WesternUnion WU | Business Solutions

A guide to Currency Options

Currency Options can seem complicated and are often thought of as products used by investors to speculate on the money markets. However, this is not entirely true.

The Options offered by Western Union Business Solutions are designed to reduce the risk of being exposed to fluctuating exchange rates. They are increasingly being used by small and medium-sized enterprises in certain circumstances to help control this risk and achieve better cash flows.

What is a Currency Option?

A simple example of a Currency Option is called a Vanilla Option. This gives you the choice of whether or not to sell one currency and buy another at a specified exchange rate (the protection rate) on a date in the future (the expiry date). If, on the expiry date, the prevailing market rate is less favourable than your protection rate, you will exercise your right to deal.

Alternatively, if the spot rate is more favourable you can allow your Option to expire and deal at the more advantageous spot rate. The right to choose is valuable and, as a result, to take out a Vanilla Option, you must pay an amount of money up front (the premium) to the counterparty that sold you the Option.

Vanilla Option to sell GBP and buy USD at $1.30

Customer	Western Union Business Solutions
Outcome 1 At expiry date **SPOT Rate is $1.35** The customer can exercise their right not to purchase the Dollars at $1.30 but by SPOT at **$1.35**.	**Outcome 2** At expiry date **SPOT Rate is $1.25** The customer can exercise their right to purchase the Dollars at **$1.30**.

What is the difference between an Option and a Forward Contract?

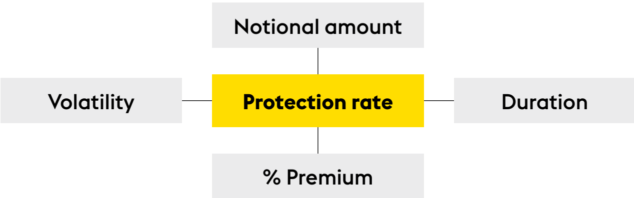
In comparison to a Vanilla Option, a Forward Contract (which has no upfront cost) also gives you the right to sell one currency and buy another at a specified exchange rate, on a date in the future, but it does not give you the right to choose. This means that if the market moves in your favour, you are still obliged to buy and sell at the specified rate so you cannot benefit from the market movement.

	Forward	Options
Upfront cost	✗	✓
Known rates	✓	✓
Participate in favourable markets	✗	✓

Although both products protect you should the market move against you, only an Option will allow you to benefit should the opposite occur. Moreover, whilst a Forward has no upfront cost, an Option will require payment of a premium. This premium is non-refundable, even if you choose not to exercise your Option on the expiry date. The premium is a known cost that can be budgeted for so there are no surprises.

How is the premium calculated?

A number of factors will be considered when determining the premium of a Vanilla Option including how close the specified protection rate is to the current spot rate, the duration of the contract, and the volatility of the underlying currency pair. All of these inputs are used to determine how likely it is that the buyer of the Option will want to exercise his right to deal at expiry; the more likely this outcome, the more expensive the premium.



This means you should expect to pay more if your Option is due to expire just after a significant market event such as an election or an interest rate decision. Events of this nature can cause a short-term spike in volatility and possibly shift the exchange into your favour at the time the contract expires. Similarly, as uncertainty increases over time, a longer-term Option will be more expensive than a shorter term one.

Other types of Options

You can avoid paying a premium altogether by using what is known as a Structured Product or a Zero Cost Option Structure. These more complex Options can be tailored to your requirements and market conditions, which could make them an attractive alternative.

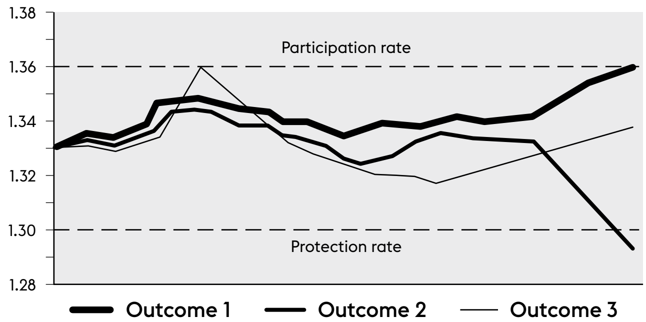
Collar Options

A simple example of a zero cost Option is known as a Collar Option. Imagine a simple Vanilla Option giving you the right to sell GBP and buy USD at $1.3000 in three months' time. The spot rate is trading at $1.3300 and the premium would cost 2%. The protection rate is three cents below the market, but this suits your planned budget.

However, you don't want to pay the upfront premium.

In simple terms, the equivalent Option giving the right to sell USD and buy GBP at $1.3600 would also be worth 2% to someone needing to sell US dollars, as it is also three cents less favourable to them than the prevailing spot rate.

In order to make your purchase of protection at $1.3000 cost nothing you sell this opposing option at $1.3600 for the same premium to Western Union Business Solutions. The cost of one premium is offset by the other.



What does that mean at expiry?

Outcome 1

If the GBP / USD rate is trading above $1.3600, Western Union Business Solutions would exercise the Option you sold us. This gives us the right to sell you US dollars at $1.3600 and obliges you to buy at that rate. This is the best possible scenario.

Outcome 2

If the GBP / USD rate is below $1.3000, you will exercise your right to buy USD at $1.3000. This is the rate you have budgeted for and also your worst-case scenario.

Outcome 3

If the GBP / USD rate is between $1.3000 and $1.3600, both options would expire worthless and you would deal at the prevailing spot rate. This is a better deal than you have budgeted for.

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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