

Submission on “ Improving the Integrity of Prescribed Private Funds (PPF’s)”
From Annie and John Paterson Foundation

This Submission addresses 4 sections of the discussion paper ;

- 1(a) Future Mandated Distribution Rates
- 1(b) Issues re Mark to Market Valuations
- 1(c) Minimum Sizes for PPF’s
- 1(d) Privacy Issues re public disclosure of PPF contact details

1(a) Future Mandated Distribution Rate

Any discussion of the future desirable distribution rate is by necessity linked to the likely rate of return a PPF can achieve on its corpus in a financially prudent manner . We are fortunate that the Australian Federal Government’s Finance and Treasury Departments have undertaken some very robust research in this area assisted by , arguably , the very best asset consultants in the world. In 2006/07 in response to the formation of Australia’s Future Fund these studies came to the conclusion that a realistic return from the Future Fund’s Portfolio will be 4.5-5.5% real over the long term (generally defined as minimum rolling 10 year periods) in an inflationary environment assumed to have an average 2.5% inflation rate ie producing nominal returns of 7.0-8.0% per annum. One must remember that this target return for the Future Fund will exceed the majority of PPF’s as :

- (1) The Future Fund has massive scale which consequently delivers economies of scale in costs incurred and bargaining power in investment management fees paid.
- (2) It’s standing will give it preferred status allowing it to participate in many investment opportunities not accessible to most investors.
- (3) It has a strongly qualified Board and access to the best consultants in the world
- (4) It is mostly likely to have no withdrawal of funds until 2020 . So illiquid assets that deliver excess returns are a proposition available to it but not to most PPF’s .

As a consequence the assumption of a 5% real return for PPF’s is likely to overstate the likely outcomes but in this submission I will use that figure as it has been developed using a very thorough process by Finance/Treasury/ and Asset Consultants and there is no comparable data for PPF’s. The comparisons with Future Fund return expectations are ideal as the Future Fund operates under an almost identical domestic tax regime as PPF’s and charities ie no income tax but receives the cash value of franking credits back from the ATO.

Firstly , I will address the current distribution regime for PPF’s . Currently PPF’s can grow in real terms in the accumulation phase . Thereafter they can sustain the real value of their corpus and consequently their ability to deliver sustained donations in real terms to charities into the future.

The proposition put forward in this Discussion Paper of a 15% mandated distribution rate represents a dramatic change in the philosophy regarding Philanthropy in Australia and the place of PPF’s in expanding the resources available to the

Charitable Sector . If one assumes that PPF's earn a maximum 5% real return over the longer term but have to pay out a mandated 15% per annum in distributions the consequence is that , prior to any further contribution inflows , the PPF sector will shrink by 10% per annum compound. Most PPF's would reach uneconomic size within 10 years of their formation. The previous proposition of a Government encouraging a growing and sustainable private sector contribution to philanthropy embedded in the previous rules would be lost with a 15% distribution rate . This new proposition raises some very relevant issues ;

- (a) Why in the future would an individual consider setting up a PPF knowing that its effective life was likely to be relatively short ?
- (b) Why would anyone set up a PPF whose legacy will be that by necessity it will be remembered as giving a generous donation to a charity in year one and gave it less in every year thereafter as its capital base was eroded ?
- (c) Charities greatly appreciate commitments for periods of say 3 years particularly to ensure new programmes are consistently funded in their early years while they are established . Under the proposed rules this may be possible in year 1 of a PPF's existence but thereafter the continual erosion of its corpus will preclude commitments beyond one year's duration.
- (d) Many PPF's are formed by successful business people in the 45-65 age group when they sell a business or retire after a very successful career . Current rules allow them to have confidence that they can pursue their charitable interests with full energy for the rest of their life . This is of great value to Charities as it brings a high level of skills to the sector on a pro bono basis alongside considerable funding. If the proposed laws had applied and a PPF's existence was doubtful beyond say 10 years I am fairly sure that many PPF's that were formed would not have come into existence .
- (e) Many PPF's are formed as a result of realisation of one large business asset and so there is little capability for the individual to make future donations of anywhere near the scale of 10% per annum to offset the erosion by the mandated high 15% distribution rate.

I will return to the question raised of what is an appropriate distribution rate if we are to move to a simpler and more transparent distribution regime (which is a desirable proposition in itself) . I think a return to the figures developed by Finance and Treasury in regard to their expectations of returns from the Future Fund would be a good guide – 5% per annum ie distributing all real returns but maintaining the real value of the funds future distribution stream. This would also be compatible with encouraging prudent investment policies by PPF's rather than encouraging the temptation to “ stretch “ investment returns to compensate for the erosion of the fund by the mandated very high 15% distribution rate .

It is a relevant question whether the 5% real return target for the Future Fund is realistic in the long term as that organization has only 2 years of investment history . The Government of Singapore Investment Corp. recently celebrated its 25th anniversary and issued some data on its performance over that time . As I understand it their returns were compatible with outcomes of 5% real return over the 25 year period .

If a 15% distribution rate were to be introduced existing PPF's should either have their accumulation and distribution plans which were negotiated in good faith with the ATO , grandfathered , or that a mandated distribution rate of say 5% be applied to them so they are not disadvantaged by a change of ATO rules . If this were not to be the case the ATO's credibility in negotiating with parties in the future would be severely compromised.

Comment on Proposal 1(b) : Mark to Market Valuations.

Mark to market valuations are transparent and unambiguous on regularly traded assets which will normally comprise the majority of PPF assets . While I would be supportive of this proposition there are a few issues to be addressed :

- (1) The issue of non traded asset valuations eg in the current volatile investment environment it is clear that there is a lag of 1-2 years in valuations on illiquid non traded assets behind what has occurred in liquid equity and debt markets.
- (2) One has to be very wary of using a high 15% distribution rate alongside a mark to market regime eg In the last 15 months most equity markets have fallen by around 50% and even high quality fixed interest values have recorded negative returns. If PPF's had been required to distribute 15% of their asset base at the bull market peak their capital base and ability to contribute to the charitable sector in the future would have been greatly diminished in just one year. If a 5% distribution rate was mandated then the effect of market volatility could be ignored . If a 15% distribution rate was to be introduced then a valuation smoothing regime would be desirable over say a period of 3 years to diminish the adverse effects of short term volatility . However that would add complexity to the rules , an issue which you (Treasury) are rightly trying to remove .

Comments on Proposal 1(c) : Minimum Size

The discussion paper is correct in recognising that there are economies of scale which diminish leakage to non charitable expense areas such a administration and so a minimum starting size is desirable and your suggestion of \$500,000 would appear appropriate . However the proposal of a minimum fund size is totally at odds with a 15% distribution rate . A 15% distribution rate would ensure that at any time many PPF's would be in wind down phase with many below \$500,000 of corpus. The correct suggestion , I believe , is a minimum fund size of the order of magnitude you suggest alongside a 5% distribution rate. These two measures would be consistent and compatible with one another.

Comments on Proposal 1(d) : Public Disclosure of Contact Details

This would be an undesirable recommendation for 2 reasons :

- (1) It would encourage heavy use of the PPF contact list by Charities which would in effect become an expensive and unproductive junk mail stream.
- (2) Potentially the PPF Contact names could be bothered by " begging letters " by unfortunate people in our community who would not understand that PPF's couldn't distribute funds to them anyway .

The most desirable outcome would be to encourage PPF's to join a philanthropy industry body such as " Philanthropy Australia " which would assist charities in meeting those PPF's which may normally maintain a low public profile . This would have none of the adverse side effects of a public register of PPF contacts.