ALTERNATE RISK FINANCING

DISCRETIONARY MUTUAL FUNDS

Understanding DMFs
DMF Structure & Benefits

A Discretionary Mutual Fund (DMF) is a financial vehicle for the management of risk.

It is important to note DMFs are not insurance[1]. A DMF is therefore an *alternate risk financing* strategy.

DMFs are established by companies or associations with a common business purpose. For mutuality more than one entity/person is required; these entities /people become members' of the DMF.

DMF members' contribute funds to create an Aggregate, which is utilised to manage the primary layer of risk. This capital is often reallocated from insurance purchase to the DMF.

Above the Aggregate, Excess of Loss (XOL) insurance is utilised to provide catastrophic loss protection and cap members' liability at the Aggregate.

For administrative simplicity DMFs utilise a company limited by guarantee. The company will have a board of directors' in which the DMF members', with intimate working knowledge of the business and industry, have majority representation. DMFs are therefore "owned" [2] and run by members' for members' benefit.

As funds are administered for the benefit of members' there is a clear relationship between the successful execution of risk improvement strategies, which lowers risk and losses, and the increased financial strength of the DMF, which leads to greater member benefits. DMF benefit dynamics therefore reinforce the value and importance of risk ownership.

1. DMFs do not pass the test of insurance law: Medical Defence Union v Department of Trade [1980] (UK).
2. Members' effectively own DMF funds; they do not "own" the DMF, as company's limited by guarantee do not have shares.

Discretion

The unique feature of DMF risk products that set them apart from insurance is discretion.

An insurance policy promises an indemnity; in contrast a DMF risk product promises a claim for loss will be considered.

DMF risk products have reference to, but are not bound by, the XOL insurance policy.

Ostensibly, the power of discretion rests in the hands of members' on the DMF board. The board has sole and absolute discretion over all claims for loss. Discretion therefore provides the board with the flexibility to respond in situations where an insurance policy cannot.

Hard To Place Risks

DMFs are a solution for hard to place risks, as members' control the breadth of cover (as they control the DMF). It should be noted that the DMF still needs to purchase Excess of Loss (XOL) insurance, so is still limited by insurer appetite to a degree. With a large retention in the primary layer however, this can make hard to place risks more attractive to Insurers.

Risk Management

DMFs are ideal vehicles within which to promote risk management. As funds belong to members' it is our experience that DMFs alter the behaviour of participants, because it is their money. They are then, therefore, more open to risk management strategies as there is a direct financial benefit for them to do so.

Surplus funds from DMF operations can be invested in risk management.

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DMF Structure & Benefits

Control of Risk Funds and DMF Capital Accumulation

The majority of risk funds are transferred to the DMF where control is retained, and the funds work for members'.

Control of risk funds is the key to a DMF risk financing strategy as control enables the capture of two components of insurer profit:

1. Investment returns on risk funds;
2. Underwriting profit in the primary layer.

Retaining risk funds within a DMF leads to capital accumulation. The DMF should aim to grow to a size where the investment return on DMF funds is equal to or greater than all operating expenses. This increases the long term viability of the DMF.

Capital accumulation is offset by surplus fund usage. Surplus funds can be used to:

- Reduce members' contributions in future periods;
- Incentivise risk management and training programs. The goal being to reduce losses and maximise future surpluses;
- Add other risks to the DMF.

These two components lead to a lower cost of risk for members'. Investment returns reduce the administrative cost of the DMF, while surplus funds are generally applied to lower the cost of risk financing and risk control/improvement.

The DMF board must strike a balance between maintaining the financial strength of the fund and ensuring surplus funds are utilised to benefit members'.

Note, a DMF is a vehicle for the management of risk, it is not an investment vehicle per se.

Economies of Scale

Aggregating both risk and risk funds from members' creates economies of scale, increasing the bargaining and buying power of the member group.

Tax Effective

Member contributions are not taxed on entry or exit from the fund[3].

Investment revenue is taxed at the company rate. However the effective tax rate will be lower if investment revenue contains fully franked dividends and deductible expenses are paid from investment revenue.

DMF products are not insurance and therefore statutory charges do not apply. In some states this can add fifty percent (50%) to the cost of insurance.

Risk Control & Improvements

As discussed, the structure of a DMF encourages risk ownership and enhances the effectiveness of risk control and improvement strategies.

3. The mutuality tax principle was restored in 2005: http://assistant.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2005/046.htm&min=mtb

Understanding DMFs
Prudential Management

Fidelity Guarantee Insurance

Purchased to provide fidelity cover – employee theft/dishonesty – for DMF funds.

Investments

The investment manager appointed by the board must comply with the board mandated investment policy which for funds at risk in the aggregate is typically conservative and risk averse. They therefore carry little to no investment risk.

DMF Structure

All DMFs we establish are "non-call" and aligned with the Federal Governments current position. This means that the DMF has no "right" to make a call on members and XOL insurance is utilised above the DMF aggregate.

Contingent Risk

In years where the DMF runs a surplus and risks within the DMF give rise to long-tail liabilities, this contingent risk must be carefully managed.

Often contingent risk expires at the end of a statutory period. There are a number of ways to manage contingent risk.

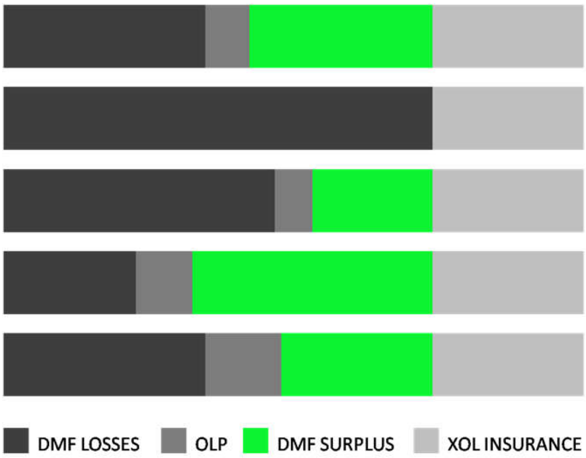
Full Reserve: Leave all surplus funds in the DMF and in conservative risk averse financial instruments until the statutory period has expired.

Actuarial Reserve: An actuary calculates outstanding loss provisions [OLP] at the end of each period. OLP's are risk estimates. OLP reserves are created based on the actuary's projection.

The DMF actuary utilises insurance methodology to calculate the OLPs for two reasons:

1. It aligns with Insurers;
2. It assists negotiation with the XOL and portfolio transfer insurers'.

Risk Transfer: Transfer the portfolio of contingent risk to an insurer.



This graph illustrates DMF aggregates for a five year period.

The portfolio of risk for transfer is the sum of all surpluses. Note the actual surplus is all funds above the outstanding loss provisions. On an actuarially expected basis these funds are not required for the payment of losses, however a contingent risk still exists.

It is prudent for the DMF board to consider a portfolio transfer to "free" these funds from contingent risk.

Understanding DMFs
Compliance, Risks and Regulation

Compliance

DMFs should operate with an Australian Financial Services License (AFSL). When establishing a DMF there are two options: apply for a new license, or utilise an existing license.

There is an increased focus on AFSL applications and the qualifications of the persons nominated as Responsible Managers'. To obtain an AFSL you must have the requisite expertise, and, as DMFs are a niche product, this expertise is in limited supply.

Licensing and DMF management are therefore barriers for organisations or associations considering a DMF.

Licensing can occur by way of an Intermediary Authorisation (s911A(2)(b) of the Corporations Act), provide the licensing for DMFs we design and implement and provide our expertise to as DMF managers.

Risks

Not all companies and associations will suit a DMF. The following factors should be considered on a preliminary basis:

- Nature of risk
- Claims history
- Intended DMF members
- Is there unity in business purpose and risk profile?
- Current total cost of risk

The risks of a DMF are mitigated by an in-depth up-front feasibility study.

Regulation

A DMF formed as a company limited by guarantee is regulated by ASIC under the Corporations Act. Additionally, various ASIC regulatory guides apply to DMF operations.

The Potts report recommended DMFs be regulated by APRA.

APRA acknowledged they did not have enough information to make an informed decision regarding the regulation of DMFs. As a result, APRA collected basic financial and operational data. The data collection period has ended and no announcements have been made and DMFs are not regulated by APRA.