*How does the existence of swap options add to the possibilities in risk management techniques? While option strategies have not yet been discussed, you should be able to draw conclusions from prior chapters. How options lead to an infinite range of possible strategies for swap investors.*

A swaption (also known as a swap option) is an option contract that grants its holder the right but not the obligation to enter a predetermined swap contract. In return for the right, the holder of the swaption must pay a premium to the issuer of the contract. Swaptions typically provide the rights to enter interest rate swaps, but swaptions with other types of swaps can also be created.

In terms of their trading characteristics, swaptions are closer to swaps than to options. For example, swaptions are over-the-counter securities like swaps. In other words, the derivative contracts are traded over the counter, not on centralized exchanges. Also, the swaptions benefit from a great degree of flexibility since the contracts do not come in a standardized form. This leads to many possibilities for the parties involved. Before the transaction, the counterparties in a swaption must agree on the various features of the contract. For example, the parties determine the price of the swaption (also known as the swaption’s premium) and the length of the option. In addition, the counterparties must decide on the features of the underlying swap. The features generally include the notional amount, swap’s legs (fixed vs. float), and frequency of adjustment for the variable leg. Also, the counterparties determine the benchmark for the floating leg of a swap.

Swaptions are frequently used in hedging various macroeconomic risks such as interest rate risk. A company anticipating an interest rate increase may purchase a payer swaption to protect itself from the interest rate risk. Additionally, the swaption may allow hedging the risks associated with financial securities such as bonds. Also, financial institutions commonly employ swaptions to change their payoff profile. Swaptions are primarily employed by large corporations and financial institutions, including investment banks, commercial banks, and hedge funds.