European Buy Put Option

This Product Disclosure Statement is in reference to RBI Circular dated 16.09.2021, Master Direction – Reserve Bank of India (Market-makers in OTC Derivatives) Directions, 2021.

This document contains standard information about the product, which may enable the user to determine if the product will meet its hedging needs and to facilitate comparison with other products.

Features

Put options are financial contracts that give the option buyer the right, but not the obligation, to sell an underlying at a specified price (strike price) at a specific time period (expiry day/delivery day) and user pays upfront premium for the same. This derivative product can be used to hedge FCY receivables.

An option instrument will have expiry date and delivery date. For European option, on expiry day, the option buyer decides whether to exercise option or not. If the option is exercised, the delivery/settlement of he exercised leg has to happen by the settlement/delivery date (second working day from exercise day). The settlement can happen at gross or net basis as per user's request.

Illustration:

For a receivable underlying in USD where INR is domestic currency, user buys USD put option.

The underlying exposure for this product is a USD receivable. User is exposed to risk of USD to INR conversion rate going lower resulting in lower INR realization. The put option acts as a hedge against USDINR spot rate going lower than strike price and retains full upside in case USDINR spot rate is higher than strike price. Under this product user pays an upfront cost to purchase an option that entitles it a right but no obligation to sell USD against INR.

Building Blocks:

The building blocks of this option are as below:

a. Spot FX rate,
b. Forward FX rates
c. Time to expiry and
d. Implied volatility.

Costs and fees, including break-up and details

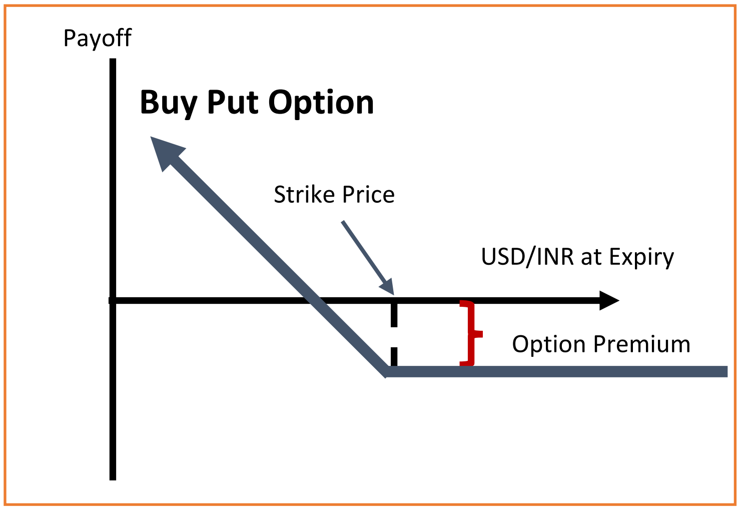
The option cost consists of market cost, which is determined through a financial model taking above building blocks as input parameters, and the price is dependent on Bid/Offer spread of the spot rate, forward rate and implied volatility along with administrative costs and transaction handling charges.

An illustration of how the product works

User buys USD Put/INR Call at strike price for agreed expiry day/delivery day

On expiry day, if the USDINR spot rate is –
(1) Above strike price, User sells USD at market spot rate
(2) Below strike price, User sells USD at strike price

Pay-off profile:



Impact Analysis

Option: Buy Put Spot at the time of deal: 73 Strike Price: 76 Option Premium: 1				
Spot at Expiry	Sell price if Unhedged	Option Payoff	Option Payoff net of Premium	Net Selling Price
73	73	3	2	75
74	74	2	1	75
75	75	1	0	75
76	76	0	-1	75
77	77	0	-1	76
78	78	0	-1	77
79	79	0	-1	78

Benefits

Under this transaction, User purchases an option that entitles it a right but no obligation to sell USD against INR. If USD to INR conversion rate goes lower, user receivable is protected at the strike price. If USD to INR conversion rate goes higher, user benefits from selling at market spot rate.

Risks

(1) Option expiring without getting exercised, effectively reducing INR realization compared to unhedged transaction on account of option premium paid
(2) Liquidity risk
(3) Bid-offer spreads in case of unwind

The terms and conditions applicable for booking/termination will be guided by deal term sheet/sanction letter/ISDA document