Information about currency option contracts

Use of contracts

The holder of an option transaction (buyer) has the right at an agreed time to buy from or sell to the writer of the option (seller) an agreed amount of underlying instrument at an agreed price. The buyer pays the seller a premium of its right. The currency specified in the currency option contract is the underlying asset in the contract. The strike price is the exchange rate specified in the currency option contract, at which the currencies of a currency option transaction are bought or sold. Consequently, the buyer of the currency option contract buys the right to execute a currency transaction at the option strike price on the option value date. So, currency option contracts are used to hedge against adverse movements in exchange rates without losing the opportunity to benefit from positive movements in exchange rates.

If an option is not exercised on its expiration date, the option shall expire. The seller is not obliged to remind the buyer of the expiry of the option. The buyer shall notify the seller by the expiration time of the option, orally or in writing, of the exercise of the option. A notice to exercise an option is irrevocable. The option transaction can be “European” or “American”. A European option can only be exercised on the expiration date of the option transaction. An American option can be exercised at any time between the effective date and expiration date of the option transaction.

Risks

The maximum loss to the buyer of a currency option contract caused by market risk is equal to the premium paid. The option writer’s risk is unlimited since the option writer is obliged to execute the currency transaction at the option strike price, irrespective of the exchange rate prevailing on the value date. The option buyer has counterparty risk concerning the option writer. Counterparty risk means a risk that the option writer does not fulfil their obligation to execute the currency transaction at the option strike price on the option value date 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.

The product involves a risk that a derivative position can be closed upon decision by the relevant authority in a resolution process that may be commenced due to the bank’s severe financial difficulties, irrespective of the terms and conditions of the derivative. Following the closure, the amount of the debt based on the derivative contract may be reduced upon the authority’s decision.

Extent of variation of currency option contract value

The extent of variation of the currency option contract value is mostly affected by the option period, the size of exchange rate variation and the option strike price.

Financial commitments and obligations related to currency option contracts

The obligations of the currency option contract’s buyer are related to paying the option premium. The currency option writer must exercise the option at the option strike price on the option value date if the option contract buyer wish so, irrespective of the exchange rate prevailing on the option contract value date.

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