American vs European vs Bermudan Options

Know how they are different from one another

Source: Corporate finance institute

There are different types of options that differ in terms of exercise restrictions. The three basic types are American, European, and Bermudan options. Let’s explore each option to find out how they are different from one another.

What are American Options?

American options are the best-known and most widely used. They include, of course, call and put options. Stock options in US stock markets typically have an expiration period of between three months and one year.

American options are widely used because they offer the most flexible exercise schedule: they can be exercised on any trading day prior to their expiration.

What are European Options?

European options are different because they can’t be exercised before the expiration date. In other words, they can only be exercised on one specific date, which means that traders enjoy much less flexibility in how they handle option trading.

European options, for this reason, are typically considered less valuable than American options, and can, therefore, usually be purchased at a discount. Another difference from American options is that European-style options are typically traded over-the-counter (OTC) rather than on an exchange.

It’s important to note that while traders of European options are limited in terms of when they can exercise options, they are still free to sell their options to another trader in the secondary market prior to the option’s expiration.

What are Bermudan Options?

Bermudan options are different from both American and European options. The contract for a Bermudan-style option denotes specific days before expiration on which the trader can exercise his option.

The specified exercise dates are usually near the time of the option’s expiration date. Thus, Bermudan options fall in between American and European options in terms of how much freedom a trader has to exercise the option.

Let’s use a scenario of a trader purchasing a call option on 100 shares of Company ABC stock, with an expiration date in April. A trader with a Bermudan call option can elect to buy shares of Company ABC for $30 per share ($30 is the strike price).

The only caveat is that he can only exercise his option on four specified days in April, as laid out in the option contract. He has more freedom of exercise than he would with a European option, but still considerably less freedom than he'd have with an American option.

Thank you for reading.

I hope that you find it useful.

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