

Example of a FFA Option

Example: Ship owner 'D' wants protection against a falling market, and so (rather like taking an insurance policy) buys a Put option for panamax Cal 11 ,at a strike price of \$17,000 at \$2400 premium per day for 30 days per month. The total premium ($\$2,400 \times 30 \times 12 = \$864,000$) is payable by the buyer to the seller at the time that the contract is concluded. The first settlement will take place on 31 January 2011. If the settlement is under \$17,000 – the buyer will be paid the difference multiplied by the contract size (which in this case is 30 days per month). If any of the 12 settlements settle above \$17,000 – the option will not be declared, and no money will change hands. Unlike options associated with physical charterparties, the buyer does not need to declare the option in advance, it be automatically declared if the option is in the money (FFA Options are European-averaged - or Asian style).

The seller (or granter) of an option sells the right to the buyer to either buy (a Call) or sell (a Put) – for that they get paid an upfront premium from the buyer. This premium is the maximum profit a seller can make on the deal. The seller will value every option individually using historical volatility and the Black and Scholes options' calculator (to calculate a suitable premium) which will match or outweigh the risk they are taking by selling an option (a right) to someone else.

The seller of the panamax Cal 11 Put option above is in effect speculating on the panamax market not dropping below \$14,600 during the next year. If any of the 12 months settle below \$17,000 the option will be declared and they will have to pay the difference between the agreed price and the settlement multiplied by the contract size. Because they received \$2,400 per day upfront they will not be out of pocket until a month settles under \$14,600. If any settlement is above \$17,000 the option will not be declared, and the seller will keep the full premium for that month.