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Swaptions and Options

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Abstract

A swaption is a derivative contract granting the right to enter into a swap. The literature on swaptions is sparse, and only the interest rate swaption has been examined. This paper examines swaptions on equities, currencies, and commodities, exploring a variety of constructions to determine how these instruments are similar to standard options on the underlying asset. It shows that in most cases, swaptions can be shown to be equivalent to a specific quantity of options on the underlying asset. As a result, standard models for pricing options on the underlying can be used to price swaptions. In addition, this paper provides a variation of the Margrabe model for pricing exchange options in which one of the assets is a bond and the other a stock, which is appropriate for pricing equity and currency swaptions.

Keywords: swaptions, options

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