Interest Rate Futures Option

An interest rate future option gives the holder the right but not the obligation to buy or sell an interest rate future at a specified price on a specified date. It is usually traded in an exchange.

The buyer normally can exercise the option on any business day (American style) prior to expiration by giving notice to the exchange. Option sellers (writer) receive a fixed premium upfront and in return are obligated to buy or sell the underlying asset at a specified price.

Interest rate future options can be used to hedge against adverse changes in interest rates. In general futures markets tend to be more liquid than underlying cash markets. Option writers are exposed to unlimited liability.

An interest rate future is a contract between the buyer and seller to deliver an interest rate asset at a specified rate on a specified date. The future allows the buyer and seller to lock in the price of the interest rate asset at a future date.

An investor who expected short-term interest rates to decline would also be expecting the price of the future contracts to increase. Thus, they might be inclined to purchase a 3-month ED futures call option to speculate on their belief.

The advantage of future options over options of a spot asset stems from the liquidity of futures contracts. Futures markets tend to be more liquid than underlying cash markets. Interest rate future options are leveraged instruments.

Reference:

https://finpricing.com/lib/EqRainbow.html