

Discretionary Mutuals:

an introduction by the Association of Financial Mutuals

At its heart, insurance is a very mutual concept: a group of individuals or entities with a shared opportunity or problem joining together to provide an effective and cost-efficient solution. That was how the sector first become established, and little more than 20 years ago, the majority of the UK insurance sector was still mutual.

Today, mutuals account for around ten per cent of premium income in the UK insurance industry, though this itself marks a recovery from the period immediately before the financial crisis in 2008. During that 20-year period we have seen demutualisations and mergers that have reduced the number of active mutual insurers below a hundred, with significant barriers to entry preventing the development of new traditional mutuals.

The solution to that has been the widening development of the discretionary mutual.

But that is not to infer that discretionary mutuals are new or small-scale: AFM's two largest UK members are discretionary mutuals, and both have been in business over 100 years. To illustrate, the friendly society Benenden, was established in 1905 to support postal workers suffering from tuberculosis. They explain their approach to their 800,000 customers as follows:

“This means that the provision of services is subject to the resources we have available through membership contributions. Furthermore, when members request support we have discretion as to whether we provide assistance and the level of assistance to be provided. We manage our funds and the services we provide carefully to ensure that we can continue to provide assistance to members who require our support.”

The rapid expansion of regulation from the late 1990s onwards accelerated the scale of demutualisation, as ambitious organisations realised regulation was driving a more standardised model, based on the PLC. This included limitations in the way mutuals could grow their capital base, which in turn restricted their capacity to grow.

Part of the attraction of the discretionary model is that the cover provided does not equate to an insurance contract. As a result, the provision of discretionary cover is not a regulated activity under the Financial Services and Markets Act 2000. Hence, the business may not require authorisation by the Financial Conduct Authority, and payments for discretionary protection do not count towards the threshold for inclusion in the Solvency 2 regime, supervised by the Prudential Regulatory Authority, which sets minimum capital requirements.

Discretionary mutuals sit outside the Financial Services Compensation Scheme, which provides an added layer of protection for consumers and small businesses.

From a regulatory perspective therefore a discretionary mutual is significantly lower cost to run, whilst for members, discretionary cover is not subject to Insurance Premium Tax (which is currently levied at 12% of premiums on insurance contracts).

Today there is a wide range of discretionary mutuals in the UK, including those serving retail customers, such as The Military Mutual and Benenden, and those established to serve a defined audience of businesses, such as The Livery Companies Mutual, and mutuals set up within the public sector. Where a discretionary mutual is a member of AFM, it also agrees to abide by the AFM Corporate Governance Code.

A vital facet of a discretionary mutual is that claims are paid at the discretion of the Board. That means that the payment of claims is not contractually guaranteed, but within a mutual organisation, owned by its members- its customers, a claimant can expect a sympathetic response.

Indeed, as the underwriting and claims handling process is not as narrowly defined as to whether a claim meets the contractual obligations, fairness may play a greater part in assessing the validity of the claim. And because the mutual is owned by its customers there is no conflict of interest, as the organisation's sole purpose is to serve its members.

Where the Board appoints a service company to manage the business, the Board can direct decisions on claims, and where the membership is relatively small and uniform in size that will add a professionalised lens to claims handling. Ultimately, if the Board does not consider the service company is providing the standard of service expected, it can address that contractually, or replace the service company.

As well as being less costly to run than a shareholder-owned insurance company, a prominent feature of many discretionary mutuals is that the contributions paid by members create a pool of member funds. This may be drawn on to return contributions to members, invest in new products and services, or to support a short-term adverse claims experience.

Many **fully discretionary mutuals** rake the risk on expected claims up to a certain amount (the 'retention'), and have their own 'stop loss' insurance to cover an unexpected number of agreed claims within the retention, and 'excess of loss' insurance to cover agreed claims above the retention.

A **hybrid discretionary mutual** is a further evolution, where the mutual still takes the risk on agreed claims within the retention and has its own stop loss insurance, but arranges an insurance contract in the names of the members with a large excess to cover agreed claims above the retention.

In both cases, this means the mutual protects itself against a particular adverse claim resulting in significant losses, and against a large number of smaller claims.