Introduction to basic options

Basic options are financial instruments where the value depends on an underlying asset - such as a share, an equity index, a bond or a currency. The underlying asset is the asset on which the option's value is based. An option gives you the right - but not the obligation - to buy (call option) or sell (put option) the underlying asset at a future date at a pre-agreed price.

If you sell an option, you have the opposite obligation: You must sell (call) or buy (put) if the buyer chooses to exercise his or her right. As a seller, you receive a premium for taking on this risk. The size of the premium depends on the current price of the asset, the strike price, interest and cost levels, time to expiry and expected volatility.

There are two simple types of options

- European options: Can only be exercised on the expiry date
- American options: Can be exercised at any time during the term, which typically results in a higher premium

Options can be settled through physical delivery of the underlying asset or as cash settlement.

Opportunities with options

Options can be used to increase your exposure to an asset or to hedge risk - without tying up much liquidity, as you as a buyer only pay the premium. It also means you can leverage your investment. There are many options strategies, but this fact sheet describes only some of the simplest ones.

Investment

- Purchase of call option: Relevant if you expect the price to rise above the strike price including the premium.
- Purchase of put option: Relevant if you expect the price to fall below the strike price including the premium.
- Sale of call option: May be advantageous if you expect the price not to exceed the strike price including the premium.
- Sale of put option: May be advantageous if you expect the price not to fall below the strike price including the premium.

Hedge

- Covered call: The sale of a call option on an asset you already own can cover all or part of any loss if the price drops.
- Protective put: The purchase of a put option can eliminate losses below the strike price, against payment of the premium.

Spreads

By buying and selling options in the same asset, but with different strike prices, maturities or combinations, you can create strategies. One example is a long straddle where you buy both a call and a put with the same strike price and maturity. The strategy can yield gains from large price fluctuations - while the maximum loss is the premiums.

1. Benefits and drawbacks

Benefits	Drawbacks
You can invest in the underlying asset with limited capital commitment.	Selling options involves binding contracts - you are obliged to buy or sell at the agreed price.
Opportunity to make money in both falling and rising markets.	Risk of leveraged losses if the market moves against you.
You can reduce or eliminate market risk on the underlying asset.	The market can be illiquid - especially during stressed periods.
Possibility of many strategies through the purchase of spreads.	Pricing is model-based - often there is no single definitive market price.

2. Return

The return depends on whether you are a buyer or a seller and how the price develops in relation to the strike price. As a buyer of a call option, you profit if the price exceeds the strike price. As a buyer of a put option, you profit if the price is below the strike price. If the option expires without value, the loss is the premium. As a seller, you receive the premium as compensation for taking on the risk. If the option is not exercised, the premium represents your return.

3. About risk

Risk as a buyer

As a buyer, the option may expire without value if the price does not move in a direction that gives rise to a profit. This means that you can lose the entire premium paid.

Risk as a seller

Selling options carries greater risk. If you sell a call option, the loss can in principle be unlimited. If you sell a put option, the risk is limited, but losses can still be substantial. You must be able to provide security if the market develops against you.

Liquidity risk

Options can be difficult to trade during stressed periods. You may risk incurring a loss if you want to close a position before expiry.

Exchange rate risk

If you trade options in a foreign currency, changes in the exchange rate will affect your investment.

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4. What you should know before trading

When trading derivative financial instruments with the Bank, you may be required to enter into a framework agreement. This agreement outlines how the Bank monitors the risk you assume and gives the Bank the right to terminate the contract or require collateral if the market value moves so far against you that it exceeds the agreed credit limits.

If you wish to receive individual advice on setting up and managing options transactions on an ongoing basis, you should contact your adviser.

Taxation

The applicable tax rules depend on how you invest - whether as a private individual, a business, a company or through pension savings. For specific advice, you should consult an accountant.

Costs

Trading options involves trading costs that depend on market turnover and a margin covering the the Bank's costs and earnings.

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