Covered 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 risk management objectives and to facilitate comparison with other products.

Features

In this product, the user writes (sells) a standalone plain vanilla European put Option against its payable exposure at a particular strike price for an expiry/delivery date. This sell put option allows user to receive upfront premium and along with the underlying, limits the gain on the currency movement to the strike of sell put option.

This strategy should not be considered as a hedge and should be monitored closely.

Illustration:
For a payable underlying in USD where INR is domestic currency, user sells a covered USD put option.

The underlying exposure for this product is a USD payable. User is exposed to risk of INR depreciation against USD resulting in higher INR payable. This sell put option allows user to receive upfront premium and limits the gain on the currency movement to the strike of sell put option.

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

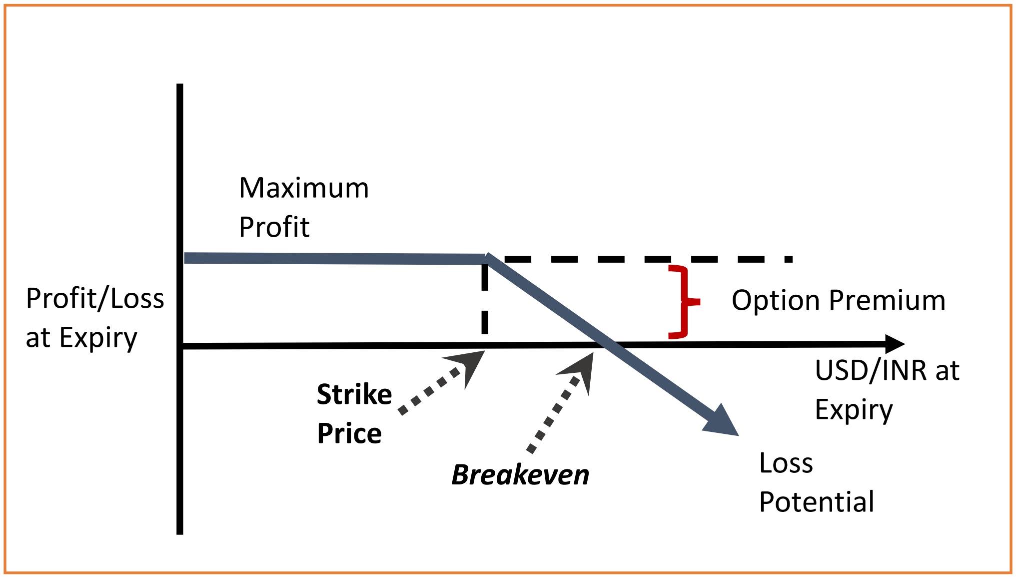
The option cost consists of market cost which is determined through a financial model taking above building blocks as input parameters and the price is dependent on Bid/Offer spread of the spot rate, forward rate, implied volatility; along with administrative costs; transaction handling charges.

An illustration of how the product works

User sells USD put /INR call at strike price for agreed expiry day/delivery day against its USD payables

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

Pay-off profile (Sold Put + Unhedged Underlying):



Impact Analysis

Option: Covered Put
Spot at the time of deal: 73
Strike Price: 75
Option Premium: 1

Spot at Expiry	Buy price if Unhedged	Option Payoff	Option Payoff net of Premium	Net Buying Price
73	73	-2	-1	74
74	74	-1	0	74
75	75	0	1	74
76	76	0	1	75
77	77	0	1	76
78	78	0	1	77
79	79	0	1	78

Benefits

It allows user to receive upfront premium and also participate in INR appreciation till sell put strike price for the unhedged portion of its exposure

Risks

(1) The strategy caps the upside gain on the underlying if spot on maturity is below sell put strike, however, it does not mitigate the currency risk and has unlimited downside risk in case spot is above the strike price
(2) Bid-offer spreads in case of unwind
(3) Liquidity risk

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