Closing out of a trade

What if I no longer want the option that I've bought?

As with forward contracts the option positions that you hold will have either a positive or negative value depending on where the underlying spot rate is trading at that time. However, unlike a forward, 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 the desired protection for the buyer and has a positive value; the remainder were sold in order to make the structure zero cost and therefore has a negative value.

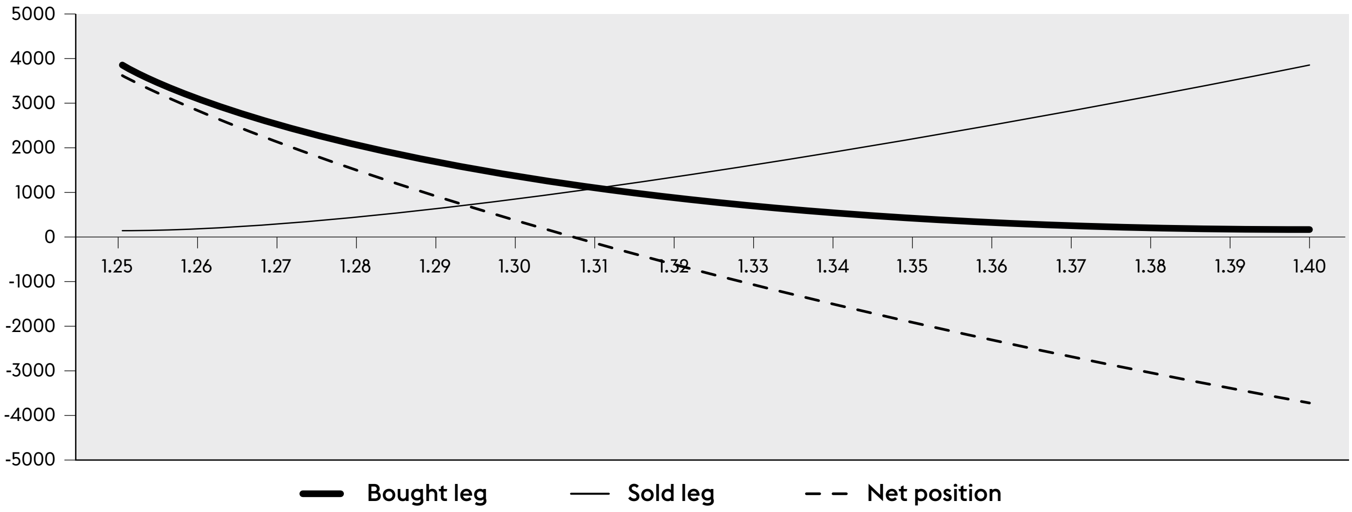
At the time of purchasing the Option structure, the component parts would have been roughly matched in value with the positive value of the protection offset by the negative value of the potential obligation. In order to cancel an unwanted Option trade, it will be necessary to sell back the protection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

Determining the value

This seems simple enough; however, whereas a forward contract with a fixed outcome is easy to calculate by the difference between the spot rate and the forward rate (+/-the forward point adjustment which results from interest rate differentials) this is only one part of the calculation of an option's value at any given point in time. 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, although the relative position of the underlying spot rate is still the primary determinant of value, so the same general rules hold true.

The following chart shows the relative values of the two component legs of a Participator option offering protection for £100,000 at $1.3000 in 3months' time. This structure is made up of the purchase of a vanilla option protecting £100,000 at$1.3000 if GBPUSD is lower at expiry, and the sale of another vanilla which will obligate the buyer of the structure to deal £50,000 at $1.3000 if GBPUSD is higher.

Clearly, as the amount of protection is twice the amount of obligation, if the spot rate were already trading at $1.3000, the option would not be zero cost. In fact, at $1.3000 the chart shows that this structure would cost just under £500 or 0.5% of the notional. The option would only be zero cost if spot is just under $1.3100 – where the thick and thin lines intersect on the chart and where the dashed line crosses zero. At this point, the value of protection 1 cent below current market (for the USD buyer) on £100,000 matches the value of obligation on £50,000 at 1 cent better than market (for the USD seller).



Following the trade, if the underlying spot rate moves higher, the value of Protection at $1.3000 decreases as the risk of the rate being sub-$1.3000 at expiry diminishes, whereas the value of the obligation to deal £50,000 at $1.3000 becomes greater as it becomes more likely be enforced. If the GBPUSD rate falls, the opposite is true.

If GBPUSD is trading at $1.3500,the vanilla option giving the right to protection at $1.3000 is only worth £359, whereas the value of the sold option is now £2,214–this results in a cost to close out of £1,855.

If GBPUSD is trading at $1.2500, the right to protection at $1.3000 is now very valuable at £3,879; however, the cost to repurchase the obligation to deal at $1.3000 is only £160 as it's now more favourable to sell USD at spot. As a result, when closing this trade the buyer would receive £3,719.

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 **business.westernunion.com/compliance-legal**

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