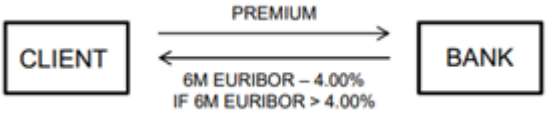
Information about interest rate option contracts (interest rate cap, floor and collar)

Use of contracts

Interest rate cap and floor are interest rate options which may have one or more interest periods. Interest rate cap buyers are hedging against rise in interest rates. If the reference rate exceeds an agreed level, the interest rate cap seller pays the difference on the agreed capital to the interest rate cap buyer. Interest rate cap can be used to hedge against higher interest rates without losing the benefits of the possible fall in interest rates.

Example 1

The client buys a 4.00% interest-rate cap from the bank with 6-month Euribor as reference rate for five years, paying a premium of 1.00% of the contract capital on the contract date.

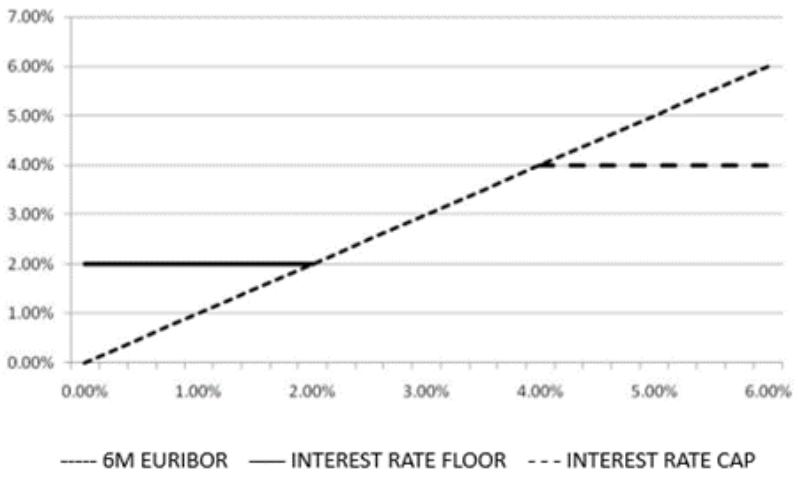


A buyer of an interest rate floor hedges against falling interest rates. If the reference rate falls below an agreed level, the seller of the interest rate floor pays the difference on the agreed capital to the buyer of the interest rate floor.

An interest rate collar is a combination of bought (sold) interest rate cap and bought (sold) interest rate floor. When the interest rate cap and floor premiums are equal, the interest rate collar is called a zero-cost collar.

Example 2

A five-year zero-cost collar with an interest rate cap of 4.00% and an interest rate floor of 2.00% with 6- month Euribor as reference rate. If the reference interest rate is higher than 4.00%, the interest rate cap seller pays the difference. If the reference interest rate is lower than 2.00%, the interest rate floor seller pays the difference.



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Option on interest rate swap (swaption)

The buyer of a payer swaption is hedging against rising interest rates. The buyer has the right to pay the previously agreed fixed interest and to receive floating interest during the specified period. The buyer of receiver swaption is hedging against lower interest rates. The buyer has the right to receive previously agreed fixed interest rate and to pay floating interest rate during the specified period. The buyer of each option pays a premium to the seller for this right on the contract date. The option may be exercised on its maturity date either as payment of net value or as a physical contract delivery.

Risks

The maximum loss to the buyer of an interest rate option contract caused by market risk is equal to the premium paid. Option writers have unlimited risk, because they are obliged to realize all cash flows arising from the contract regardless of the market conditions. An interest rate option seller's losses may be significant due to changes in interest rates and/or interest rate volatility. The option buyer has counterparty risk concerning the option writer. Counterparty risk means a risk that the option writer does not fulfil his responsibility to regarding the payments as stated in the option contract. The option writer's counterparty risk is related to receiving the premium from the buyer of the option contract.

Amount of price fluctuation of interest rate option contract

A premium will be paid on the contract on the contract date. The price depends on:

- contract period
- level of interest rate cap or floor / fixed interest rate of swaption
- level of market rates
- price volatility of interest rates

Financial commitments and obligations related to interest rate option contracts

The obligations of the interest rate option contract's buyer are related to paying the option premiums. The interest rate option writer must take care of the cash flows arising from the option contract.