[Frequently Asked Questions]

[Derivatives (Part - 2)]

Subject:	Business Economics
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Frequently Asked Questions

Q.1. **How do options differ from swaps and forwards?**

Ans. In a forward or swap, the parties lock in a price (e.g., a forward price or a fixed swap rate) and are subject to symmetric and offsetting payment obligations. In an option, the buyer purchases protection from changes in a price or rate in one direction while retaining the ability to benefit from movement of the price or rate in the other direction. In other words, the option involves asymmetric cash flow obligations.

Q.2. **What is the credit risk associated with options?**

Ans. For a buyer of an option, the amount at risk is generally the value (premium) of the option at default. For the seller of an option, there is no credit exposure.

Q.3. **What is an open interest?**

Ans. Open interest refers to the number of outstanding contracts in the exchange market.

Q.4. **What is the premium of an option?**

Ans. The premium is the option price: it is the money that the buyer (holder) pays the seller (writer) for the implicit right in the option. It is the only contract concept that is negotiated between the parties in institutionalized markets. The premium is the maximum amount that the buyer can lose and the maximum amount that the option writer can win, whether or not the buyer exercises the option.

Q.5. **What is the time value of an option?**

Ans. The time value is the amount of money that buyers wish to pay now for a certain option, anticipating that, with time, a change in the price of the underlying asset will generate an increase in the option's value. It also reflects the minimum price that sellers are willing to accept for writing a certain option. The time value of an option represents for the buyer the possibility that in time the option might gain intrinsic value. Time value at expiration is zero. Time value = premium - intrinsic value. An "out of the money" option will only have time value.

Q.6. **What is the meaning of Option Contract?**

Ans. An option contract is a contract, that, in exchange for the option price, gives the option buyer the right , but no obligation, to buy (sell) an asset at the exercise price from (to) the option seller (buyer) within a specified time period, or depending on the type of option, a precise date (i.e. expiration date).

Q.7. **What is Call option?**

Ans. A Call option gives the option holder the right to purchase the underlying asset by a certain specified date for a specified date for a specified (in advance) price.

Q.8. **What is a Put option?**

Ans. A Put option gives the option holder the right to sell the underlying asset on a selected date for pre-selected price.

Q.9. **How many types of Option Positions are there?**

Ans. There are four types of option positions:

1. A long position in a call option
2. A long position in a put option
3. A short position in a call option
4. A short position in a put option.

Q.10. What is Covered Call Strategy?

Ans. When a long position on the underlying stock is combined with a short position on an out of the money call option a covered call strategy can be constructed.