From: David L Allen, GPO Box 1865, Sydney, NSW 2001 Mob (0419) 268583, Mathematician, Inventor of Things that Work

To: Bank for International Settlements, Switzerland http://www.bis.org/bcbs/publ/d386.pdf

Ref: *Regulatory treatment of accounting provisions – interim approach and transitional arrangements*

Overview.

It is interesting to see that The Basel people are exploring the option of pressing ahead with their Regulatory program for the world. It is also interesting to see how the word Tax is used and Europeans have a long history of being involved with onerous taxation schemes in countries such as Australia. I am writing this as a private citizen as I believe the Australian Governments are on holiday at the moment.

My Aussie motto is “Benefits for Australasia” and, while it doesn’t deliver much in the way of financial remuneration, it is quite effective in getting results. It is possible that Basel1, 2, 3 or any subsequent Basel proposals may eventually deliver benefits to resource rich countries such as Australia, but current proposals are perhaps not designed that way. I discussed the possible Australian ‘benefits’ of a few European initiatives with a Dutch colleague more than a decade ago and his comment was that it was “too far from his bed to concern him” and that attitude appears to predominate Basel Committees. People tend to focus on their own interests and this is the way human nature works.

Quite a lot has happened in Australia since I sent you a rushed submission after the 2014 G20 meeting in Australia and it is unclear why Basel is focusing on this particular sub-issue at this particular point in time. It is getting very little publicity in the USA, the UK or Australia. Points of interest include:

P1: References to colonial taxes have been superseded by what Europeans are calling ‘a post-colonial period’ although this may be quite inaccurate. Basil II was, of course, famous for his colonial t-axes and your committee may have chosen a most inappropriate name.

P2: Bill Coen and Thomas Pikkety both visited Australia and their ‘advice’ was welcome. We do miss the sophisticated, fact-oriented economic discussions that Europeans enjoy as our discussions tend to focus on point scoring. While we may have ‘learnt’ that we live in a post colonial era and that slavery was abolished quite some time ago, countries such as Australia are expected to pay international taxes for a variety of reasons and some rates may be quite high. As the first joint-statement the current Popes made was about modern slavery, it may sometimes difficult to see where some international experts get their facts from. We recently heard some ‘interesting’ proposals for new Aussie t-axes.

P3: I have concluded that Australia’s government may have been unconstitutional since 1942. Interestingly Australia is one of the few countries in which the States do not collect taxes. Section 97 of our Constitution (Audit) is a major worry, where did the money from our mining boom go?

P4: The UK is Brexiting and discovering just how complex European agreements can be. The same may apply for Basel-type regulations.

P5: My general approach to bodies such as Basel and to the Australian Government is to adopt a more business oriented approach.

51 What worked from the last change? Are proposals to move Australian organisations even further from Government-ownership towards a share-market system that provides a super-level playing-field for massive multinationals in the interest of countries such as Australia? Europe and European countries seem to be quite flexible w.r.t. Government owned enterprises and European countries seem to be overrepresented in Basel Committees.

52 What are we trying to fix? Can we project the effects of proposed changes into a world a decade down the track in which discoveries of major new resources will be far less frequent?

53 Is it possible for the changes to be cost-effective and deliver a benefit to average countries across the globe? Proposals made at Australia's meeting to cut commodity prices did not appear to be in Australia's interest.

54 Can Basel get accurate, reliable statistics w.r.t. taxes? Are the counties that are proposing the changes strongly honest in the way they collect taxes from their own people and organisations?

55 Can we propose a model that can be implemented fairly? A system that favours resource-poor countries (who historically may prefer to pay very low taxes) and is unfair for resource-rich countries may not be advisable.

56 Assuming that a fair and effective model can be designed, is the technical expertise available to implement it? Some of the responses to previous stress-tests may have been mathematically inaccurate. Technical expertise is a rare commodity these days. Throughout the millennia, smooth talking salesmen have been able to convince wealthy bureaucrats and financial wizards that they possess exceptional expertise on every topic. As an example, it takes years of hands-on experience to build up the expertise that is necessary to make semi-intelligent comments on IT-security or Banking-risk. An inexperienced person who has the ability to repeat the advice of the last salesman they have spoken to may be leading their country to destruction, with 'doing nothing' perhaps being a preferable option.

57 Assuming that a fair and effective model can be designed, do local bureaucrats have the mathematical skills to analyse it and the integrity to implement it? Some propositions appear to violate the laws of Supply and Demand (Economics does not have many Laws), with ever-increasing levels of remuneration and lower real-taxation levels for Top People being an example. Such remuneration practices may also tend to use dubious Mathematics such as Black Scholes, where the equations are exceptionally difficult to solve.

58 Have the previous models been evaluated to show that they made a positive contribution to the world's economy?

58.i) As an example, Basel III (or IIb) and Australia's G20 voted to reduce the price of commodities to increase the world's economy by a trillion dollars, perhaps 'instantaneously'. Just a few months later, there was quite a real risk of a GFC-repeat and markets threatened to collapse. I spoke on two TV stations and may have assisted one of our major banks to succeed in their Basel-credit-raising exercises.

58.ii) As a second example, Australian banks were strongly advised by Basel and attendees at Australia's G20 to raise $40B worth of extra capital and this advice was repeated by various local organisations in Australia. I wrote to Basel and to the Government and our banks eventually only raised $19B in that limited exercise. While our banks may be acutely at risk, their per-capita capital is high relative to most other countries. The thought of thanking me for at least trying does not seem to have occurred; bankers and Government-officials are busy people.

58.iii) Australia's economy was doing so well in the 1990's that we just simply had to have a GST. Since then, debt levels and prices have risen sharply and the economy is less robust than our pre-GST economy. The advice to raise the GST-rate was farcical. India had a similar experience. During Australia's G20, India's economy was performing so well they were strongly advised by international 'experts' to implement a GST asap. I publically advised them to stop paying colonial taxes at a large meeting in Sydney and the GST concept was dropped about two months later. Instead they were advised to demonetarise, catching about a billion people by surprise. The GST option has again been put on the table for them. Additionally Australia is frequently advised to raise our GST-rate as our debt-oriented economy is underperforming.

58. etc There are a lot of examples to show that Basel-type advice does not always work. On the other hand, I have been able to save significant amounts of money for Australia by doing simple mathematical analysis of the relevant facts. Additionally I have developed several proposals that could enhance Australia's technological reputation and economy but International Rules designed by Transparency and Witness organisations prevent the Australian Government from engaging in formal consultation with me. Some products (e.g. IT Security, Energy Efficiency and a new approach to teaching Mathematics that may work for talented under achievers) may be of interest to Europe or perhaps to the USA.

59. The one, two, three, many type of mathematical education that was provided to countries such as Australia may cause current politicians to pause for thought before committing too strongly to new Basel proposals. Assuming that the Basel Committee can provide concrete advice that might work, terms need to be defined and timelines need to be realistic. A rushed timetable may be a sign that undue pressure is being applied on selected countries.

P6. Publish Success-metrics before any change is made and show how subsequent goals could be met. Etc, for example, new Legislation needs to be examined to show that it has reduced the number of loopholes as the current Swiss-cheese Sierpinski-triangle system provides little long-term benefit for any country.

1. Introduction

"*The timely recognition of, and provision for, credit losses serve to promote safe and sound banking systems and play an important role in bank regulation and supervision. The FASB's new* *standard will take effect on 1 January 2020 for certain banks that are public companies and in 2021 for all other banks, with early application permitted for all banks in 2019*."

I told a leading Australian historian I was trying to change our Constitution to stop the country going bankrupt. His reply was "It's a bit late for that" and the same comment may apply to the 'timely recognition 'statement above. While we do need to fix protocols that are broken, we do need to have a plan and this document does not seem to contain one. Australian experience may show that such documents may be better written by experts (or even randomly selected members of the public) than by the targeted audience.

As some organisations are doing exceptionally well, what is the percentage of those that are experiencing credit-loss? How significant is this? Is it simply better to allow non-viable companies to fail rather than to continue the enormously expensive tasks of propping them up? Organisations that have been poorly managed may not always reform their ways and refocus on risk management techniques.

International advice for Australia appears to be that Government-owned is bad and such companies must be privatised whatever the cost to the nation. By contrast, European companies appear to be relatively relaxed about allowing the Government to own quite large financially-oriented companies.

One would expect that an introduction would contain a reference to a glossary as the meaning of several key words may vary from country to country.

"*The Basel Committee supports the use of ECL approaches and encourages their application in a manner that will achieve earlier recognition of credit losses than with incurred loss models while also providing incentives for banks to follow sound credit risk management practices*." The Market, reportedly, does this with ruthless efficiency.

"*In addition, the Committee has identified a number of reasons why it may be appropriate to introduce a transitional arrangement for the impact of ECL accounting on regulatory capital*." It may be expedient to spell out these reasons and to support them with reliable metrics. Given the way this material has been presented, it does not appear that the new ECL accounting standards are warranted. Even Basel Committee members appear to disown their own proposals when they are speaking to their own national interests. One committee member expressed the opinion about a year ago that a minimum number of banking regulations (perhaps two) would be sufficient. It may be excessively difficult to implement numerous regulations that may contradict each other as well as the logic of the market.

Current regulations appear to have resulted in a massive flight of laundered money and gold into formal or informal tax havens, leaving massive debts in resource-rich countries. Have such regulations been analysed? On the other hand, regulations that are coherent and fair are quite important.

"*It therefore seeks comments on the options proposed in this document, so that the Committee can consider if any transitional arrangement is warranted to allow banks time to adjust to the impact that the new ECL accounting standards will have on capital for regulatory purposes. It does not appear that sufficient mathematical work has been done to warrant any transitional arrangements*." This document appears to be confused about its possible objectives.

2. Proposal to retain the current regulatory treatment of accounting provisions for the interim period

“*Basel I permitted a limited amount of general provisions to be included in total (Tier 2) capital to reflect that they are freely available to meet future losses that currently are not identified, while excluding all specific provisions from capital*.” Basel I does not appear to have worked, is a different approach required?

2.1 Standardised approach
A standardised approach does not seem to work, even for Europe. Each country has their own way of managing their financial affairs and some such arrangements appear to be quite sophisticated.

2.2 Internal ratings-based approaches
Existing rating-agencies appear to be the subject of quite a lot of criticism. The advice they provide does not have arrested the very impressive rate at which Australia is accumulating Foreign and Personal debt. To accumulate a trillion dollars over a decade would require money to be spent at the rate of over a million dollars per hour. An enormous amount of debt-oriented work appears to have been done and it appears that almost no fraud has been committed in Australia in connection with this debt-creation odyssey. The effect that an alteration in rating (e.g. a drop from AAA to Bxx) appears to vary from country to country and this is an issue Basel may care to address.

Never have so few people exported c.q. destroyed such a vast quantity of valuable resources in such a short period of time in return of such an enormous per capita debt.

If current regulations do not deter hyper-debt activity, would a totally unregulated system be an improvement? A mathematically accurate answer may surprise.

2.3 Proposal to retain the current regulatory treatment of provisions
It appears that the current regulatory treatments have not worked for Australia. Now the UK is Brexiting, it is possible that international support for a better system may be difficult to obtain.

3. Possible transitional arrangements

3.1 The Committee’s primary considerations
“*The Basel Committee has identified a number of reasons why it may be appropriate to introduce a transitional arrangement for the impact of ECL accounting on regulatory capital*.” It may be appropriate to complete the analysis before proposing any transition. It may be more appropriate to discuss transitional arrangements when the benefits have been identified a little more clearly. It appears that a few details may need to be ironed out.

“*The Committee has not yet determined whether or not these factors will warrant the introduction of transitional arrangements, and the discussion below should be read with that qualification in mind. The Committee is aware that the transition to ECL accounting will generally result in an increase in the overall amount of loan loss provisions, which in many cases will reduce the capital ratios of banks as they transition to the ECL approach*.” This is a very general statement that might apply more strongly to banks in some countries than in others. If any research has been done, could references be provided?

3.2 Some possible approaches
See comments on 3.1 above

3.3 Approach 1: Day 1 impact on CET1 capital spread over a specified number of years
See comments on 3.1 above

3.4 Approach 2: CET1 capital adjustment linked to Day 1 proportionate increase in provisions
See comments on 3.1 above.

3.5 Approach 3: Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions
See comments on 3.1 above

3.6 Request for feedback
I have read the document and my comments are included above. One possible conclusion is that events such as Brexit may have prompted Basel to release this document prematurely. I trust a good working model that is fair to resource-rich countries such as Australia can be designed and implemented and assistance of experts with practical hands-on experience may be of assistance.

***** End of Document ****