

# A GUIDE TO CURRENCY OPTIONS



## Dollar-Rupee Options

## DEFINITION

- In finance, a foreign exchange option (commonly shortened to just FX option or currency option).
  - ✓ is a derivative financial instrument where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date.
  - ✓ The FX options market is the deepest, largest and most liquid market for options of any kind in the world.
  - ✓ In India, most of the FX option volume is traded OTC and is lightly regulated, but now SEBI has given approval to start Exchange traded options in dollar-rupee.

## TERMINOLOGY

- **Call Option** - The option gives the holder the right but not the obligation to buy a set amount of the currency during a specified time period at a specified price .
- **Put Option** – The option gives the holder the right but not an obligation to sell a set amount of currency during a specified time period at a specified price.
- **Strike price** - The strike price (or exercise price) of an options contract is the price that the underlying currency will be bought or sold at if the option is exercised.

# HOW DOES CURRENCY OPTIONS WORKS

## PRODUCT NOTE

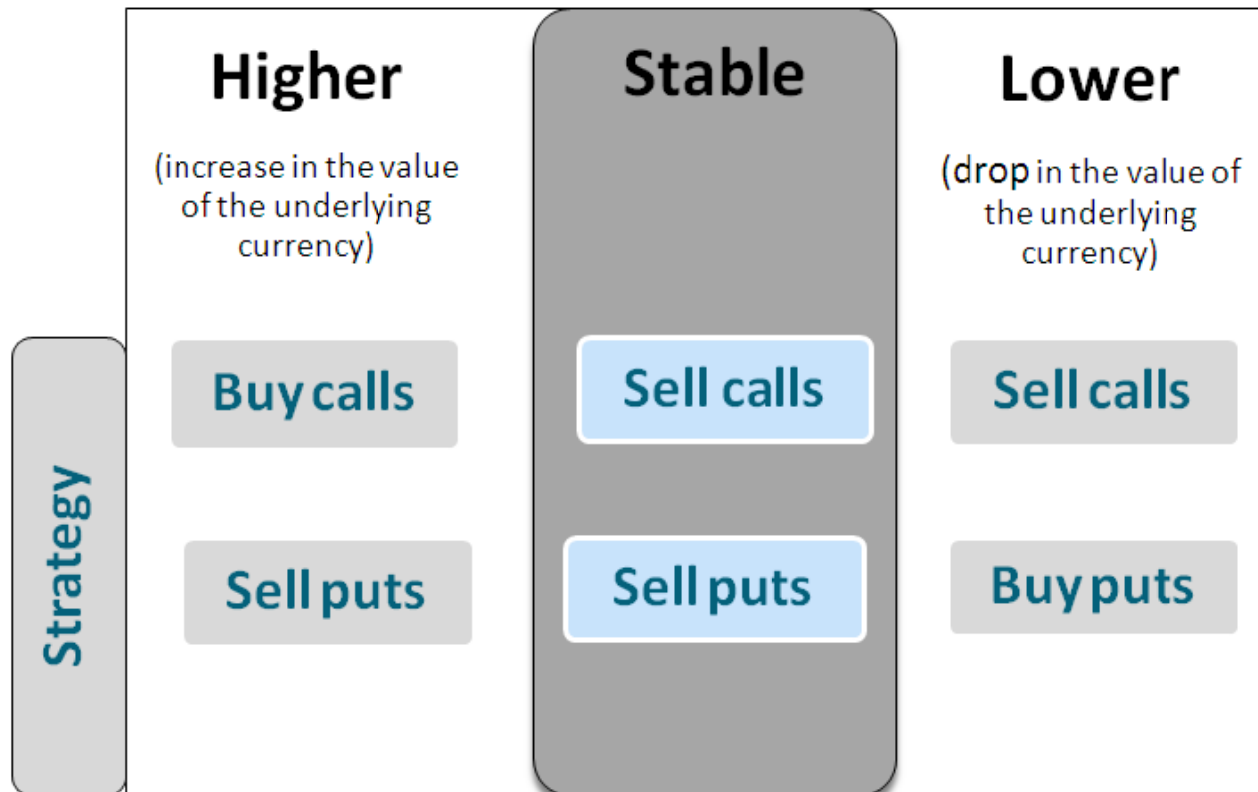
<b>Underlying Currency</b>	US. DOLLAR
<b>Trading Unit (Contract size)</b>	US\$1000
<b>Option premiums</b>	Expressed in rupee terms
<b>Instrument Type</b>	OPTCUR
<b>Strike prices</b>	Total twelve in-the-money, twelve out-of-the-money and one at-the-money strikes - All available at an price interval of 0.25 paise
<b>Margin Requirement</b>	As per Exchange norms

<b>Trading and Settlement</b>	European styled options, but can be discretionary squared-up early by taking offsetting position in the market.
<b>Expiry / last trading day</b>	Two working days prior to the last working day of the expiry month.
<b>Settlement Price</b>	RBI's reference rate
<b>Settlement Mechanism</b>	Cash settled in Indian rupees.
<b>Settlement of Premium</b>	Premium would be paid in by the buyer in cash and paid out to the seller in cash on T+1 day
<b>Available Contracts</b>	Three serial monthly contracts followed by one quarterly contract of the cycle

## WHY CHOOSE OPTIONS ?

- Ample liquidity.
- Best tool available to hedge foreign exchange exposures or to benefit from short-term price movements in dollar-rupee.
- Favorite of market players, as they have limited downside.
- They have greater leveraging power.
- Can work for all market conditions, like volatile, stagnant, bullish & bearish.
- Efficient pricing transparency and nil counterparty risk.

# SELECTING A CURRENCY OPTIONS TRADING STRATEGY



# TRADING STRATEGIES

## Positional Trading

### Buy Call options to profit from a rise in the U.S. dollar

For Example, on October 3, 2005 an investor/trader (importer) anticipates that the U.S. dollar will strengthen against the rupee. The USDINR is 49 Rs. per U.S. dollar. The investor purchases 10 lots of USDINR NOV at 49 call options for a premium of 0.5 paise per dollar. At expiration, RBI's reference rate is 51 Rs. per dollar.

**PROFIT** : Unlimited =  $(51-49.5)*1000\$*10 = \text{Rs. } 15,000$

**LOSS** : Premium paid =  $0.5*1000\$*10 = \text{Rs. } 5,000$

## Sell Call options to profit from a fall in the U.S. dollar

Selling call options is a riskier strategy than buying put options, some investors prefer it in a bear market as they can act on their view without any cash outlay. Instead, sellers collect premiums. For Example, suppose investor think dollar will drop and he sells 10 lots of USDINR DEC at 49 call option for a premium of 0.75 paise per dollar.

**PROFIT ZONE:** Max Rs. 7500, if RBI reference rate settles below 49.75

**LOSS ZONE :** Unlimited, if it settles above 49.75

# IMPORTERS

## BULLISH MARKET CONDITION

BUY CALL

SELL PUT

Spot	Exercise Rate Call @ 45.50	Premium Paid	P/L
43.00	0.00	0.20	-0.20
43.50	0.00	0.20	-0.20
44.00	0.00	0.20	-0.20
44.50	0.00	0.20	-0.20
46.00	0.50	0.20	0.30
46.50	1.00	0.20	0.80
47.00	1.50	0.20	1.30

For Example, assume a Corporate buys a USD call option for covering its import transactions from a bank on 1st June 2010, at a strike rate of 45.50. The expiry date is 3 months i.e. 31st August 2010. The premium is 20 paise on the call. When spot > strike price, there are gains, when spot < strike price there are losses, which are maximum to the extent of premium paid (See table).

However, a comparison can be made for evaluating the decision whether to cover imports by forward contracts or purchased call options.

## OPTION v/s FORWARD COMPARISON

Spot	Fwd@ 43.85+0.15=44.00	Call @ 44 +0.20 =44.20
42.70	-1.30	-0.20
43.00	-1.00	-0.20
43.10	-0.90	-0.20
43.20	-0.80	-0.20
43.30	-0.70	-0.20
43.40	-0.60	-0.20
43.50	-0.50	-0.20
43.60	-0.40	-0.20
43.90	-0.20	-0.20
44.00	0	-0.20
44.20	0.20	0
44.50	0.50	0.30
44.70	0.70	0.50

For Example, If suppose Forward contract quote for the same expiry date is at 43.85 with a premium of 15 paise. Then the Forward contract cost would be 44.00. Assume Call strike price to be 44 available at a premium of 20 paise. Then when USD depreciates, purchased call options are profitable than forward contracts, because options provides downside protection against risk of opportunity loss, however when USD appreciates, purchased call options are less profitable than forward contracts. Since the objective of hedging is to minimize and cover loss, it is advisable to cover imports through purchased call options.

## EXPORTERS



Spot	Exercise Rate PUT @ 45.50	Premium Paid	P/L
44.00	1.50	0.30	1.20
44.50	1.00	0.30	0.70
45.00	0.50	0.30	0.20
45.50	0.00	0.30	-0.30
46.00	0.00	0.30	-0.30

For Example, A MNC buys a USD Put option for covering its export transactions from bank on 1st June 2006, at a strike rate of 45.50. The expiry date is 3 months i.e. 31st August 2006. The premium is 30 paise on the Put. The given pay off table demonstrates that on decrease in spot above the strike price, there are gains, when it increases above the strike price; there are losses, which are maximum to the extent of premium paid.

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