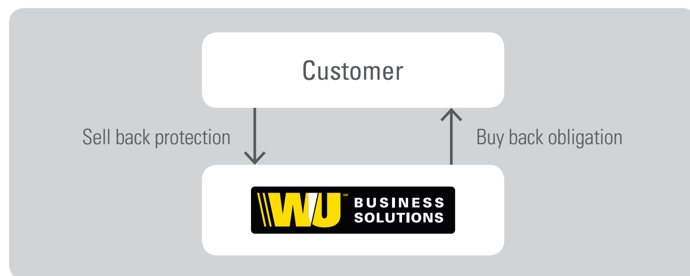
Closing out – when an Option is no longer needed

Unlike a Forward Contract, which is one contract with a fixed outcome, an Option structure is made up of two or more underlying Option contracts. One of these has been bought to provide protection for the buyer and has a positive value, the other(s) was sold in order to make the structure zero cost and therefore has a negative value.

At the time of purchasing the Option structure, the component parts would have been roughly matched in value with the positive value of the protection offset by the negative value of the potential obligation. In order to cancel an unwanted Option trade, it will be necessary to sell back the protection that was bought and buy back the obligation that was sold.

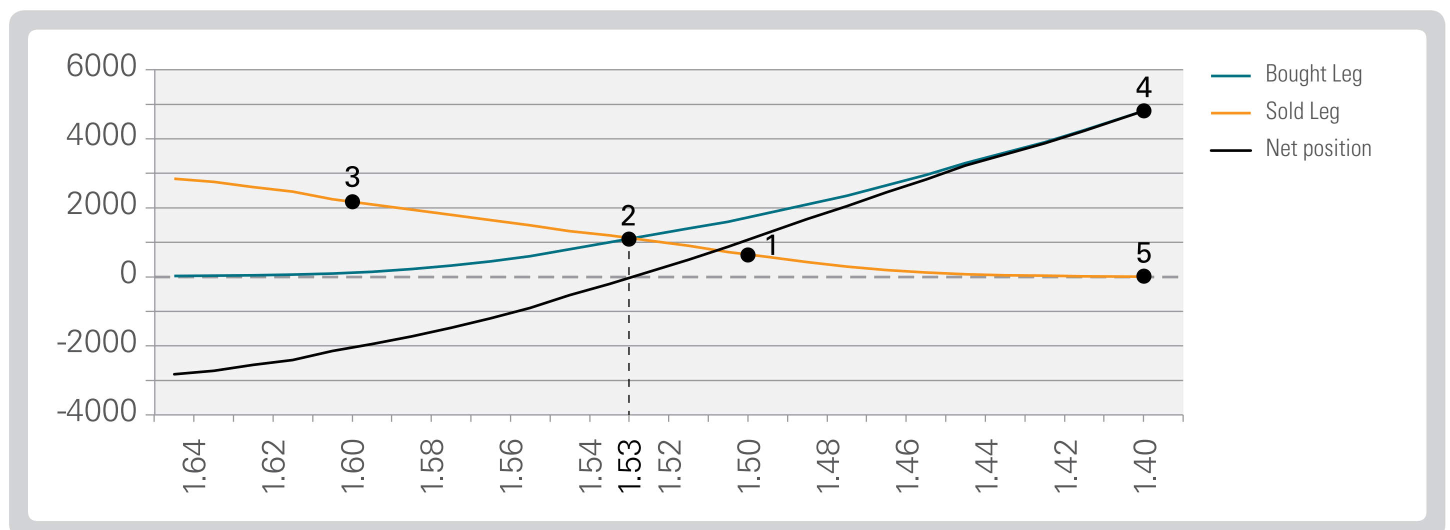


Determining the value

A Forward Contract with a fixed outcome is easy to calculate by the difference between the spot rate and the Forward rate, but this is only one part of the calculation of an Option's value at any given point in time. While the same general rules hold true, and the relative position of the underlying spot rate is still the primary determinant of value, the Option value also takes into account the time remaining to expiry and the volatility of the underlying currency pair. This tends not to result in a linear profile.

The chart below shows the relative values of the two component legs of a Participator Option offering protection for £100,000 at $1.5000 in 6 months' time. This structure is made up of the purchase of a Vanilla Option protecting £100,000 at $1.5000 if the GBP / USD rate is lower at expiry and the sale of another Vanilla Option which will oblige the buyer of the structure to deal £50,000 at $1.5000 if the GBP / USD rate is higher.

As the amount of protection is twice the amount of obligation, if the spot rate were already trading at $1.5000, the Option would not be zero cost. In fact, at $1.5000 the chart shows that this structure would have a positive value of just under £1,000 or 1% of the notional (see chart notation **1**). The Option would only be of zero value if spot is at $1.5300 – where the green and orange lines intersect on the chart and where the black line crosses zero (**2**). At this point, the value of protection 2 cents below current market (for the USD buyer) on £100,000 matches the value of obligation on £50,000 at 3 cents better than market (for the USD seller).



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Following the trade, if the underlying spot rate moves higher, the value of protection at $1.5000 decreases as the risk of the rate being sub-$1.5000 at expiry diminishes, whereas the value of the obligation to deal £50,000 at $1.5000 becomes greater as it becomes more likely to be enforced. If the GBP / USD rate falls, the opposite is true. As a result, in order to close out of this deal it will be necessary to sell what was bought and buy back what was sold.

If the GBP / USD rate is at $1.6000, the Vanilla Option giving the right to protection at $1.5000 is only worth £100, whereas the value of the sold option is now £2,250 – this results in a cost to close out of £2,150 (**3**).

If the GBP / USD rate is at $1.4000, the right to protection at $1.5000 is now very valuable at £4,750 (**4**). However, the cost to repurchase the obligation to deal at $1.5000 is only £10 (**5**) as it's now more favourable to sell USD at spot. As a result, when closing this trade the buyer would receive £4,740.

NOTE: although the Option structure has a negative value if the GBP / USD rate rises, this is actually the desirable outcome for the buyer of the structure as it means they will be able to deal 50% of their requirement at the more favourable spot rate meaning their net rate will be improving.

Western Union International Bank provides you with a monthly mark-to-market statement showing the value of your Option structures broken down into their component parts. If you require an up-to-date position report at any point, this can be provided on request.

What to Consider when closing out of a deal

1. If your Option has a positive value, this means that the market has moved against you and, if you do still need to buy your currency at a future date, it may well cost you more than with your existing hedge. If your payment need is delayed rather than cancelled, you should look to extend the hedge rather than closing out.
2. The bid / offer spread on an Option structure is much wider than with a Forward Contract or spot deal. Even if you realise very soon after trading that you no longer need the hedge, the cost to close may be significant.
3. Even if the spot rate has not moved, the value of your Option structure will still change because the Option's value takes into account the time left to expiry (which will have reduced) and the volatility of the underlying currency pair (which may have changed).

Please refer to the **Product Disclosure Statement** for information on our full range of option structures. This can be found at: http://business.westernunion.co.uk/Risk-Management/Fx-options/MiFID

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