



MODTAGET
LEDELSESSEKRETARIATET

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REPUBLIKA SLOVENIJA
DRŽAVNI SVET

20th June 2011

Jerzy Buzek
President of the European Parliament
Rue Wiertz 60
1047 Brussels
Belgium

Dear President of the European Parliament Mr. Buzek,

At June's plenary session the National Council of the Republic of Slovenia debated the current state of the European Union and the financial and economic problems that it is facing today. The National Council made a conclusion to propose to the European Parliament that, in cooperation with the European Commission, the European Central Bank and other institutions, it should formulate, adopt and implement measures that would improve the quality of life of European citizens, especially in the area of employment and social security. We believe that it is urgent that European Union gains back the trust of its citizens and to re-establish their wish to identify themselves as not only the citizens of their countries but also as citizens of the European Union.

Enclosed you will find the proposal of the National Council of the Republic of Slovenia.

Yours sincerely,

Blaž Kavčič, MSc
President

Courtesy copy:

- *President of the Republic of Slovenia*
- *President of the National Assembly of the Republic of Slovenia*
- *Prime minister of the Republic of Slovenia*
- *Ministers of the Republic of Slovenia*
- *Members of the National Assembly of the Republic of Slovenia*
- *Parliaments of the EU Member States*
- *Slovenian Members of the European Parliament*



REPUBLIKA SLOVENIJA
DRŽAVNI SVET

Ljubljana, 8 June 2011

Pursuant to Articles 66 and 98 of the National Council Rules of Procedure (Official Gazette of the Republic of Slovenia, Nos. 70/08, 73/09 and 101/10) it shall be proposed that the National Council of the Republic of Slovenia submits to the European Parliament

THE PROPOSAL REGARDING URGENT MEASURES TO PROTECT THE QUALITY OF LIFE OF THE CITIZENS OF THE EUROPEAN UNION

The National Council of the Republic of Slovenia, the second chamber of the Slovenian parliamentary system, **shall propose** to the European Parliament that it **requests** from the European Commission and other European institutions an immediate formulation of tangible measures regarding the institutional improvement in the operation of the European Union.

It is assumed that the primary mission and duty of political bodies and all branches of government is **to provide for the preservation and the improvement of the quality of life of citizens**. It is assessed that current international conditions basically **prevent** the quality of life from being the basic strategic goal of the economic policy of the European Union and the interests of **the financial industry** have become the guiding principle. In the specific case of Greece it is crystal clear that the interests of transnational speculative financial funds were the reason for the crisis and, what is particularly unconscionable is that profit is made in every phase triggering the crisis and during the crisis. Austerity and other measures in the case of Greece or any other of the countries in trouble cannot be effective as long as the operation of speculative financial instruments continues to be allowed. We cannot shut our eyes to the fact that the functioning of political institutions is under the prevailing influence of transnational capital. The notion of the free functioning of trade mechanisms and their satisfactory regulation of the economy has become a **dangerous illusion**, unacceptable from the point of view of common sense, of human rights and the principals of world ethos. How can it be expected that the citizens of the European Union can support the stabilisation

of macroeconomic parameters by means of austerity measures with regard to salaries, pensions and reduction of social security in the fields of health care and education when there is widespread recognition that immense financial assets are being accumulated in tax oases. How can the citizens of the European Union accept the logic that players in the financial crises are being paid vast amounts unimaginable to the common citizen?

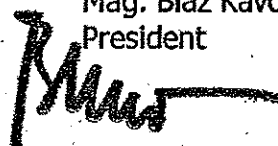
It is not possible to find satisfactory justifications for **adding value** and finding a large enough number of **work posts** in the EU Member States within the present institutional framework. The complete liberalization of the international economy runs in compliance with the requirements of WTO, IMF and WB but causes rapid cuts in traditional work posts in the EU Member States which is unacceptable within society as it creates a society of disappointed persons receiving support instead of a society of active and motivated citizens

The European Union and the **Euro** are matters highly valued by EU citizens and yet they are in great crisis. We have to be aware that, objectively neither the EU nor the Euro alone must be the ultimate aim for the citizens of the EU but they must be items which have extraordinary significance and yet still have the role of funds and not the role of the ultimate goal. The question arises whether the EU authorities will ever allow it to happen that measures for the protection of the fundamental interests of the EU citizens would lapse since in so doing they would create genuine doubts about the reasonableness of the existence of the EU and Euro. It is hard to imagine the successful functioning of the EU without the Euro acquiring a stronger role as a world currency. The restructuring of the international monetary system with the greater role of the Euro and a reduced role of American dollar is an urgently needed component of the institutional framework to ensure the conditions of the quality of life of EU citizens.

This is why we specifically propose to the European Parliament that, in cooperation with the European Commission, the European Central Bank and other institutions, it should **formulate, adopt and implement** the following measures:

1. Regulation of financial markets by disabling the operation of immoral financial instruments.
2. Protection of work posts in the EU Member States.
3. Enhancement of the role of the Euro as the global currency.

Mag. Blaž Kavčič
President



Detailed explanation regarding the role of financial instruments

Trading with financial derivatives has increased enormously in the past ten years both in the regulated and non-regulated markets. There are many reasons why the interest in derivatives has increased rapidly. Among other matters, participants in the market demand derivatives to secure the positions of investments with underlying financial instruments. Speculators, by means of leverage, seek for fast profits through arbitrage between the price of the basic instruments and synthetic equivalents. Members of the Academic world seek for an inspiration for models of various kinds which, with luck, might classify them in the short list for selection as potential Nobel prize winners. But behind all this there is a drive which is powered by financial institutions in global financial centres which deal and trade in all kinds of exotic financial products, to use the poor knowledge of mass market participants regarding the complexity of the structure of derivatives for their own benefit. However, the fact is that financial derivatives have an immense power which is attractive and has a mystic temptation particularly due to the ever increasing complexity of their structure and influence on the development of the world economy and modern "imperialism".

The marketing capabilities of convincing neo-liberal Academics (University of Chicago) and profitability-oriented financial institutes (Wall Street) have particularly contributed to the innovation and ever increasing number of financial instruments in the past 40 years. The gradual elimination of the Glass-Steagall Act of 1933 was of key importance:

- first by means of the Depository Institutions Deregulation and Monetary Control Act in 1980 which enabled the banks to determine by themselves the level of interest rates to be paid on clients' saving accounts, and later
- with the Gramm-Leach-Bliley Act from 1999 which enabled the banks to merge once more into financial holdings (merger of operation of retail and investment bank under one capital structure which allowed investment banks additional leverage to operate on risky financial markets).

With the liberalisation of statutory restrictions the banking sector has lived to see its revival in the sense of financial innovation which greater capital leverage has contributed to, in particular due to the possibility of the merger of capital both for retail and investment banking operations. Commercial banks have continued their operation in a more or less unchanged form while with regard to investment banks the period of experimental quantitative and intensive modelling on the basis of neo-liberal ideology has begun. Innovation in investment banking began to develop in the direction of complex and quantitatively complicated formulas and definitions both to determine the value of individual instruments and to avoid the capital requirements of regulators.

1. Contribution of the Academy to the development and valuation of financial instruments

a. Neo-liberal ideology

Models which are the foundation for the calculation of the fair value of individual financial instruments are based on assumptions which make complex economic rules easier and more general (for example, the revolutionary Black Scholes option pricing model; among other matters, its equation for the valuation of options includes the historical volatility of the rate of the underlying assets). The basis of the entire concept of the model to determine the value of financial instruments is hidden in the probability calculation whereby the bases are the historical correlation among instruments, the volatility of rates, etc.).

Such models are a generally accepted and approved practice which is taken into account in the calculation of the fair value of financial instruments. This, however, is overpriced in the great majority of cases due to interests of market participants. This overpriced value of financial instruments indirectly inflates the value of underlying assets, and inflates financial markets and the balances of financial institutions holding these kinds of financial instruments in their books of accounts.

However, it is interesting that the so called Advanced Method for the calculation of capital requirements for banks is also being established on the basis of probability. The concept is based on the parameters to calculate capital requirements mentioned below:

- PD (Probability of Default);
- LGD (Loss Given Default);
- EAD (Earnings At Default);
- AVC (Asset Value Correlation).

In this case, regulatory institutions assume that on the basis of the historical analysis of a bank it might be possible to evaluate what is the actual probability that the bank's investment might fail. On the basis of models which must be first approved by a regulator, and the completed analyses of banks, the capital requirements of a bank are then formulated. When calculating capital requirements, banks see an opportunity in complex financial instruments since it is hard to determine their fair value and the hypothesis in this regard is such that for a risky investment in complex financial instruments lower capital requirements need to be set. This is an additional motive in resorting to trading with complex financial instruments. Originally, the capital requirements were prescribed according to the so called Standardized Approach where every investment has its risk weights with regard to capital requirements (for example, risky investments have higher risk weights than less risky ones).

b. Financial Investment Management Culture is based on neo-liberal assumptions

Professional investors and asset managers take into account the fair value for individual financial instruments and correlations between them through models and historical analysis which contribute to the idea of the optimum management of investment portfolio in the sense of seeking for a suitable "position" between the level of risk and the rate of return of the investment portfolio. The management of financial assets is also based on assumptions of neo-liberal ideology (for example, Markowitz, who set foundations for the Modern Portfolio Theory, includes in his model assumptions such as: (1) constant correlation between individual financial instruments, (2) all market participants have the same access to important information influencing rates, (3) tax and transaction costs are not included in the price of financial instruments, (4) market participants are rational and risk averse, etc.).

The key problem with regard to the neo-liberal models for the valuation of financial instruments and investment portfolio management are the insuperable faith and trust in models and historical correlations between financial instruments which are based on historical rate trends. Financial market participants wish to push their view into the future with such analysis and quantitative tools, but, as Heraclitus in ancient Greece observed that you cannot step twice into the same stream, so will financial markets never again be the same and the approximations of constants of rate trends obtained on the basis of historical analysis will carry with them more or less negligible content. Prof. Nassim Taleb started to warn more seriously about this with so-called fat tails which on the basis of the probable distribution means that rare events, which are neglected by financial models in their calculations, have catastrophic consequences (for example, the AIG case).

c. Newly grown up generation of neo-liberals in financial markets

The concept of the neo-liberal thought described above has slowly made its way into the understanding of the functioning of financial markets and financial instruments as the best method to determine the value of financial instruments and their management. The increasingly recognized CFA certificate (Chartered Financial Analyst) of American origin has contributed the most to this idea; the certificate is composed of three parts and is passed only after two and a half years of work experience. These comprise a very demanding series of exams focused on neo-liberal thought. Approximately 300,000 candidates applied to sit the exam last year and the number is increasing every year since the exam certificate has almost become a requirement on the part of employers in the financial industry. Increasingly a greater inclusion of the CFA contents into the university syllabus is also noted.

2. Contribution of financial institutions to development of financial instruments

d. Financial Instruments are an initiative of various interests.

Financial instruments per se are not the core of the argument but a tool to realise various interests. The useful value of financial instruments lies in particular in protecting against various market risks to which import and export

enterprises are exposed through their operation. But if speculators get involved in the trading with financial instruments a high level of volatility of the rates of these instruments is achieved. The pulse of the market is based on the feeling of investors which, however, may be fatal for an institution which is placed on the wrong side of a transaction with too great a concentration of investments in illiquid instruments under the negative pressure of investors. The main argument of protagonists defending the existence of a great number of financial derivatives is that they are the medium enabling the distribution of risks on market participants willing to take over the risk from those who wish to get rid of them.

e. Categories of financial instrument

Generally speaking, financial instruments are divided into basic financial instruments (shares, bonds, commodities, etc.) and derivatives. Financial derivatives are further divided into:

- the relationship between the underlying financial instrument or asset and derivative (swap, options, futures contract, etc.);
- asset type (equity-based derivatives, foreign exchange based derivatives, interest rate based derivatives, debt based derivatives, etc.);
- markets in which the derivatives are traded (regulated or OTC (over-the-counter) or non-regulated market) and
- the repayment method in regard to individual derivatives.

f. Method of trading with immoral purposes

Speculation and trading with financial instruments in order to gain a profitable result with the fall of rates and the bankruptcy of enterprises of the issuer of financial instruments is an immoral concept. This is allowed by the financial market regulators mostly due to the fact that through so called short selling the non-articulated increase of financial instruments is being corrected which complies with the theory of the invisible hand and the market which is being independently corrected.

Immoral pre-judgements are also present in trading with financial instruments representing insurance for credit derivatives, the so-called CDS (Credit Default Swap). The trading with the so called naked CDS is particularly critical – in this case, a market participant may buy insurance for credit risk without owning the underlying instrument (for example, a speculation that Greece will go bankrupt has triggered the credit insurance – CDS – for Greek bonds to record levels and in this manner the interest rate for the newly issued debt has also been directly increased which will place additional pressure on the public finances of Greece upon the repeated issue of government bonds. In this case it is possible to understand that market players who are exposed to investments in Greek government bonds wish to become insured against the collapse of the Greek government bonds but speculative moves without owning the mentioned government bonds, which directly make the situation regarding the public finances of Greece more difficult, cannot be understood.

g. Modern financial innovation – credit derivatives

Credit derivatives (CDOs – collateralised debt obligations and ABSs – asset backed securities) first appeared in massive numbers in 2001. These financial instruments are linked to cash flow which derives from the payments of mortgage borrowers, payments of car purchase loans, payments of credit card debt, etc., split into so called tranches. In regard to this kind of credit derivatives it is a matter of an issue of amounts in several billions of USD dollars or other currencies whereby loans are collected either according to their purpose or according to the

¹ Short selling or going short is a trading procedure where a market participant "borrows" a financial instrument for a certain period of time for a certain provision and sells it immediately. The market participant is speculating that the value of the financial instrument will fall. When its value is low, the same financial instrument will be repurchased by the market participant and returned to the lender. The market participant who has sold the borrowed financial instrument received a profit in the amount of the value of the fall of the financial instrument price.

borrower's rating and split into tranches which are then separated one from the other according to the borrower's rating. An investor into an upper layer (tranche) of a CDO instrument having at the same time the lowest rate of return has bought the right to cash flows of debtors with the highest rating, the middle layer (tranche) represents the borrowers with slightly lower rating and higher rate of return while the equity tranche represents the expected cash flows on the part of borrowers with the lowest rating and simultaneously the highest rate of return of this financial instrument due to the great probability that the debt will not be repaid.

Originally, CDO financial instruments derived from the wish of the American government, that "every American citizen shall become the owner of his/her home". This started the chain and maybe even fuelled the crazed lending to those borrowers without jobs, any suitable collateral for loans, etc. (the so called NINJA loans – No Income No Job or Assets). In the USA, the first contact with these kinds of borrowers wishing to obtain their own homes are mortgage brokers selling mortgage loans to commercial banks, commercial bank then sell the loans to an investment bank which collects the mortgage loans together from great number of sources from all over the USA and securitizes them – i.e. issues a bond with an expected cash flow of the original borrowers split into tranches and markets it in the financial market.

In this manner all brokers earned commissions and liquidity was created in selling mortgage loans further down the chain until the final buyers of CDO financial instruments, due to the complexity of this financial instrument, did not know any longer who was actually being financed by the loan. In this process any care for the borrower's rating – the real distributor of cash flow – is unnecessary because, with the exception of the final investor, nobody in this procedure of "reselling loans" is actually interested in who was originally given the loan.

In this process it often occurs that the track to the original borrowers becomes lost, and due to complicated quantitative models nobody knows how to determine the real value of these products (neither the investment bank nor the regulator or the investor).

Beyond that there are institutions, such as for example AIG issuing insurances in the form of CDS financial instruments for each of the tranches of individual CDO products in case a mass bankruptcy of the original borrowers takes place. In this manner they are exposed to concentration risk and solvency risk, comments on which have been made above.

The fact is that nobody knows what consequences might be brought about by this financial innovation as long as these products are sold and as long as there is interest in exotic products with high rates of return marketed by investment banks, and for however long these products will be produced and placed on the market by investment banks. In this complex and tightly integrated world it will be increasingly more difficult to include all of the factors influenced by the mass production of various kinds of financial derivatives which is why it is impossible to evaluate the added value and the influence of new instruments a priori.