Foreign Currency Options

Description of the product

1. Foreign Currency (FX) options are contracts that give the buyer the right, but not the obligation, to buy or sell one currency against the other, at a predetermined price and on or before a predetermined date. The buyer of a call (put) FX option has the right to buy (sell) a currency against another at a specified rate. If this right can only be exercised on a specific date, the option is said to be European, whereas if the option can be exercised on any date prior to its maturity, the option is said to be American.

Permitted Product and Activity

2. All Authorized Derivative Dealers and Non Market Maker Financial Institutions are permitted to carry out derivatives business in Foreign Currency Options as follows:

    a. Dealing in FX options is permitted in G-7 currencies only.
    b. No entity may offer any PKR / USD or PKR / Other Currency option unless specifically permitted by State Bank of Pakistan.

Size

3. There is no restriction on the minimum or maximum size of `notional principal' amounts of FX options.

Tenor

4. Maximum tenor of the Option may not exceed 1 year. Any transaction, which exceeds this tenor, would require separate approval from relevant approving authority.

Risk Management

5. All FX option transactions will be covered by ADD and NMI on a back-to-back basis and FIs will not be allowed to carry any market risk in this respect, except as permitted in 9 below.

6. Authorized Derivative Dealer must cover all exposures on a back-to-back basis from a foreign bank or their branches abroad.

7. Authorized Derivative Dealers, which have their Head Offices in Pakistan, may cover their position with their branch abroad, however they must ensure that their branch also covers its position on a back-to-back basis offshore.

8. Authorized Derivative Dealer, which has its Head Office outside Pakistan, will be required to cover their exposure with their branch outside Pakistan.

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9. ADD in order to cover its long / short FX position may purchase Vanilla FX Options with a maximum maturity of 6 months. Such FX options will be reported on a net delta weighted basis in the net foreign exchange exposure reporting.

10. Banks may enter into packaged products involving cost reduction structures for customers provided the structure does not involve customers receiving a premium.

11. Banks may quote the option premium in US Dollars or in the currency of the underlying option and will be allowed to remit abroad the premium required to cover the transaction on a back-to-back basis.

12. Hedges entered against a particular exposure or part thereof for a given time period should not exceed the total principal / duration of the underlying exposure.

13. A customer may enter into FX Option hedge with any Financial Institution irrespective of the exposure being booked in that Financial Institution or not.

14. Authorized Derivative Dealer / Non-Market Maker Financial Institution must ensure that its customer has Board / Head office / senior management approval to enter into derivative contracts for hedging.

Settlement

15. Option contracts may be settled on maturity either by delivery on spot basis or by net cash settlement as specified in the contract. In case of unwinding of a transaction prior to maturity, the contract may be cash settled based on the market value of an identical offsetting option.

16. Options can be booked against all existing FX exposures arising out of trade transactions and loan exposures. In cases where exposures are against PKR, the customer will either run their USD / PKR exposure or cover this separately in the interbank forward market.