Polish Toxic Currency Options

Corruptio optimi pessima.

A matter of State

In February 2009, the Council of Ministers of Poland was discussing the problem of currency options issued by Polish companies and the losses incurred due to the quick depreciation of the zloty, the country’s currency (abbreviation: PLN).

Moreover, there was evidence that Polish banks were only intermediaries in the currency options transactions, which originated in few foreign investment banks, including Goldman Sachs and JP Morgan, and also in the Polish subsidiaries of American, German, Belgian and Portuguese banks, that were betting on the weakening of the Polish zloty. Therefore, the losses of the enterprises were transferred abroad, thus causing even further depreciation of the Polish zloty and intensifying the problem.

— We are in a “beautiful” trap, where profits from options are going to be transferred abroad, and Polish entrepreneurs and banks will be fighting with each other — said Pawlak, the Deputy Prime Minister and the Minister of Economy of Poland.¹

Remembrances of George Soros’ attack on the British pound in 1992 came into mind to many financial commentators regarding the scene.

The origin of the problem

The long-lasting appreciation of the Polish zloty until August 2008 (Exhibit 1 shows the EUR/PLN performance over the previous 5 years), resulted in smaller profits for exporting companies and companies whose revenues were based in foreign currency. As a consequence, many of these companies started looking for financial instruments that aimed at limiting the negative influence of the exchange rate on their businesses. The firms’ reluctance to pay a premium for protective PUTs induced banks to offer zero-cost financial structured products based on collars. These products were very sophisticated option hybrids with asymmetric triggers that were difficult to understand, even for managers familiar with the “plain vanilla” options.

In finance, an option is a contract between a buyer and a seller that gives the buyer the right—but not the obligation—to buy or to sell a particular asset (the underlying asset) at a later day at an agreed-upon price. In return for granting the option, the seller collects a payment (the premium) from the buyer. A CALL option gives the buyer the right to buy the underlying asset, while a PUT option gives the buyer the right to sell the underlying asset. If the buyer chooses to exercise this right, the seller is obligated to sell or buy the asset at the agreed-upon price. The buyer may choose not to exercise the right and let it expire. The underlying asset can be a piece of property, shares of stock, or some other security, such as a futures contract, among others. For example, buying a foreign currency CALL option provides the right to buy a specified quantity of a foreign currency at a set exchange rate, known as the “strike price” at some time on or before expiration, while buying a PUT option, provides

¹ Kreśniak M., Iwaniuk W., Trudne negocjacje z bankami, “Rzeczpospolita” 4-5.04.2009, B5.
the right to sell. Upon the option holder's choice to exercise the option, the party who sold or wrote the option must fulfill the terms of the contract.

A long option position is similar to an insurance policy. Instead of an insurance fee, the holder of this option pays a premium to secure against an adverse event: the fall of the price in the case of long PUT position or the rise of the price in the case of a long CALL position. On the other hand, the writer of an option acts as an insurance company and earns a premium for taking risks.

The theoretical value of an option can be evaluated according to several models. These models, which are developed by quantitative analysts, attempt to predict how the value of the option will change in response to changing conditions (Exhibit 2 presents the basic terminology related to financial options).

Due to the fact that the Polish zloty was gaining strength and the probability of depreciation was relatively low, PUT options were more expensive than CALL options. Therefore, to keep the zero-cost mechanism, companies had to leverage options; i.e. write more short CALLs than the long PUTs they were buying (basic option trades are shown in Exhibit 3).

When the trend inverted and the Polish zloty depreciated almost 50% in a few months (see Exhibit 1), the companies found themselves with several short CALLs in the money. Exhibits 4 and 5 present a simulation of a contract for a PUT face value of 1 million euro and a CALL face value of twice as much.2

In mid 2008, when the Lehman Brothers went bankrupt, Poland seemed to be safe and free of “toxic assets.” Although Polish banks did not hold subprime securities, other structured financial products began to be toxic for the Polish economy.

The losses incurred by companies were estimated at PLN 9–15 billion by the Polish Financial Supervision Authority (KNF). Other experts estimated these losses at PLN 40–50 billion.3 The greatest losses from currency option contracts are shown in Exhibit 6.

**Positivistic approach to contracts**

Poland has a long tradition of democracy and legality. However, during the last decades, a positivistic approach to the law became the basic doctrine of Polish judges. Due to this fact, discussions on currency options from the legal point of view seemed to be limited by obligations to the *pacta sunt servanda* – Latin for “promises must be kept” at any cost.

Prominent lawyers advised companies that embarked on unfavorable currency option contracts to look for mistakes and technical lacks in the contracts or to post an anti-execution claim to the judge until the finalization of the litigation as a way to defend themselves against bank executions of liabilities.4

However, other lawyers argued that the clause of the fulfillment of contracts was not an absolute law. In some cases, *rebus sic stantibus* (Latin for “things thus standing”) could be invoked. This clause presents the legal doctrine that allows for treaties to become inapplicable because of a fundamental change of circumstances. It is essentially an “escape clause” that makes an exception to the general rule of *pacta sunt servanda*.

The doctrine is part of the customary international law5 and provides two justifications of the invocation of *rebus sic stantibus*: first of all, that the circumstances existing at the time of the

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2 Most of the contracts were for higher amounts and some cases with bigger disproportions between PUT and CALL face values.
5 The doctrine of *rebus sic stantibus* is also provided for in the 1969 Vienna Convention on the Law of Treaties under Article 62 (Fundamental Change of Circumstance), although the doctrine is never mentioned by name. In the Polish Civil Code, the clause was contemplated in articles 357 and 358 § 3.
conclusion of the treaty were indeed objectively essential to the obligations of treaty, and secondly, that the change of circumstances has had a radical effect on the obligations of the treaty.

If the parties to a treaty had contemplated the occurrence of the changed circumstances, the doctrine does not apply and the provision remains in effect. The clause *rebus sic stantibus* only relates to changed circumstances that were never anticipated by the parties.\(^6\)

Therefore, to enforce this clause, several conditions should be met:

a) changes in circumstances were alien to the parties,

b) changes were not anticipated by the parties,

c) changes had a significant effect on either one of the parties,

d) changes made the obligations of the parties inadequate.

Nevertheless, it was believed that this comprehensive approach to contracting theory would be difficult to invoke and prove to the judges.

### Moral hazard and moral responsibility

The toxic currency options problem stimulated discussions on the role of banks as entities of public trust. On the one hand, companies entrusted their savings to banks and expected advice from them on financial products. According to MiFID standards,\(^7\) banks should always disclose to their clients any possible risks, a requirement which bank option dealers, fostered by their managers to meet financial goals, have not always fulfilled.

On the other hand, others argued that banks were only a link in the value chain and, therefore, that the banks were also maximizing profits as other players. CFOs should have known what they were buying and the risks involved in those transactions. Krzysztof Pietraszkiewicz, President of the Polish Bank Association (ZBP), said that there was a lot of ambiguity in the managers’ behavior. When companies earned money from option contracts, nobody protested; when the roles turned, the banks seemed to be guilty of everything. Moreover, he claimed that some CFOs, looking for the improvement of their financial performance, contracted options in several banks without declaring previous transactions\(^8\) to speculate on currency exchange. Pietraszkiewicz explained that it is in the interest of banks not to lead companies into bankruptcy.

Some experts argued for more strict regulation of financial markets to limit opportunistic behavior, both from banks and companies.

The fundamental question of whether “greed is good” arose again and again to the pitch, but debate also surrounded who was responsible for the “intoxication” of the economy: greedy bankers or greedy managers. Many questions also what the government should do if any actions should be taken.

### Plausible solutions

All political parties—from both the ruling coalition and the opposition—agreed on the fact that something has to be done on legal terms to solve the problem regarding currency options. However, the proposed solutions were different and varied, including contract annulment, contract renegotiation, and individual suing of banks by companies for financial losses incurred.

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7. The Markets in Financial Instruments Directive (MiFID) as subsequently amended is a European Union law which provides a harmonized regulatory regime for investment services across the 30 member states of the European Economic Area (the 27 Member States of the European Union plus Iceland, Norway and Liechtenstein). The main objectives of the Directive are to increase competition and consumer protection in investment services. Although the President of Poland in September, 2008 vetoed the amendments to the law that introduced MiFID, the law would not be in force until the second half of 2009 due to the obligatory vacatio legis.

Adam Szejnfeld, Deputy Minister of Economy, classified harmed companies into three groups: 9

a) companies involved in risky transactions on purpose; i.e., those that gambled on leveraged options and, in some cases, even secured the same export transactions with several banks;

b) companies that had frame contracts for “plain vanilla” options with banks, but within this frame contracted some toxic options without detailed knowledge of the involved risks; and

c) SMEs that were in an unfavorable position vis-à-vis banks regarding experience with option contracts and that were probably induced into error.

If any legal action were to take place, according to Szejnfeld, they should involve only the last two of the above mentioned groups.

Annulment of contracts by law would be analogical to nationalization—an administrative intervention by the government between private parties for an upper and arguably just reason. Nonetheless, it could also jeopardize Poland in the eyes of private investors and decrease direct foreign investments.

The government could also induce banks to renegotiate currency option contracts with companies (e.g., payments in installments or change of American options into European options) by threatening banks on future guarantees or permits or other legal repressions. The government could also open an express legal road for private companies to sue banks for usury while not being the object of bank asset executions.

Some other solutions were also considered, including an intervention in the currency market to strengthen the Polish zloty or issuing guarantees from BGK, a national bank, to companies with liabilities from options.

Whichever action would be taken, it would harm banks, companies, or taxpayers. Milton Friedman’s dictum that “there is no free lunch” was realized once again. Currency options became not only a toxic, but also an expensive lunch, and somebody had to pay for it.

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9 Domagalski M., Bez rządowej interwencji trudno o rozwiązanie, “Rzeczpospolita” 4.03.2009, C3.
Exhibit 1. EUR/PLN performance from April 2004 to April 2009

Exhibit 2. Basic terminology related to financial options

**CALL option**: the right (but not the obligation) to buy an asset at a certain price (the “strike price”) on or before a future date.

**PUT option**: the right (but not the obligation) to sell an asset at a certain price (the “strike price”) on or before a future date.

**Covered CALL writing**: the practice of selling (“writing”) CALL options on an asset which the writer also owns. This approach is used by some retirees to supplement their income.

**Cash-covered PUT writing**: a mathematically equivalent tactic for covered CALL writing. The writer sells a PUT option, which is covered by cash in his account. [If the asset’s price goes down and the PUT is exercised, the cash will be needed to buy the asset.]

**Strike price**: the value at which the option can be exercised.

**Premium**: the amount received by the option writer (before commissions).

**Expiration date**: the date after which the option becomes worthless. European options can be exercised on the expiration date (majority of options traded in the world). American options can be exercised any time before or on the expiration date (rather rare due to high prices). Polish currency options were due at the end of each month.
Exhibit 3. Basic stock option trades

**Long CALL**

A trader who believes that a stock's price will increase might buy the right to purchase the stock (a CALL option) rather than just buy the stock. He would have no obligation to buy the stock, only the right to do so at the expiration date. If the stock price at expiration is above the exercise price (price paid), he will profit. If the stock price at expiration is lower than the exercise price, he will let the CALL contract expire, worthless, and will only lose the amount of the premium. A trader might buy the option instead of shares, because for the same amount of money, he can obtain a larger number of options than shares. If the stock rises, he will thus realize a larger gain than if he had purchased shares. [Potential loss is limited to premium; potential gain is unlimited.]

**Long PUT**

A trader who believes that a stock's price will decrease can buy the right to sell the stock at a fixed price (a PUT option). He will be under no obligation to sell the stock, but has the right to do so until the expiration date. If the stock price at expiration is below the exercise price by more than the premium paid, he will profit. If the stock price at expiration is above the exercise price, he will let the PUT contract expire worthless and only lose the premium paid. [Potential loss is limited to premium, potential gain is unlimited.]

**Short CALL**

A trader who believes that a stock price will decrease can sell the stock short or instead sell, or “write,” a CALL. The trader selling a CALL has an obligation to sell the stock to the CALL buyer at the buyer's option. If the stock price decreases, the short CALL position will make a profit in the amount of the premium. If the stock price increases over the exercise price by more than the amount of the premium, the short will lose money, with unlimited potential loss. [Potential gain is limited to premium; potential loss is unlimited.]

**Short PUT**

A trader who believes that a stock price will increase can buy the stock or instead sell a PUT. The trader selling a PUT has the obligation to buy the stock from the PUT buyer at the PUT buyer's option. If the stock price at expiration is above the exercise price, the short PUT position will make a profit in the amount of the premium. If the stock price at expiration is below the exercise price by more than the amount of the premium, the trader will lose money, with the potential loss being up to the full value of the stock. [Potential gain is limited to premium; potential loss is unlimited.]

Source: http://en.wikipedia.org/wiki/Option_(finance)
### Exhibit 4. Example of a currency zero premium collar option contract (table)

**Assumptions**
- Revenues in EUR: 1 000 000 EUR
- Costs in PLN: 3 200 000 PLN
- Spot price at contracting: 3,50 PLN
- PUT strike price: 3,30 PLN
- PUT face value: 1 000 000 EUR
- PUT Premium: 200 000 PLN
- CALL strike price: 3,50 PLN
- CALL face value: 2 000 000 EUR
- CALL Premium: 200 000 PLN

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Exhibit 6. Example of a currency zero premium collar option contract (chart)

### Assumptions

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Polish Toxic Currency Options

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Exhibit 6. Biggest losses from currency option contracts (PLN million)

Source: Companies’ quarterly reports, quoted after “Rzeczpospolita” 19.03.2009, C5.
Polish Toxic Currency Options
Preparation sheet

1. From the companies’ point of view, what were the roots of the currency options’ problem?
2. Why was the government preoccupied by currency option contracts?
3. Are banks institutions of public trust? In light of MiFID, are banks responsible for risk management in companies?
4. Is financial “hazard” (when it is not the core business of the company, as may be the case with a hedge fund) morally right?
5. Can rebus sic stantibus be invoked in the case of Polish toxic currency options? Why?
6. Who is responsible for the toxic currency options: banks or company managers?
7. Should the government intervene? What if somebody had acted opportunistically and there had been an attack on the Polish zloty?
8. From the government’s perspective, what are the plausible solutions? What would you recommend? Who would be affected by those actions?