FX VANILLA OPTIONS

Sometimes, businesses want protection for their FX exposures as well as the flexibility to participate if exchange rates move in their favour.

You might know about Forward Exchange Contracts, and how they could help manage your business’ FX risk. In this short video, we’ll look at the difference between a Forward and a vanilla option, to compare the certainty and flexibility they could provide your business.

A Forward Exchange Contract works by securing a known exchange rate with a specific amount, for a date sometime in the future. So whether you’re making payments to an overseas supplier, or receiving payments from overseas, Forwards can give you certainty in the ups and downs of a volatile market.

With a Forward Exchange Contract, you are protected against any movements in exchange rates for the value of your contract. If you’re an importer and at maturity, the spot price is more favourable than your Forward Exchange Contract, Forwards won’t allow you to participate in that higher exchange rate. This is where a vanilla option can help.

A vanilla option gives the right but not the obligation to use your contract, with complete flexibility to take advantage of favourable exchange rate movements.

An important factor when purchasing a vanilla option is the premium, or upfront cost payable. The option premium is variable depending on many factors including, how long the option is for, (also known as the time to expiry), the face value (or amount), the strike price or protection level compared to the current spot rate, and underlying volatility in currency markets.

Let’s look at an example. William’s business imports furniture and he pays his invoices in US dollars. The current spot rate is 77 cents and William has agreed to pay a supplier USD 200k in 3 months time. William has budgeted at an AUDUSD rate of 75 cents and wants to get this rate or better, to protect his gross profit margin from being eroded. William buys a 3 month, USD 200k put option, with a strike price of 75 cents which is the right but not the obligation to sell AUD and buy USD 200k in 3 months’ time at the rate of 75 cents. The premium, or cost, of buying this option is $5000 which William must pay at the time of purchase, similar to an insurance premium.

Let’s consider 2 possible outcomes in 3 months’ time. If the AUDUSD spot rate is below the strike price of 75 cents, William would exercise the option to sell AUD and buy USD 200k at the rate of 75 cents, in this way he is fully protected from a weakening AUDUSD.

Alternatively, if the spot rate is above 75 cents, then William lets the option expire, choosing not to use it because the spot rate is more favourable. He is able to purchase the USD 200k at the prevailing higher spot rate, in this way he gets full participation in moves higher in the AUDUSD.

On the other hand, if William was an exporter, he could buy an Aussie dollar call option, which is the right but not the obligation to buy AUD by selling USD.

For example, if William is receiving USD 200k in 3 months’ time, he can buy an AUD call option for USD 200K and expiry in 3 months, with a strike rate at 79 cents. The cost of this option is approximately $5000.

In 3 months’ time, if the AUD is trading above 0.7900, William would be 100% protected and would exercise his option to sell USD 200k and buy AUD at 79 cents. If the AUD was trading below 79 cents in 3 months’ time, William lets the option lapse and converts his USD to AUD at the more favourable spot rate.

Using Vanilla FX Options have their own unique costs and benefits. They are however, another valuable tool available to help manage FX currency risk.

To find out more and see if a Risk Management strategy can work for your business, speak to your Business Banker or call the NAB Markets Team on 1300 960 355.

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