Vanilla Options: Calls

The Situation

Your firm imports goods from the UK. You are in the middle of setting your price lists for next year and you would like to set a maximum cost for the Sterling imports. You do not want to enter into a forward contract because you want to benefit from any possible weakness in Sterling. However, you want to protect yourself against Sterling becoming stronger.

The Product: Call Option

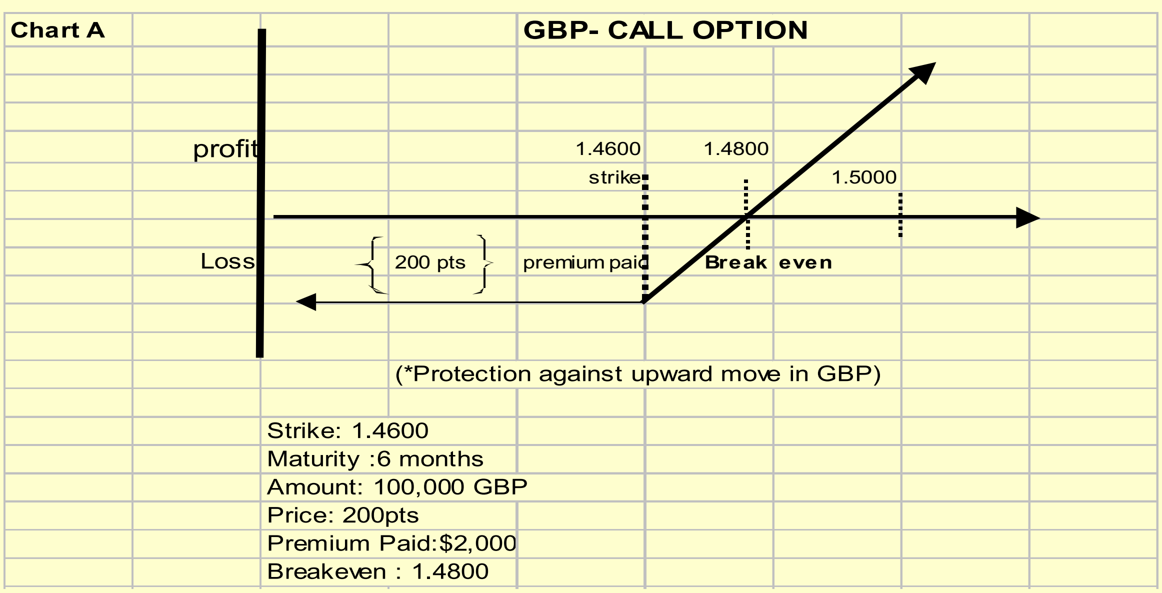
The purchase of a foreign-Currency Call Option is a contract between you and the Bank, which gives you the right, but not the obligation, to buy a fixed amount of foreign currency at a fixed price (strike) on or before a fixed date (expiration date). To do this, you must pay a fee (premium) to the Bank at the time you enter into the contract.

The solution

You need to buy 100,000 Sterling during the next 6 months. You want to guarantee a maximum rate of 1.4600, so you buy a Sterling Call option with a "strike rate" of 1.4600 maturing in 6 months time. To enter into this contract you must pay a premium to the seller of 200 GBP points ($2,000). Entering into this option contract you have protected yourself against any adverse upward move in Sterling (above 1.4600).

If, in 6mths time, the rate of exchange is at or above 1.4600, you will exercise this option. In doing so, you will buy Sterling (100,0000) at the strike rate of 1.4600. This contract would have a breakeven level of 1.4800, on the upside, which is derived from the strike level of 1.4600 plus the premium paid (200 points). Any level above 1.4800 is profit. If, on the other hand, the rate of exchange is below1.4600, you will not use the option and it will expire worthless and therefore, you may buy Sterling at the current market rate. You have protected yourself above 1.4600 and can also benefit from gains below that level.

If the current rate is at or below 1.4400 you recoup (via the current rate spot transaction) all premium you paid and possibly more. (1.4600 –200 PTS paid)
(See Chart A below).



The Benefits and Features

- Simple structure
- Maximum cost (know exactly Premium paid is before you enter into the contract)
- Underlying exposure has unlimited profitability
- The option gives you protection against unfavorable changes in exchange rates
- Flexibility, you may sell the contract back to us at any time and you may receive some value in return