

FX Options

Easy to use risk management product explained in plain English

There are risks associated with doing international trade and whilst most of them are usually taken care of many businesses fail to manage currency risk adequately. Volatility in exchange rates can make a big difference to the profitability so having a sound risk management policy is paramount to conducting international trade.

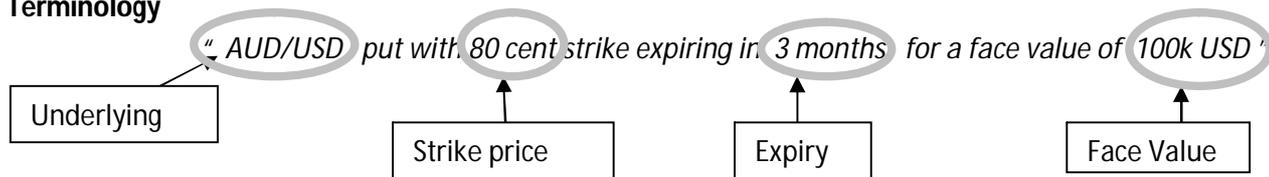
This document will aim to explain some simple tools businesses can use to minimise the negative effect currency fluctuations can have on the bottom line.

What is an option? A currency option (referred to as an FX Option) is the right but not the obligation to purchase a currency at a specified exchange rate at some future point in time. **So it gives the holder a guaranteed worst rate scenario with a get out clause should they choose, for whatever reason, not to go ahead with the currency conversion.**

Example - An Australian based importer knows he will have to pay a supplier \$100k USD in 3 months time. He has calculated the price for his customer by converting his AUD into USD at the current spot exchange rate of 80 cents at a cost of \$125k AUD. He is aware that the exchange rate will fluctuate over the next 3 months and does not want to pay more than \$125k AUD as it will erode some, possibly all of the profit on the client deal.

In this instance the importer could reduce his currency risk by purchasing an FX option which will allow him to convert the \$100k USD at 80 cents in 3 months time. This way if the currency falls he has secured the right to convert at 80 cents however he also has the "option" to not to convert at this rate and take the prevailing spot rate at the time if it is more favourable.

Terminology



What confuses most people about FX options is the terminology used - the phrase above might as well be in a foreign language to many. Words such as call, put, strike, expiry and premium are in many ways unique to options hence the mysterious nature of their meaning to many people.

It may help to think about an option in similar terms to an insurance policy for a car or a house. In such an example the policy holder pays a premium to insure the underlying asset which gives them cover for the specified period. Similarly the purchaser of an FX option will pay a premium to insure against adverse exchange rate movements.

Underlying – The currency pair which the option buyer has the right to buy or sell

Strike Price – Also commonly referred to as the exercise price. The strike price is the predetermined exchange rate that the holder of the option has the right (but not the obligation) to buy (or sell) the currency.

Premium – Is the cost the buyer will have to pay in order to purchase the option. Similar to an insurance premium one pays for a car or property.

Expiry Date – The date at which the option will lapse. This is the last day on which the holder can exercise their right to buy (or sell) the underlying currency.

Face Value – The amount of currency the option holder has the right to claim.

Call Option – Gives the holder the right to buy a particular currency at a specific rate on an exact date.

Put Option – Gives the holder the right to sell a particular currency at a specific rate on an exact date.

European Expiry – The option can only be exercised by the holder on the expiry date.

FX Options with OzForex

OzForex offers clients the ability to manage currency risk through the use of what are referred to as Vanilla FX Options, bought call or put options. Clients can buy a call or a put option, pay a premium and then decide on the expiry date if they choose to exercise the option and enter into the underlying a spot transaction.



Example *“AUD/USD put with 80 cent strike expiring in 3 months for a face value of 100k USD ”*

Let us assume the Australian importer wishes to hedge his USD payment and buys an AUD/USD put option. By doing so they have purchased the right to sell AUD and buy \$100k USD at an exchange rate of 0.8000 expiring in 3 months time. At the time OzForex quoted the client a premium of \$2k AUD which he accepted and paid to OzForex that same day in order to secure the right.

Scenario a - In 3 months time on the expiry date the spot AUD/USD exchange rate has fallen to 0.7500 so they decide to exercise their right to buy 100k USD and sell AUD because they have the right to convert at a more favourable rate of 0.8000. This triggers a spot deal with OzForex on the expiry day whereby the client has sold \$125,000 AUD and bought \$100,000 USD at an exchange rate of 0.8000, in essence saving the company \$8,333 AUD (difference between converting the 100k USD @ 0.7500 and 0.8000).

The client then provides settlement instructions and the foreign currency is remitted to the beneficiary account as per a normal spot transaction.



Scenario b – In 3 months time the AUD/USD spot rate has risen to 0.8500 so they decide not to exercise their right to buy 100k USD and sell USD at 0.8000 because they can convert at a more favourable spot rate on the open market. In this scenario the client has saved themselves \$7,352.94 AUD on the transfer (excluding the cost of the option premium).

Why a FX Option?

One of the reasons options are attractive to some is the ability to hedge downside risk whilst providing the ability to reduce costs should the subsequent spot rate become more favourable. This can be achieved at a known cost which will not vary throughout the life of the option – the premium.

Disclaimer: The information in this document is provided for information purposes only. It is not intended to constitute financial advice of any kind. Independent financial and taxation advice should be obtained before entering into any specific transaction with OzForex.