

# DESCRIPTION OF FINANCIAL INSTRUMENTS AND RELATED RISKS

## INTRODUCTION

This document is addressed to the Bank's clients or potential clients (Clients) in the sense of Directive 2014/65/EU on markets in Financial instruments ("MIFID") and Commission Delegated Regulation (EU) 2017/565.

Pursuant to the requirements of legal acts and in order to enable the Client to take an investment decisions on an informed basis, the Bank hereby presents a generalized description of the character of financial instruments' types and risks inherent to them. A particular financial instrument may have additional conditions and risk factors inherent to that particular instrument.

This description is provided with a purpose to explain the nature of the specific type of instrument concerned, the functioning and performance of the financial instrument in different market conditions, including both positive and negative conditions, as well as the risks particular to that specific type of instrument in sufficient detail.

The Client should review this description prior to making an investment decision. This document does not constitute investment advice (nor any other advice of any nature) and is not intended as a personal recommendation to invest in the financial instruments. Before making an investment decision, a Client should consider whether such investment could be suitable taking into account his/her knowledge and experience in the financial instrument market, financial state and investment objectives and, if necessary, seek appropriate professional advice.

## 1. GENERAL PROVISIONS

An investor's main objective is to seek a positive return on his/ her investment/ hedging. However, any investment is risky. Therefore, an investment may fail to ensure the expected return, or even be loss-making. Normally, there exists a direct relation between the amount of the expected return and the scope of the risk, i.e. the higher the return on investment is expected, the higher the risk of incurring losses. Different financial instruments carry different risks. One of the methods for limiting the risk of losses is to invest in a set of financial instruments rather than in one, or in several similar financial instruments. The purpose of this is to distribute the risk evenly and avoid the same negative impact on all financial instruments at the same time.

The Client is personally responsible for a decision to invest in one or another financial instrument. The Client is responsible for monitoring the status of his investments regularly, irrespective of whether he or she has been given investment advice in respect of a certain investment or not. The Client should use all the information accessible to him in order to monitor price changes and to follow the value of his investments, including data provided by the Bank or other information providers (e.g. trading systems, Reuters, Bloomberg, and other information facilities), or collected by the Client personally.

**Please note that the current list of risks is not exhaustive and includes only the most important of them, and other risks may occur to the Client in the course of the transaction.**

## 2. GENERAL INFORMATION ABOUT THE FINANCIAL INSTRUMENTS AND RISKS

### 2.1. Definition of Different Types of Risks

The most significant common risks that the Client should take into account:

- **Price risk** – the likeliness and magnitude of relevant financial instrument price changes.
- **Market risk** – also called "systematic risk", is the likeliness to experience losses due to factors that affect the overall performance of relevant financial markets.
- **Liquidity risk** – the risk that certain financial instruments cannot be purchased or sold unless significant additional expense is taken due to lack of liquidity in the market. The liquidity of a financial instrument can be measured as a spread between bid/ask price.
- **Currency risk** - the risk that an investor may incur losses if investments in financial instruments are denominated in foreign currencies. The customer should be aware that the value of investments may fall as a result of unfavorable fluctuations of exchange rates.
- **Interest rate risk** - the risk that the Client will incur losses due to the fluctuations in interest rates.
- **Information risk** – the risk that the Client will incur losses due to the fact that, at the time of adopting a decision on investments in certain financial instruments, complete information on the issuer is not available or the information is erroneous.
- **Counterparty credit risk** – the risk that the Client may incur losses if a counterparty who has credit exposure to the Client or to the Bank acting on behalf of the Client is unable to meet its obligations.
- **Country risk** – the risk of loss due to occurrence of adverse events in a particular country which may negatively impact the issuer based in it and, consequent decrease of the value of financial instruments issued by that issuer and/or the ability of the issuer to meet its obligations.

- **Legal risk** – the risk of incurring additional expenses or loss by the Client due to adverse restrictions or duties, which occurred after acquisition of the financial instruments as the result of changes in including, but not limited to legislation, mandatory regulations or guidelines issued by competent authorities and judicial decisions.
- **Product specific risks** – are described per asset class below.

### 3. SECURITIES

#### 3.1. Shares

##### **General Description**

*Intended for retail and professional clients*

Shares (equity securities) are units of ownership in the companies. If the company that issued the shares (the issuer) earns profit, a portion of the profit may be distributed to the shareholders in the form of dividends. Shares can also grant the voting right at shareholders meetings. The risk faced by an investor when acquiring a share constitutes the price paid by the investor and the dynamics of that price. The price may either increase or decrease in the future. Theoretically share price drop is limited by 0 and increase is unlimited.

The prices of equity securities fluctuate, prices of equities can be influenced and affected by many micro and macro factors such as economic, political, market, and issuer-specific changes. Such changes may adversely affect the price of shares which can go up and down, regardless of company-specific performance. Additionally, different industries, financial markets, and securities can react differently to these changes.

In addition there can be no guarantee that the companies which have historically paid dividends will continue to pay dividends or to pay dividends at the current rates in the future. The reduction or discontinuation of dividend payments may have a negative impact on the price of shares.

##### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Development of issuer's economic situation (company specific)*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the company/industry/economy as a whole*	Positive	↗
	Negative	↘
General development of stock market*	Positive	↗
	Negative	↘
Political and psychological factors*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

##### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**
- 

See 2.1. Definition of Different Types of Risks for more information

##### **Product specific risks**

**Public relations risk** – is the risk that unfavorable news published in media or social channels will have negative impact on relevant company or industry.

**Price risk of resources used by the company** – risk that the price of resources used by the company (like commodities, work, energy) price changes will have negative effect to business of relevant company.

**Rating risk** – is the risk that relevant company's credit rating will change and cost of financing will increase.

**Country risk** - country risk is a collection of risks: political risk, exchange rate regime risk, economic risk, government action (inaction) risk.

**Volatility of the price** - there are many different companies and volatility depends on company's industry, liquidity, market conditions and other factors. For example, biotechnology sector is generally tied to the success or failure of new drug developments, thus dependent of this success share price will significantly rise or fall in value. Meanwhile companies in consumer goods sector generally will tend to have lower volatility.

**Exit methods** - purchased shares can be sold at the exchanges where they are listed. Relevant trading venues might halt or suspend trading in relevant shares. As well it might be very difficult to sell illiquid shares (when there is no buyers and/or sellers in the market).

### 3.2. Bonds

#### **General Description**

*Intended for retail and professional clients*

A bond is a non-equity security, under which the issuer (company, government or other issuing institution) becomes the bond holder's debtor. There is a number of types of bonds and following list is not exhaustive and serves to clarify certain characteristics or special features of relevant types.

Fixed-interest bond holders are paid with regular fixed interest payments known as coupons and receive invested principal at the maturity date.

Variable interest rate bond holders are paid with regular interest payments, where interest rate is dependent on other reference rate such as index. At maturity holder receives principal.

Zero-coupon bonds are similar to fixed-interest bond, but are issued at a discount from nominal value and have no interest payments. The bonds are redeemed at nominal value. Investor earns interest from the difference between issue price and nominal value of bond at redemption.

Convertible bonds are bonds that may be converted into company's equity under certain conditions.

Callable bonds are bonds where issuer has an option to redeem (call back) the bonds from bond holders at issuers discretion Typically callable bonds have higher yield due to the risk of being redeemed prior to maturity.

#### **Functioning and performance in different market conditions**

	<b>Market interest rate*</b>		<b>Issuer's credit quality*</b>	
	<i>Increase</i>	<i>Decrease</i>	<i>Improves</i>	<i>Worsens</i>
	<i>Performance</i>			
<i>Fixed-interest bond price</i>	↘	↗	↗	↘
<i>Bonds with variable interest rates (floaters) price</i>	→	→	↗	↘
<i>Zero-coupon bond price</i>	↘	↗	↗	↘
<i>Convertible bond price</i>	↘	↗	↗	↘
<i>Callable bond price</i>	↘	↗	↗	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**

See 2.1. Definition of Different Types of Risks for more information

#### **Product specific risks**

**The interest rate risk** - when the interest rate in the market increases, the price of the bond decreases and vice versa.

**Reinvestment risk** – is the risks that after bonds are redeemed investor have to reinvest proceeds at lower interest rate, thus receiving lower return on investment. This usually happens when interest rates fall over time and/or issuer executes its right to redeem a callable bond.

**Inflation risk** – when inflation increases investor will see his purchasing power erode and may achieve a negative rate of return when factoring in inflation.

**Credit risk** - the issuer is responsible for the payment of interest and redemption of bonds. Distributors of bonds are not liable under the obligations of the issuer; therefore, investors should assume the risk of the issuer being unable to redeem the bonds and/or to pay interest. On frequent occasions, issuers finance the redemption of bonds while engaging in additionally borrowing on capital markets. In case market conditions deteriorate (e.g. in the case of a decrease in the demand for debt securities or an increase in the interest rate), it may be difficult or impossible for the issuer to arrange additional borrowing, as a result the bonds may remain unredeemed.

**Rating risk** – if bond issuer’s rating is downgraded, it becomes more costly to borrow money and this can have an adverse impact on the issuers’ ability to satisfy its debts with current bondholders.

**Liquidity risk** - the price of low-turnover (non-liquid) bonds may change extremely rapidly and radically. If a bond has a longer maturity and/or higher yield its price could fluctuate more compared to other bonds. If bonds are distributed and/or traded by only one intermediary, it may be difficult (or impossible) to sell the bond in the market if that intermediary stops trading activities of that bond. It should be noted that even if bonds are quoted and (or) traded in exchange, it does not ensure liquidity of those bonds.

**Volatility of the price** – bonds having lower liquidity or worse credit quality have higher price volatility.

**Exit methods** - bonds are typically traded over the counter (OTC). In normal market conditions bond may be sold before the maturity date. When selling bonds, yield may be either lower or higher compared to the yield at the time of their acquisition. The yield may also be negative. Since bonds are traded OTC due to negative market developments or illiquidity it might become difficult to find buyer for extended period of time.

**Limitations on the available market** – since bonds are traded OTC due to negative market developments or illiquidity it might become difficult to find buyer or seller for extended period of time.

**Commitments and obligations** - usually, investor who purchases a bond, in addition to the cost of acquisition, does not assume additional financial commitments and other additional obligations, including contingent liabilities.

### 3.3. Investment Funds

#### 3.3.1. Mutual Funds

##### **General Description**

*Intended for retail and professional clients*

Mutual Funds are collective investment schemes that are made up of a pool of funds collected from investors for the purpose of investing in various financial instruments, like shares, bonds, other mutual funds, derivatives and etc. Mutual funds are operated by fund managers, who invest the fund's capital and attempt to produce capital gains and/or income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus. Mutual fund’s performance is directly impacted by the performance of instruments held by it. The ability of a mutual fund to achieve its investment goal is directly related to, in part, the ability of its manager to select performing portfolio of instruments into the fund.

##### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Fund’s portfolio value*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the relevant company/industry/economy where fund has exposure*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

##### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**

See 2.1. Definition of Different Types of Risks for more information

##### **Product specific risks**

**Fund strategy risk** - funds’ investment strategies are different, ranging from the wholly conservative, when investments are made only in guaranteed yield financial instruments, to the aggressive, when investments are made in the shares of enterprises of developing and rapidly growing countries, derivatives or in commodities. The more aggressive a fund’s investment strategy, the higher the risk of incurring losses owing to fluctuations in the market is.

**Fund manager's expertise risk** - funds that have the same investment strategy may achieve different investment results, considering the varied experience and expertise of their managers. Usually, the results of funds managed by less experienced managers are difficult to forecast; therefore, the risk of incurring losses is higher in a case where investment is made in funds run by such managers and especially in case of an unstable market situation.

**Liquidity risk for closed-end funds** - as there is a restriction for investment management company to redeem fund certificates from investor, it could be hard to sell fund certificates prior maturity on secondary market.

**Fund manager risk** – due to various reasons fund's management body might decide to liquidate fund or materially change fund rules. Such decisions and changes might have significant negative impact for investor.

**Volatility of the price** - as the focus markets vary a lot, so does the volatility of the respective mutual funds. Depending on the focus market, volatility may range from none to a lot.

**Exit methods** - mutual fund units can be sold back to the management company, only. The eventual outcome of the investment is mainly dependent on the success of the fund's investments – if they gain in value, the fund units' value rise as well. However, should the fund's investments decrease in value, so will the value of the fund and the shares in that particular fund, resulting in a loss to the investor.

### 3.3.2. Alternative Funds

#### **General Description**

*Intended for retail and professional clients*

Alternative investment funds are collective investment schemes that are made up of a pool of funds collected from investors for the purpose of investing in non-conventional assets. Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of the complex natures and limited regulations of the investments. Alternative investments include private equity, hedge funds, managed futures, real estate, commodities and derivatives contracts.

#### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Fund's portfolio value*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the relevant company/industry/economy where fund has exposure*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**

See 2.1. Definition of Different Types of Risks for more information

#### **Product specific risks**

**Counterparty risk** – due to various reasons fund's management body might decide to prematurely liquidate fund or materially change fund rules. Such decisions and changes might have significant negative impact for investor.

**Fund strategy risk** – in addition to the usual market and investment risks associated to traditional mutual funds, alternative investment funds may face additional risks to the extent they use relatively complex investment and trading strategies. Depending on the strategy being used, these potential risk include use of derivatives and leverage, futures contracts, short selling, swaps or other instruments which might be illiquid. Some funds use complex derivative instruments, which are only comprehensible to people of considerable financial sophistication.

**Fund manager's expertise risk** - funds that have the same investment strategy may achieve different investment results, considering the varied experience and expertise of their managers. Usually, the results of funds managed by less experienced managers are difficult to forecast; therefore, the risk of incurring losses is higher in a case where investment is made in funds run by such managers especially in case of an unstable market situation.

**Liquidity risk for closed-end funds** - as there might be a restriction for investment management company to redeem fund units/shares from investor, it could be hard to sell fund units/shares prior maturity on secondary market.

**Volatility of the price** - As the focus markets vary a lot, so does the volatility of the respective alternative funds. In addition, volatility may be hard to measure due to low liquidity and similar fund-specific factors.

**Exit methods** - These type of funds mostly are a so called closed-ended funds, which means that the most likely exit method is the redemption of fund's shares/units at the maturity of the fund or partial redemption during the life cycle of the fund in case of excess cash held by the fund (e.g. upon sale of fund's assets). The sale of units back to the management company or any other investor might be also possible depending on circumstances. However, the liquidity risk is usually rather high and the ability to actually exit the investment may be circumstantial. The eventual outcome of the investment is mainly dependent on the success of the fund's investments – if they gain in value, the fund units' value rise as well. However, should the fund's investments decrease in value, so will the value of the fund and the shares in that particular fund, resulting in a loss to the investor.

**Commitments and obligations** - *May include capital call commitments or some other highly specific obligations – profound due diligence highly recommended.*

### 3.4. Structured Financial Instruments

#### 3.4.1. Index linked bonds

#### **General Description**

*Intended for retail and professional clients*

An index-linked bond is a bond which periodic payments are linked to some market index or a basket of indexes and allows investor to take exposure in that market index. For example if the index performs well, investor is compensated by higher periodic payments, but if index does not perform, investor receives no periodic payments and in some cases may lose part or full initial investment.

Index linked bonds may have a feature of capital protection, meaning that losses of the investor are limited to certain percentage (as per terms and conditions of the bond).

#### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Development of issuer's economic situation (company specific)*	Positive	↗
	Negative	↘
Value of the underlying option*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### **Product specific risks**

**Issuer related risk** – should the Issuer become insolvent or fail in any other way the investor may not receive back any of investment monies, not even the initial investment amount as the principal protection will not apply in this situation.

**Value related risk** – structured bonds are complex investment products and are subject to investment risks which include principal protection and this is provided only when the investment is held until maturity. The bonds value can fluctuate significantly between issue and maturity dates and is dependent of the value changes of the related option contract.

**Liquidity risk** – structured bonds are designed to be held until maturity. Structured bonds may have no established trading market or a trading market that is not very liquid. Therefore investors should be aware that they may not be able to sell their bonds or the prices might be unfavorable as index linked bonds usually do not have developed secondary market

**Rating risk** – is the risk that issuing company's credit rating will change and cost of financing will increase.

**Volatility of the price** – depends on change of the underlying option value according to its contract.

**Exit methods** – instrument is designed to be held till maturity. Depending on the issuer, it may be possible to sell on the secondary market.

**Limitations on the available market** – usually there is no established trading market or market is illiquid. Availability of secondary market trading is subject of the possibility created by the issuer.

### 3.5. Exchange Traded Products

#### 3.5.1. Exchange Traded Funds (ETF)

##### **General Description**

*Intended for retail and professional clients*

Exchange traded funds (ETFs) are collective investment schemes that are listed on stock exchanges. ETFs are managed by professional investment management companies. ETFs can be traded throughout the day and are bought and sold like ordinary stocks during normal trading hours of the respective stock exchange.

##### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Fund's portfolio value*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the relevant company/industry/economy where fund has exposure*	Positive	↗
	Negative	↘
Market expectations regarding the performance of the fund*	Positive	↗
	Negative	↘
Political and psychological factors*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

##### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**

See 2.1. Definition of Different Types of Risks for more information

##### **Product specific risks**

**Underlying risk** – ETFs have different portfolio and investment strategies ranging from simple index tracking to exotic exposures such as leveraged commodities. It is very important for investor to get acquainted with ETF prospectus and understand the exposure before entering into any transaction.

**Shutdown risk** – if management company decides that specific ETF is not performing or not generating enough interest among investors such ETF might be liquidated. In that case the investor gets the cash equivalent value of the fund's assets at the time of liquidation (it may not be the value of the final closing price on the last day of trading), proportional to the units of the fund investor holds.

**Volatility of the price** - As the underlying markets vary a lot, so does the volatility of the respective ETF. Depending on the underlying instrument, volatility may range from none to a lot.

**Exit methods** - ETF can be sold in the open exchange – just like ordinary shares. If the price has fallen since the purchase, the investor suffers a loss. However, should the price be higher than the purchase price, the investor would gain a profit.

**Commitments and obligations** – Usually, investor who purchases a ETF unit/share, in addition to the cost of acquisition and management fee, does not assume additional financial commitments and other additional obligations, including contingent liabilities.

#### 3.5.2. Exchange Traded notes (ETN)

##### **General Description**

*Intended for retail and professional clients*

Exchange traded note (ETN) is a type of unsecured, unsubordinated debt security based on the performance of a underlying asset or basket of underlying assets with no periodic coupon payments. Similar to exchange-traded funds (ETFs), ETNs are traded on exchanges. ETNs, unlike ETFs, do not have an actual investment portfolio, therefore no assets are bought or sold. An ETN simply represents a promise by the issuer to pay investor an investment return reflecting the performance of a specified underlying asset or basket of underlying assets.

**Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Value of underlying asset or basket of underlying assets*	Positive	↗
	Negative	↘
Credit rating of the issuer*	Improves	↗
	Deteriorates	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

**General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**

See 2.1. Definition of Different Types of Risks for more information

**Product specific risks**

**Liquidity risk** – ETNs usually has lower liquidity than ETFs. For some ETNs early repurchase by the issuer is only available with a specified minimum amount.

**Issuer credit risk** – since ETNs are unsecured debt obligations, usually issued by the banks, credit risk is the major factor that distinguishes ETNs from ETFs.

**Volatility of the price** - *volatility depends on performance of underlying assets, demand for ETN units and creditworthiness of the issuer.*

**Exit methods** - *ETN can be sold on the open exchange – just like ordinary shares.* For some ETNs early repurchase by the issuer is only available with a specified minimum amount.

## 3.5.3. Exchange Traded Commodities (ETC)

**General Description**

*Intended for retail and professional clients*

An exchange traded commodity (ETC) provides exposure to relevant commodities such as oil, gold, grain and other. ETC may track individual commodities and/or a commodity basket.

Even though ETC tracks commodity price it is actually a debt obligation, called a note. Inverse ETCs are more complex instruments, which move up when a commodity moves down, or vice versa.

Leveraged ETCs are structured in a such a way that commodity movements are multiplied by a particular factor, such as two or three, resulting in two or three times the volatility of the underlying commodity.

**Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Value of underlying commodities or basket of commodities*	Positive	↗
	Negative	↘
Credit rating of the issuer*	Improves	↗
	Deteriorates	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

**General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**

See 2.1. Definition of Different Types of Risks for more information

**Product specific risks**



**Liquidity risk** – ETCs typically has lower liquidity than underlying commodity. For some ETCs early repurchase by the issuer is only available with a specified minimum amount.

**Issuer credit risk** – since ETCs may be unsecured debt obligations, usually issued by the banks, credit risk is the major factor that distinguishes ETCs from ETFs.

**Volatility of the price** - volatility depends on performance of underlying assets, demand for ETC units and creditworthiness of the issuer.

**Exit methods** - *ETC position can be sold on the exchange – just like ordinary shares.* For some ETCs early repurchase by the issuer is only available with a specified minimum amount.

### 3.6. Derivative Financial Instruments

#### 3.6.1. Foreign Exchange Forward and Foreign Exchange Swap

#### **General Description**

*Intended for retail and professional clients*

Foreign Exchange Forward is an agreement to buy/sell currency at a predetermined rate on a future date. Foreign exchange forwards are also known as currency forwards or FX forwards and are traded Over The Counter (OTC).

Foreign Exchange Swap is an agreement to exchange agreed amount of one currency into another for agreed time period. It can be considered as two Forward contracts entered into at the same time, therefore swap properties are the same as of 2 Forwards.

#### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Economic developments relevant to specific currency(ies)*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the relevant currency(ies)*	Positive	↗
	Negative	↘
News relevant to specific currency(ies)*	Positive	↗
	Negative	↘
Political and psychological factors*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**

See 2.1. Definition of Different Types of Risks for more information

#### **Product specific risks**

**Liquidity risk** – the foreign exchange market is considered to be highly liquid. But in some situation (due to political, financial performance, macroeconomic factors or other reason) liquidity risk may arise. There's no way to predict with any certainty how price movements will develop in illiquid periods of time. Liquidity is also reduced by market holidays in various countries and seasonal periods of reduced market interest, such as the late summer and around the Easter and Christmas holidays.

**Counterparty credit risk** - counterparty risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations.

**Country risk** - country risk is a collection of risks: political risk, exchange rate regime risk, economic risk, government action (inaction) risk.

**Leverage risk** - leverage amplifies returns and losses from investment. For example 1:10 leverage, would gain or lose ten times the amount of investment. If we invest 1000 EUR and instrument with leverage of 1:10 increases or falls in value by 10% this would bring 100% capital gain or 100% loss. Thus potentially reducing our investment to 0. If price on investment in this example would fall more than 10%, we would end up with losing more than we have invested, and would owe funds to the bank to cover amount of loss that exceeded our capital.

**Margin risk** – margin trading requires regular monitoring of the market and the use of margin. If client fails to post

adequate amounts of margin in time, client's open positions might be closed by the bank.

**Risk of unlimited loss** – in certain market conditions client could potentially suffer losses and would owe funds to the bank to cover amount of loss that significantly exceeds client's capital.

**Volatility of the price** -Volatility in foreign exchange market is generally very high and dependent on currency pair.

**Exit methods** - forward contract could be closed before maturity by selling or buying it back from manufacturer.

**Commitments and obligations** - in trading derivative instruments, the customer may be obliged to provide a security of performing obligation (e.g. security deposit). Depending on the change in the value of the underlying assets, the customer may also be obliged to increase the value of the security with a short period of notice (margin call).

**Margin Requirements** – the ratio between position and security provided to secure that position. Margin required depends on currency pair and for example can range from 1:100 to 1:1.

### Trade example

1. Let's assume EU based company, exporting goods to US and therefore receiving USD income in the future, wishes to hedge themselves from currency rate fluctuations. Company is exposed to USD depreciation against EUR. Therefore a company sells USD forward against EUR at the rate agreed today. This transaction is a bilateral liability, meaning one side (the company) is obliged to sell pre-agreed amount of USD against EUR at the pre-agreed price.

Transaction costs

Bank trades FX forwards on a principal basis when requested for a quote (RFQ). The company sells USD and buys EUR at the quoted price, there are no additional costs and charges. The pricing for FX forwards depends on the maturity of the contract, currency pair, counterparty risk.

Possible negative scenarios

Forward is a bilateral liability, where one side (the company) is obliged to sell pre-agreed amount of USD against EUR at the pre-agreed price and no circumstances relieves either party from this liability. If for example the company did not receive USD funds from US counterpart, it still has an obligation to sell USD to the Bank (the prevailing market rate at the time of the Forward maturity may be substantially higher or lower than the price of the original Forward).

2. Let's assume EU based company, importing goods from UK and therefore paying GBP in the future, wishes to hedge themselves from currency rate fluctuations. Company is exposed to GBP appreciation against EUR. Therefore a company buys GBP forward against EUR at the rate agreed today. This transaction is a bilateral liability, meaning one side (the company) is obliged to buy pre-agreed amount of GBP against EUR at the pre-agreed price.

Transaction costs

Bank trades FX forwards on a principal basis when requested for a quote (RFQ). The company buys GBP and sells EUR at the quoted price, there are no additional costs and charges. The pricing for FX forwards depends on the maturity of the contract, currency pair, counterparty risk.

Possible negative scenarios

Forward is a bilateral liability, where one side (the company) is obliged to buy pre-agreed amount of GBP against EUR at the pre-agreed price and no circumstances relieves either party from this liability. If for example the company changed its mind and are not planning to do any GBP payments, it still has an obligation to buy GBP from the Bank (the prevailing market rate at the time of the Forward maturity may be substantially higher or lower than the price of the original Forward)

### 3.6.2. Foreign Exchange Options

#### **General Description**

*Intended for retail and professional clients*

FX Option is an agreement which gives the option buyer the right (but not the obligation) to buy (sell) currency at a specified rate on a future date. There are two types of options: calls and puts. A call option holder has the right to buy currency for a certain price at a certain future date. A put option holder has the right to sell currency for a certain price at a certain future date. The fee paid when purchasing an option is called option premium. To enter in to option transaction requires a premium to be paid up front. The maximum loss of the option buyer is limited to the amount of the premium paid. The seller of option may face unlimited losses. Options are traded Over The Counter (OTC).

#### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Economic developments relevant to specific currency(ies)*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the relevant currency(ies)*	Positive	↗
	Negative	↘
News relevant to specific currency(ies)*	Positive	↗
	Negative	↘
Political and psychological factors*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**
- **Counterparty credit risk**

See 2.1. Definition of Different Types of Risks for more information

#### **Product specific risks**

**Liquidity risk** -the foreign exchange market is considered to be highly liquid. But in some situations (due to political, financial performance, macroeconomic factors or other reason) liquidity risk may arise. There's no way to predict with any certainty how price movements will develop in illiquid periods of time. Liquidity is also reduced by market holidays in various countries and seasonal periods of reduced market interest, such as the late summer and around the Easter and Christmas holidays.

**Counterparty credit risk** - counterparty risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations.

**Country risk** - country risk is a collection of risks: political risk, exchange rate regime risk, economic risk, government action (inaction) risk.

**Volatility of the price** - volatility in foreign exchange market depends on currencies pair. In general currency market is considered to be extremely volatile.

**Exit methods** - *options might be sold before maturity to the issuer.*

**Commitments and obligations** – applicable only to short positions. If the buyer of the option requires that the option should be exercised, the seller of the option must sell (buy) the currency at the pre-agreed price.

**Margin Requirements** – applicable only to short positions.

#### **Trade example**

Let's assume EU based company, exporting goods to US and therefore receiving USD income in the future, wishes to hedge themselves from currency rate fluctuations. Company is exposed to USD depreciation against EUR, but gains if USD appreciates. If company would like to hedge itself from the negative impact of USD depreciation, but remain open to possible USD appreciation, it may decide to buy USD put option (a right but not

an obligation to sell USD at a pre-agreed rate). This transaction is a right for a buyer of the option (company), but an obligation for issuer of the option (bank).

#### Transaction costs

For FX options buyer must pay a fee – premium to the seller. Bank trades FX options on a principal basis when requested for a quote (RFQ). Premiums depend on maturity of the contract and currency pair.

#### Possible negative scenarios

If option remains unexercised due to unfavorable rate at the maturity compared to the prevailing market rate, option buyer loses its premium (the buyers loss is limited to the amount of premium).

### 3.6.3. Interest Rates Swaps

#### General Description

*Intended for retail and professional clients*

Interest rate swap (IRS) is exchange of one set of cash flows to another. In other words, it is an agreement between two counterparties in which one stream of future interest payments is exchanged for another on the principal amount.

Fixed to floating swap – one counterparty pays fixed rate and receives floating rate, while other counterparty does vice-versa.

Floating to fixed swap – it is opposite to Fixed to floating

#### Functioning and performance in different market conditions

<b>Market condition</b>		<b>Value of IRS for Fixed rate payer</b>	<b>Value of IRS for Floating rate payer</b>
Changes in relevant long term interest rate*	Positive	↗	↘
	Negative	↘	↗

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### General risks

- Price risk
- Market risk
- Liquidity risk
- Currency risk
- Interest rate risk
- Counterparty credit risk

See 2.1. Definition of Different Types of Risks for more information

#### Product specific risks

**Reference rate risk** – interest rate swaps might follow different reference rates. Reference rates such as LIBOR or EURIBOR are widely used and publicly available, but there as well might more exotic reference rates, which are not calculated on daily basis or available publicly.

**Counterparty credit risk** - Counterparty risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations. Counterparty risk is a risk to both parties and should be considered when evaluating a contract.

**Volatility of the price** –Volatility of the IRS value is directly proportional to volatility of relevant long term interest rates and maturity of IRS contract.

**Exit methods** – interest rate swaps can be closed prematurely if agreed by both counterparties (client and manufacturer). In the event of an early termination of interest rate swap value is calculated using discounted cash flow model.

**Margin Requirements** - in order to manage counterparty risk, client may be required to provide security deposit. If price of IRS moves against client, additional security deposit may be requested.

### Trade example

Let's assume a company, receiving fixed amounts of cash flow (e.g. income from building lease) enters into a floating rate (e.g. EURIBOR) loan contract for funding. The company is exposed to interest rate fluctuations, because if the floating rate will increase, expenses on the loan will increase while the income stays the same.

Under these or similar circumstances a company may wish to enter into an interest rate swap (IRS), exchanging a series of floating rate payments into fixed rate payments, and secure future cash flows. Floating rate payments received by the client from the Bank under IRS then would be used to pay interest on a floating rate loan, thus changing companies floating rate liability (loan) into a fixed rate liability. IRS transaction is a bilateral liability, meaning one side (the company) is obliged to pay fixed rate payments and the bank is obliged to pay floating rate payments.

Transaction costs

Bank trades IRS on a principal basis when requested for a quote (RFQ). The company then pays a quoted fixed rate, there are no additional costs and charges. The pricing for IRS depends on the maturity of the contract, currency, structure (amortizing/increasing balance), counterparty risk.

Possible negative scenarios

IRS is a bilateral liability, meaning one side (the company) is obliged to pay fixed rate payments and the bank is obliged to pay floating rate payments. Floating rate payments might increase or decrease based on the floating rate in the market. Floating rate may be negative, thus meaning client will have to pay both fixed AND floating amounts.

### 3.6.4. Commodity Swaps

#### General Description

*Intended for professional clients*

Commodity swap is an agreement where two counterparties agree to exchange cash flows, which are dependent on the price of the underlying commodity (fixed price into floating and vice-versa). A commodity swap is usually used to hedge against the price movement of the commodity. Commodity swaps are traded over the counter (OTC). Under the agreement the Bank offers financial settlement and no physical delivery of underlying commodity.

#### Functioning and performance in different market conditions

<b>Market condition</b>		<b>Price</b>
Economic developments relevant to underlying instrument*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the relevant underlying market*	Positive	↗
	Negative	↘
News relevant to underlying market*	Positive	↗
	Negative	↘
Political and psychological factors*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### General risks

- Price risk
- Market risk
- Liquidity risk
- Currency risk
- Interest rate risk
- Counterparty credit risk

See 2.1. Definition of Different Types of Risks for more information

#### Product specific risks

**Counterparty credit risk** - counterparty risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations.

**Underlying commodity risk** - commodity swap value is directly proportional to the price of underlying commodities, which are sensitive to various factors such as weather, production output and market demand.

**Volatility of the price** – is directly proportional to specific underlying commodity. In general commodities are

considered extremely volatile.

**Exit methods** - contract could be closed before maturity by selling or buying it back from manufacturer

**Commitments and obligations** - upon the maturity date, one of the counterparties to the transaction pays the difference in price.

**Margin Requirements** - in order to manage counterparty risk, client may be required to provide security deposit. If price of swap moves against client, additional security deposit may be requested.

### 3.6.5. Future contracts

#### **General Description**

*Intended for retail and professional clients*

A futures contract means a contract in a standardized form for the purchase and sale of a specified underlying asset (share, currency, commodity or other) at a pre-agreed price with settlement to be made at a future time. Futures contracts are traded on trading venues.

As futures can be traded with leverage, allowing you to take a larger position than you would otherwise be able to based on your funds with the bank, a relatively small negative or positive market movement can have a significant effect on your investment. Futures' trading therefore involves a relatively high degree of risk. This makes the potential gain quite high, even if the deposit is relatively small. If your total exposure on margin trades exceeds your deposit, you risk losing more than your deposit.

#### **Functioning and performance in different market conditions**

<b>Market condition</b>		<b>Price</b>
Economic developments relevant to underlying instrument*	Positive	↗
	Negative	↘
Market expectations regarding the future development of the relevant underlying market*	Positive	↗
	Negative	↘
News relevant to underlying market*	Positive	↗
	Negative	↘
Political and psychological factors*	Positive	↗
	Negative	↘

\*assuming that other market conditions remain the same and the market is not in any kind of distress

#### **General risks**

- **Price risk**
- **Market risk**
- **Liquidity risk**
- **Currency risk**
- **Interest rate risk**

See 2.1. Definition of Different Types of Risks for more information

#### **Product specific risks**

**Underlying risk** – risks inherent in underlying instruments are applicable to futures as well. See relevant underlying asset risk description for more information.

**Leverage risk** - leverage amplifies returns and losses from investment. For example 1:10 leverage, would gain or lose ten times the amount of investment. If we invest 1000 EUR and instrument with leverage of 1:10 increases or falls in value by 10% this would bring 100% capital gain or 100% loss. Thus potentially reducing our investment to 0. If price on investment in this example would fall more than 10%, we would end up with losing more than we have invested, and would owe funds to the bank to cover amount of loss that exceeded our capital.

**Margin risk** – margin trading requires regular monitoring of the market and the use of margin. If client fails to post adequate amounts of margin in time, client's open positions might be closed by the bank.

**Risk of unlimited loss** – in certain market conditions client could potentially suffer losses and would owe funds to the bank to cover amount of loss that significantly exceeds client's capital.

**Volatility of the price** - Due to different variety of underlying assets and different liquidity for each of them, volatility of futures contracts will substantially differ from one futures contract to another, yet overall volatility of futures are considered to be very high.

**Exit methods** - Position in futures contracts can only be exited via sale or purchase (depends if initial position was long or short). Since futures are traded on a trading venue, trading takes place only during relevant exchange work hours. In certain market conditions, when liquidity is drained and there are no buyers or sellers, exit would not be possible until market conditions improve.

**Commitments and obligations** - If price moves against the client, additional collateral has to be submitted in order to satisfy margin requirements, otherwise open positions will be closed.

**Margin Requirements** - Margin requirements are set by futures exchange as a fixed amount for each futures contract, not as a percentage.  
For example E-mini S&P 500 (Dollar) futures contract, which at market price of 2 500 USD has a nominal value 125 000 USD, has a margin requirement of 4 500 USD per contract, thus resulting in margin requirement of 3.6%.

#### **4. MARGIN TRADING (LEVERAGED TRADING)**

Margin trading or leveraged trading allows an investor to engage in trading in financial instruments without being in possession of the total sum of money. It is sufficient that the investor provides the Bank with a relatively small margin (funds, securities, etc.). The margin is held on a special margin account with the Bank and is provided to the Bank as a collateral. The Bank will return the money from the margin account only after having ascertained that the investor's obligations under the concluded margin transactions have been fulfilled. In margin trading, financial instruments shall not be delivered upon maturity, i.e. the respective counterparty to the transaction shall collect the difference in price.

Take, for example, trading in the currency market (FOREX). If the margin requirement for a certain currency pair is 1 per cent, an investor willing to buy/sell 100,000 currency units must hold no less than 1,000 currency units on his or her margin account. In this case, the investor can use a leverage of up to 1/100.

Margin trading is associated both with the possibility of earning enormous profits and suffering significant losses in comparison with capital investments. Margin trading carries a high degree of risk both for buyers and sellers, irrespective of the underlying asset class. If market prices move in a direction opposite to the investor's positions, the investor may not only lose the original investment but also incur a substantial amount of debt.

Margin trading requires a close and regular monitoring of the market and the use of margin. If the value of the deal changes the investor may receive a margin call. The investor's failure to meet the margin call will cause the deal to be closed and the incurrence of losses respectively.

#### **5. RISKS RELATED TO TRADING FACILITIES**

Nowadays, all trading facilities are computerized to greater or lesser extent, i.e. the placement, registration, and execution of orders, as well as other necessary operations, is carried out electronically. As with other electronic systems, the operation of the trading facility might be temporarily interrupted due to causes beyond the control of the Bank. Consequently, the execution of orders might be temporarily interrupted or they might not be executed to the fullest extent, or an investor may fail to receive essential information on a real time basis. Should an investor incur losses due to interruptions of this nature, he or she can expect to recover only a limited amount of the losses, with the precise amount being determined by the Bank, other market intermediaries, or a clearing house.

#### **6. RISKS RELATED TO TRANSACTIONS IN FOREIGN MARKETS**

Foreign markets are regulated by the relevant supervisory authorities, the requirements of which may differ from those applicable in Estonia. Consequently, investors' protection may differ significantly from the protection level applicable in Estonia. Accordingly, the investors may incur additional losses due to different requirements.

#### **7. WARNING REGARDING THE LIKELY RETURN ON SOME OF THE FINANCIAL INSTRUMENTS**

Those financial markets which function based on the principle when the profit of some investors is covered by the same loss of other investors (zero-sum game) are not able to ensure capital gain for all participants. The total value of invested capital does not change, but gets regularly distributed among the participants of the market (excluding the commission fees paid to intermediaries). Such are currency, option and futures markets. The likely return in such markets in long perspective is close to zero.

#### **8. RISKS RELATED TO THE COLLATERAL OF FINANCIAL INSTRUMENTS AND INVESTMENT OF BORROWED FUNDS**

*The market risk:* when financing investments, or a portion thereof, using funds borrowed from third parties, the risk emerges of losing not only one's own and borrowed capital which has been directed to the corresponding investments, but also of incurring additional losses with respect to the borrowed funds, e.g. pay interest on the loan.

*Interest:* borrowed funds usually require payment of a given interest. Therefore, an investor may lose a portion of the invested funds and/or incur additional losses if the return on investments is lower than the interest to be paid on the loan.

*The collateral value risk:* the market value of pledged financial instruments may fluctuate significantly. In the case of a decrease in the value of the pledged financial instruments, the creditor may require an increase of the security by means of monetary contributions or by financial instruments it deems acceptable. In the case of a failure to increase

the security within the stipulated time (which may be 1 working day), the creditor may terminate the credit agreement and cover the loan from the funds raised by selling pledged financial instruments/debiting cash. If the funds received from the sale of the financial instruments/debiting cash are not sufficient to cover the loan, interest, and other amounts payable, the investor is obliged to cover the outstanding debt.

Considering aforementioned, in the case of a sharp drop in the market value of the financial instruments, the investor may lose not only the pledged financial instruments, but also the additional funds. The pledge value risk is especially relevant in a case where non-liquid financial instruments are pledged, since their market price may fluctuate considerably. In economic and market terms, repo transactions are loans with the pledge of financial instruments, while financial instruments purchased from the investor are held as a security.