ARE DMFS THE ANSWER WHEN INSURANCE ISN'T?

PFS CONSULTING

FORESIGHT INSIGHT OVERSIGHT

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With insurance capacity and affordability becoming increasingly problematic in a number of classes of insurance, DMFs are once again being turned to - to provide a solution where insurance is failing.

However these structures can be controversial and not all DMFs are created equal.

WHAT IS A DISCRETIONARY MUTUAL FUND (DMF)?

DMFs are a form of Managed Investment Scheme (MIS) that issue Discretionary Risk Products (DRPs). These can look like insurance, and are designed to substitute or compete against insurance products.

There are licensed banking and insurance mutuals which are not DMFs - it is the legal requirement for the Board (or Trustees) to apply discretion to decision-making that sets the DMF apart.

While DRPs are often designed to look like insurance products, when challenged, Australian courts have routinely determined that laws relating to insurance products do not apply to DRPs.

For a period, APRA considered DMFs important enough to investigate and collect data on, however that was abandoned toward the end of 2016.

WHY THE CONTROVERSY?

DMFs have been entangled in a range of Australian class actions, including against the funds themselves or the service providers and Trustees around them.

DMFs require the application of discretion which can always lead to controversial outcomes. Lawyers have become emboldened to challenge outcomes and the bespoke nature of many DMFs make them a target for legal challenge.

Is discretion a problem?
DMFs can provide a solution where the insurance market has failed, so they are often not perceived as a problem.

Some DMFs have governance structures that lead to controversy. eg. An APRA-licensed insurer would not be able to outsource its management, risk management, investment management, pricing, claims handling and reinsurance broking to the same entity, as some large DMFs do. Such arrangements would likely fail APRAs (independence) requirements under CPG110, CPS220, CPS 231, CPS 320 and CPS 510.

DMFs have also been reviewed by Auditors General in Victoria and South Australia. The Victorian Auditor General stated that there were:

> *"concerns with the governance, financial sustainability and management of the state's local government mutual insurance scheme."*

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WHAT DO DMFS DO?

DMFs are different to mutuals - including across banking and insurance, which are APRA regulated.

DMFs have a lot of flexibility to structure their Governing Deeds as they see fit (and members will agree to). Generally, a manager is appointed to run the DMF similar to an insurer and 'in the spirit of APRA'. In many cases this flexibility is what makes them a solution when there is insurance market failure, but it is also the source of most controversy.

Running 'like an insurer' typically means issuing a DRP, maintaining sufficient funds to then pay out claims requests (at the discretion of the Board), managing investments, appointing a fund manager and calculating contributions.

DMFs also often utilise offshore captives, giving reinsurers a pathway to access direct business without the need for a fronting insurer.

WHEN DO DMFS WORK WELL?

Due to the requirement for the Board or Trustee to apply discretion, DMFs work best when there is a high degree of trust between all parties involved.

As they also involve mutual pooling of risk, respect for the risk management practices of other members is important.

DMFs tend to be much faster to set up than obtaining an insurance license (some DMF structures are now available 'off the shelf'). They are good at responding to a market failure or crisis, where timing is important.

There are well-functioning DMFs proving risk solutions across the university sector as well as all levels of government, and they suit groups of like-minded entities with similar risks such as professions, trades or religious organisations.

They've been able to provide solutions to gaps in compulsory classes of insurance which enable industries or government to continue to operate when they would not otherwise be able to.

CASE STUDY

A Western Sydney children's soccer club has noticed that its liability premium has been increasing for a few years despite never having had a claim. One of the parents involved in running the club has a background in insurance and has made sure that the policies in place have been followed and monitored more closely in the last few years. Despite this, their insurance broker tells them that other clubs have had claims issues and insurers are withdrawing cover or putting prices up for all clubs. This year, they're facing a 200% increase on their insurance costs which they can't afford. Their broker is finding it hard to get quotes from other insurers.

With solid existing risk management practices in place, the club might be interested in 'owning its risk' by setting up a DMF with like-minded clubs that it trusts. If contributions into the DMF prove more than needed for claims requests, they can return the surplus to members, who then have a direct interest in managing their risks to minimise the overall claims activity of the DMF.

GOVERNANCE AND REGULATION

There is limited regulation of DMF's. Governance requirements are typically only broadly described in the Governing Deed or (more recently) a Constitution.

Toward the end of 2021, the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) released "the Show Must Go On", a report focusing on whether a DMF was the solution to a public liability insurance crises focusing on Australia's amusement, leisure and recreation industry. In it the Hon Bruce Bilson states:

"Operating a DMF is not easy. It requires exceptional governance practices, including ensuring an appropriate balance of member representation with independent directors and specialist expertise."

He further expands in relation to regulation of DMFs:

"DMFs are subject to significantly less regulation than traditional insurance, however they do operate with a degree of regulation, with the requirement of an Australian Financial Services Licence (AFSL) to be held by the manager."

AFS Licensees have several obligations, relating to:

- conduct and disclosure
- training and competence
- compliance
- managing conflicts of interest
- risk management

(among others)

Toward the end of 2022, the Business Council of Co-operatives and Mutuals (BCCM) issued a discretionary mutual Code of Conduct, however adherence remains optional and to date only a few DMFs have signed up to follow it.

DMFS IN A NUTSHELL

FEATURES

DRPs look a lot like an insurance contract, however there is NO enforceable contract, therefore:

- Members pay contributions rather than premiums
- Members make a request rather than a claim
- Members are typically issued a Certificate or Protection rather than a Certificate of Currency

DMFs are not regulated by APRA, nor does the Insurance Contracts Act apply to DRPs.

Discretionary coverage can be accepted by financiers or to fulfil legal requirements for risk protection coverage.

DMF manager does not owe a fiduciary duty to members.

Suit groups of aligned members seeking to solve common problems – eg. Universities (Uni-mutual), Councils, Takaful, Industry associations, Professional Standards Schemes.

MEMBER BENEFITS

Allow members to group together and take ownership of their own risk.

Member owned, so excess premiums or beneficial claims outcomes can flow back to Members (or alternatively to advisors & brokers in the form of high fees).

Currently avoid ESL (NSW) & Stamp Duty.

Avoid APRA regulatory and compliance costs although many chose to run in the spirit of APRA.

Can be structured to access reinsurance markets much like a captive or by utilising captives

BEST PRACTICE

Best practice and requirements for a DMF to succeed can include:

- ensuring an appropriate structure focused on one suitable for providing good governance over a longer period, and the ability to raise capital when required.
- operating with sufficient surplus.
- sound governance processes that utilise an appropriate balance of member, management and independent expertise and build trust.
- have appropriate risk management practices in place and ensure members understand that in the long term they own the DMF and hence the risk they are transferring to it.

POTENTIAL FOR FURTHER CONTROVERSY

Without regulation there are a number of features of some DMFs which may continue to court controversy, these include:

- The stakes are getting bigger - more DMF's likely, expansion of the ARPC
- Auditor general reports
- Potential for appeal against court findings
- Confusion over roles and responsibilities vs insurance
- Role for Codes of Conduct and questions over their enforcement - eg. BCCM
- Ability to raise capital through Mutual Capital Instruments (MCIs), creating a new class of stakeholders
- Fees for services
- ESL and Stamp Duty exempt
- Many are unlikely to be required to have competitive tendering of services
- Potential for confusion over roles when a single entity is fulfilling multiple functions

ARE DMFS THE ANSWER?

DMFs can continue to be part of the solution when insurance fails, but it is critical that they engender trust from all stakeholders, and stay focused on governance best practice. They need high quality external advice and clear factual messaging to members.

ABOUT PFS

PFS' Principals and employees have deep experience in the regulatory space, with a number having worked for APRA or global insurance regulatory organisations as well as managing large insurance demutualisations. We have been involved in the set up and licensing of insurance companies globally, as well as working with DMFs in Australia. We have advised a number of global insurance regulators regarding their regulatory frameworks.

During 2015 and 2016 we undertook detailed reviews of some of the larger DMFs in Australia and have independently advised their members. We continue to advise existing DMFs.

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