Act 1936 to a mutual discretionary fund (ATO ID 2005/98).