Standard Financial Instruments at Tatra banka, a.s. and Their Associated Risks

TATRA BANKA
Member of Raiffeisen Bank International

1. Shares

Description of Shares

- **Share** means a security which gives to the holder of the share (share-holder) the right to participate in the management of the company, in its profit, and in the liquidation assets in case of dissolution of the company. The holder of the share has no right to request the issuer (issuer of the security) to pay the nominal value of the share, the share may be sold solely for the current market price. The gain from possession of the share may be the dividend (the amount thereof depends on the profit of the joint-stock company) and the capital profit/loss (the difference between the purchase and sales price for the share).

Risks Connected with Trading with Shares

- **Equity risk** means the risk of loss of value of the share as the result of the change of price of the share in the stock market,
- **Market risk** means the risk of loss of value of the share as the result of general drop down of the stock market,
- **Liquidity risk** means the risk that the share cannot be sold for money in the stock market in due time or for an adequate price,
- **Currency risk** – if the share is nominated in other currency than in EUR, its value can decrease due to the changed exchange rate of the local currency to the currency in which the share is nominated,
- **Risk of the issuer** means the risk of the change of market perception of the issuer of the share,
- **Inflation risk** causes that the amount of liability of the issuer to pay the debt in certain currency has a lower real value than in the time of investment due to higher inflation of this currency,
- **Event risk** means the risk of loss of value of the share due to any event outside the financial markets, e.g. a natural disaster, taking over of the firm having issued the share or any regulatory changes.

In respect of the shares, neither the return of the paid investment nor regular payment of dividend is guaranteed. The amount thereof depends on the issuer's economic results and from the decisions of the General Meeting. The value of the shares may fluctuate also according to the value of the issuer's assets and economic results.
Maximum loss which may be incurred by the client in case of purchase of shares is limited by the amount of his initial investment, unless the shares were used by the client as security for a loan from which the client obtained funds which were further used for purchase of a financial instrument, and in such case, the client is exposed to the risk of leverage effect according to Section 14 thereof.

2. Debt Securities

Description of Debt Securities

Debt security means a security, the holder of which has the right to claim repayment of the outstanding amount (face value) in the nominal value and payment of gains (coupons) thereto as of certain date, and represents the obligation of the obligor issuing the debt securities (issuer) to fulfill the obligations. Issuers of debt securities may be various entities, e.g. countries, towns and municipalities, banks, private firms. The issuer is liable to repay the issued debt securities in their nominal value in a single installment as of the determined date or in installments on several dates. The issuer may reserve the right to prepay the debt securities in their nominal value. The holder of the debt security may claim repayment of the debt security in its nominal value prior to the determined maturity, only if guaranteed by the issuer in the issue conditions.
From the aspect of currency, a debt security may be issued, in EUR or foreign currency.

According to the type of gain, the debt securities are divided as follows

- with fixed rate,
- with floating rate,

- with zero coupon,
- with combined interest rate.

Risks Connected with Trading with Debt Securities

Trading with debt securities is connected with the risk of drop in value of the debt security as compared with the price for which it was acquired by the holder, as well as with fulfillment of the obligation by the issuer. The value of the debt security depends on several factors and the individual risks which affect the value or increase the risk from failure to fulfill the issuer's obligations are particularly the following:

- **Interest risk** means the risk of drop in value of the debt security as a result of changed interest rates. In case of increase of the interest rates, the value of the debt security usually falls down.
- **Credit risk** means the risk of drop in value of the debt security due to changed market perception of the creditworthiness of the issuer and the risk of failure to fulfill the obligations by the issuer.
- **Market risk** means the risk of drop in value of the debt security due to the overall drop down of the market with debt securities.
- **Risk of reinvestment** arises from the fact that in the event of drop down of interest rates, the regular gains from debt securities (coupons or regular repayment of debt) are reinvested for lower interest rates reducing the gains of the holder of the debt security.
- **Risk of calling** the debt security is in the event the debt security comprises the option of prepayment of debt by the issuer (callable bond). In the event the interest rates drop down, the issuer has the right to exercise this option (on the date or dates precisely determined in advance) in order to reduce his interest expenses. The holder of the debt security has then the option to reinvest the face value of the debt security only for interest rates which are lower than initially anticipated. In the event the issuer has the right to prepay only a part of the outstanding owing amount, it is the same type of risk called the **prepayment risk**. If the issuer has the right to prepay the entire debt or a part thereof, the investment into such debt security is connected with the **volatility risk**. The higher the volatility of the interest rates (fluctuation rate), the higher the chance that the issuer of the debt security will exercise such right.
- **Liquidity risk** means the risk that in the event sale of a debt security, the realisation price is lower than the estimated market price due to low demand for the given debt security.
- **Currency risk** of the debt security applies for the debt securities which are issued in any (foreign) currency other than the local currency of the holder of the debt security. In the event of negative movement of the exchange rate of the currency of the debt security versus the local currency of the holder of the debt security, the holder will lose the value of the investment into the debt security.
- **Inflation risk** means that the amount of the issuer's obligation to repay the debt in certain currency has lower real value due to the increased inflation rate of that currency than at the time of investment.
- **Political risk** means the risk of loss of value of the debt security due to any changes in the political situation in individual countries or regions, which may have negative effect on the value of the debt security.
- **Event risk** means the risk of loss of value of the debt security due to any event outside the financial markets, e.g. a natural disaster, taking over of the firm having issued the note or any regulatory changes. Maximum loss which may be incurred by the client in case of purchase of a debt security is limited to the amount of the client's initial investment, unless the debt security was used by the client for the purpose of security for a loan from which the client raised money which were used again for purchase of a financial instrument, because in that case the client is exposed to the risk of leverage effect according to Section 14 hereof.

3. Mutual Fund Shares

Description of Mutual Fund Shares

- **Mutual fund** share means a security which may be issued for one or several shares of the shareholders in the assets of the mutual fund and which is connected with the shareholder's right to the corresponding shares in the assets of the mutual fund and the right to receive a share from the gains from the assets according to the statutes of the mutual fund.

The aggregate value of all shares in circulation represents the net value of the assets in the mutual fund.

- A mutual fund established in the Slovak Republic may be established as an open mutual fund or closed mutual fund. Open mutual fund means a mutual fund whose shareholder has the right to receive payment, upon his request, of the mutual fund shares from the assets in that mutual fund. Closed mutual fund means a mutual fund whose shareholder has no right to receive payment, upon his request, of the mutual fund shares from the assets in that mutual fund. In addition to open mutual funds and closed mutual funds, there are also special mutual funds which may be created as risk special mutual fund (only as an open mutual fund), diversified special mutual fund (only as an open mutual fund) or special mutual fund of properties (as an open mutual fund or closed mutual fund).

According to the current financial assets or property to which the funds collected in the mutual fund's assets are invested or according to the risk of the market being an objective of the mutual fund's investment strategy, the mutual funds are divided into the following types:
- monetary market mutual funds,
- note mutual funds,
- mixed mutual funds,
- stock mutual funds,
- funds' mutual funds,
- reinsured mutual funds,
- real estate mutual funds.

Risks Connected with Trading with Mutual Fund Shares

Trading with mutual fund shares is connected with the risk of drop in the value of the mutual fund. The value of the mutual fund depends on the value of individual assets or property contained in the mutual fund. Thus, the risk of drop of value of the mutual fund is directly connected with the risk of drop of value of an individual asset or property contained in the mutual fund. Subject to the type of the mutual fund and the specific assets or property contained in the mutual fund, investment into the mutual fund shares may be connected with various types of risks, particularly the following:

- **Market risk** means the risk of drop in the market of certain category of assets or property contained in the mutual fund, resulting in drop of value of those assets or property and at the same time of the mutual fund (e.g. fall in the market with the stock, if the stock is contained in the mutual fund).
- **Liquidity risk** (or risk of liquidity) means the risk that certain asset or property contained in the mutual fund cannot be sold for money in due time for an adequate price.
- **Currency risk** means the risk of change of value of the assets or property contained in the mutual fund, expressed in the local currency due to the changed exchange rate of the local currency to another currency.
- **Concentration risk** means the risk connected with significant concentration of investments into certain category of assets or property or to certain part of the market (e.g. if a major portion of the shares contained in the mutual fund are the shares of automotive firms and the automotive industry faces recession).
- **Inflation risk** means that the value of investments in certain currency has a lower real value, due to the increased inflation rate, than at the time of investment.
- **Interest risk** means that the assets or property contained in the mutual fund, whose value is affected by movement of interest rate, will lose value, which results in decreased value of the mutual fund.
- **Event risk** means the risk of loss of the value of the assets or property contained in the mutual fund, and thus also a loss of value of the mutual fund, due to any event outside the financial markets.
- **Settlement risk** means the risk that settlement of any asset or property contained in the mutual fund is not realised according to the agreed conditions.
- **Risk of investment in real estate property sector** means the risk of change of the value of real estate property assets due to changed value of real estate properties. The value of the real estate properties are changed particularly due to change in expected incomes connected with ownership of the real estate properties, the risk of failure to conclude a lease contract, the risk that the lease contract will be concluded under

any terms and conditions other than those assumed in the expert appraisal, due to any costs for maintenance and repair of the property other than those estimated in the expert appraisal (particularly due to effect of any prices for lease of properties, other than those estimated in the expert appraisal or due to effect of the costs for maintenance, reconstruction of the property, other than those estimated in the expert appraisal) or any change in the market expectations in respect of the required gains from investment into real estate property. In case of decreased expected income connected with ownership of the real estate property or in case of rise of the market expectations in respect of the required gains from investment into real estate property, the value of property assets usually falls down. The rate of risk of investment in the property market depends particularly on the current share of the property in the mutual fund, invested into real estate property.

Maximum loss which may be incurred by the client in respect of purchase of mutual fund shares is limited to the amount of his initial investment, unless the mutual fund shares were used by the client as security for a loan from which the client raised money which were used again for purchase of a financial instrument, because in that case the client is exposed to the risk of leverage effect according to Section 14 hereof.

Detail information about the risks connected with investment into a specific mutual fund are available in the Key Investor Information of the relevant mutual fund.

4. Currency Forwards

Description of Currency Forwards

- **Currency forward** (FX forward) means an agreement between two parties on purchase or sale of an agreed amount of foreign currency (nominal of the currency forward) for another currency under the pre-agreed contractual terms. The terms contain also the price (forward price) for which such purchase or sale will be realised and the time of realization of purchase (minimum three business days following conclusion of the trade). Both parties are obligated to fulfill the given conditions.

Risks Connected with Trading with Currency Forwards

Trading with currency forward is connected with the risk of the liability to realise the agreed trade at the time of expiry for a price which is lower than the current price in the market. In the event the current price in the market is higher than the forward price, the party which is obligated to sell the agreed amount of the foreign currency incurs a loss (sells the foreign currency for a lower price than could be sold in the market), and the other parties gains a profit (acquires the foreign currency for a lower price than could be acquired in the market). In the event the current price in the market is lower than the forward price, the party which is obligated to purchase the agreed amount of the foreign currency incurs a loss (acquires the foreign currency for a higher price than could be acquired in the market), and the other party gains a profit (sells the foreign currency for a higher price than could be sold in the market). Maximum loss of the party purchasing the foreign currency is equal to the nominal of the currency forward multiplied by the forward price. Potential loss of the party selling the foreign currency is unlimited.

- **Currency risk** means the risk of drop in value of the derivative as a result of changed exchange rate which is the underlying of the derivative,
- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rates for the respective currencies of the exchange rate which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

5. Currency Swaps

Description of Currency Swaps

Currency swap means an agreement between two parties on temporary exchange of one currency for another currency. It is actually an agreement on

purchase (sale) of the pre-agreed volume of one currency for another currency by a spot or forward exchange rate and reverse sale (purchase) of the same volume of one currency for another currency for an agreed forward exchange rate and date.

Risks Connected with Trading with Currency Swaps

Trading with currency swaps is connected with the risk of loss due to a negative change in the interest difference between both currencies which are the object of trade. This situation occurs if the interest rate for the currency which is sold is growing or the interest rate for the currency which is purchased is falling down or the difference between these interest rates is developing to the detriment of the agreed trade.

Maximum loss in the case of currency swap can occur when the maximum possible interest rate differential between swap currencies occurs.

- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rates for the respective currencies of the exchange rate which is the underlying of the derivative or the risk of the negative change of interest rate differential between currencies which are the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

6. Currency Vanilla Options

Description of Currency Vanilla Options

Currency option means financial instrument, the holder of which is entitled but not obligated to purchase (Call option) or sell (Put option) the agreed volume of one (primary) currency for another (secondary) currency under pre-agreed conditions. The so-called premium should be paid for such right. It may be in the primary or secondary currency, expressed as a percentage from the amount of the currency (nominal). The conditions contain also the price for which that purchase or sale will be realised (strike price) and on which day (expiration day).

- **European option** means an option which may be exercised solely on the expiration date and in the precisely determined time.
- **American option** means an option which may be exercised on any business day prior to the expiration date or at the time of expiration.

The value of the option depends on several factors:

- volatility of the primary currency to the secondary currency (the fluctuation rate of the exchange rate between these currencies),
- strike price,
- time until expiration,
- spot rate,
- interest rates of both currencies,
- liquidity.

Risks Connected with Trading with Currency Options

Purchase of the call option is connected with the risk of loss of the value of the option in the event the spot rate falls down or the volatility falls down. Maximum loss represents the premium for which the option was purchased. Sale of the call option is connected with the risk of the liability to sell the agreed amount of the primary currency to the option holder for the agreed price (strike price) in the event the spot rate is higher than the agreed price (strike price) at the time of expiration. The risk of fulfillment of the obligation from sale of the call option grows with the growing spot rate and also with the growing volatility. Potential loss from sale of the option is unlimited. Purchase of the put option is connected with the risk of loss of the value of the option in the event the spot rate grows up or the volatility falls down. Maximum loss represents the premium for which the option was purchased. Sale of the put option is connected with the risk of the liability to purchase the agreed amount of the primary currency from the option holder for the agreed price (strike price) in the event the spot rate is lower than the agreed price (strike price) at the time of expiration. The risk of fulfillment of the obligation from sale of the put option grows with the falling spot rate and also with the growing volatility. Maximum loss from sale of the option is limited to the amount for which the option seller is liable to purchase from the option holder the agreed amount of the currency (nominal) for the agreed price (strike price).

- **Currency risk** means the risk of drop in value of the derivative as a result of changed exchange rate which is the underlying of the derivative,
- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rates for the respective currencies of the exchange rate which is the underlying of the derivative,
- **Volatility risk** means the risk of drop in value of the derivative as a result of changed volatility of the exchange rate of the currency pair which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

7. Exotic Currency Options

Barrier Options

Description of Barrier Options

- **Barrier option** means a type of option which is switched-on (knock-in) or vice versa, switched-off (knock-out), if the spot rate between the primary and secondary currency (spot rate) touches the pre-agreed barrier. Any knock-in option which is not switched-on or any knock-out option which is switched-off is not applicable. Barrier options may be, likewise the vanilla options, either European or American. We also differentiate between the call options and put options. Barrier options are single barrier options **(single barrier options)** or double barrier options **(double barrier options)**.

Four types of single barrier options exist:

- **Up-and-out:** the spot rate is, at the time of trading, below the limit of barrier, and in order to switch-off the option, the spot rate must be above that barrier
- **Down-and-out:** the spot rate is, at the time of trading, over the limit of barrier, and in order to switch-off the option, the spot rate must be below that barrier
- **Up-and-in:** the spot rate is, at the time of trading, below the limit of barrier, and in order to switch-on the option, the spot rate must be above that barrier
- **Down-and-in:** the spot rate is, at the time of trading, over the limit of barrier, and in order to switch-on the option, the spot rate must be below that barrier

Three types of double barrier options exist:

- **Double knock-in:** the option is switched-on, if the spot rate touches or breaks at least one of two barriers.
- **Double knock-out:** the option is switched-off, if the spot rate touches or breaks at least one of two barriers.
- **Knock-in knock-out:** the option is switched-on, if the spot rate touches or breaks a pre-determined knock-in barrier and is switched-off, if the spot rate touches or breaks a pre-determined knock-out barrier.

Barrier options may be of **American type** or **European type**. Barrier option of American type means an option which is switched-on or switched-off subject to the type of barriers (or barriers) on any business day prior to the time of expiration or at the time of expiration, if the barrier is touched. Barrier option of European type means an option which is exercised on the date of expiration and in the precisely determined time or ends with a zero value, subject to the type of barrier (or barriers) and whether the barrier (or barriers) is (are) touched.

Risks Connected with Trading with Barrier Options

Purchase of barrier options is connected with the risk of loss of the value of the option, if the spot rate fails to touch a barrier (in respect of the knock-in option) and the option is not switched-on or vice versa, the spot rate touches the barrier (in respect of the knock-out option) and the option is switched-off.

Purchase of the call barrier option is connected with the risk of loss of the value of the option in the event the spot rate falls down or the volatility falls down. Maximum loss represents the premium for which the option was purchased.
Sale of the call barrier option is connected with the risk of the liability to sell the agreed amount of the primary currency to the option holder for the agreed price (strike price) in the event the spot rate is higher

than the agreed price (strike price) at the time of expiration. The risk of fulfillment of the obligation from sale of the call option grows with the growing spot rate and also with the growing volatility. Potential loss from sale of the option is unlimited if the barrier of the option is not set for limitation of loss. Purchase of the put barrier option is connected with the risk of loss of the value of the option in the event the spot rate grows up or the volatility falls down. Maximum loss represents the premium for which the option was purchased. Sale of the put barrier option is connected with the risk of the liability to purchase the agreed amount of the primary currency from the option holder for the agreed price (strike price) in the event the spot rate is lower than the agreed price (strike price) at the time of expiration. The risk of fulfillment of the obligation from sale of the put option grows with the falling spot rate and also with the growing volatility. Maximum loss from sale of the option is limited to the amount for which the option seller is liable to purchase from the option holder the agreed amount of the currency (nominal) for the agreed price (strike price) if the barrier of the option does not limit loss otherwise.

- **Currency risk** means the risk of drop in value of the derivative as a result of changed exchange rate which is the underlying of the derivative,
- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rates for respective currencies of the exchange rate which is the underlying of the derivative,
- **Volatility risk** means the risk of drop in value of the derivative as a result of changed volatility of the exchange rate of the currency pair which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

Digital (Binary) Options

Description of Digital Options

- **Digital option** means a type of option, payment of which is subject to satisfaction of a pre-agreed condition. If the condition is satisfied, the payment (payout) represents a pre-agreed fixed amount. If the condition is not satisfied, the option purchaser receives no payout. This condition depends on whether the spot rate touches or breaks the pre-determined barrier (barriers) or vice versa, the spot rate does not touch or break the given barrier (barriers).

Two types of single barrier digital options exist:

- **One-touch option:** The purchaser of this option receives the payout only in the event the spot rate touches or breaks the given barrier. If it does not touch the barrier, the purchaser receives no payout.
- **No-touch option:** The purchaser of this option receives the payout only in the event that it does not touch the given barrier. If it does not touch or break the given barrier, the purchaser receives no payout.

Two types of double barrier digital options exist:

- **Double-one-touch:** The purchaser of this option receives the pay-out only in the event the spot rate touches or breaks the lower or upper barrier. If it does not touch both of these barriers, the purchaser receives no payout.
- **Double-no-touch:** The purchaser of this option receives the payout only in the event the spot rate touches neither the lower nor the upper barrier. If it touches or breaks either of these two barriers, the purchaser receives no payout.

Digital options may be of **American type** or **European type** subject to the type of barrier.
Digital option of American type means an option, payout of which is subject to satisfaction of a pre-agreed condition on any business day prior to the time of expiration or at the time of expiration.
Digital option of European type means an option, payout of which is subject to satisfaction of a pre-agreed condition on the precisely determined date and time.

Risks Connected with Trading with Digital Options

Purchase of digital options is connected with the risk of loss of premium for which the option was purchased, in the event the condition in connection with the set barrier or barriers is not satisfied.
Sale of digital options is connected with the risk of the

liability to pay a pre-determined fixed amount in the event the condition in connection with the set barrier or barriers is satisfied. Maximum loss is determined as the difference between the fixed amount to be paid by the seller and the premium collected by the seller from the purchaser of the option.

- **Currency risk** means the risk of drop in value of the derivative as a result of changed exchange rate which is the underlying of the derivative,
- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rates for the respective currencies of the exchange rate which is the underlying of the derivative,
- **Volatility risk** means the risk of drop in value of the derivative as a result of changed volatility of the exchange rate of the currency pair which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

8. Forwards for Interest Rate

Description of Forwards for Interest Rate

- **Forward for interest rate** (Forward rate agreement – FRA) means an agreement between the parties on future interest rate for a pre-agreed fiction volume of funds (principal) in a specific currency and a pre-agreed period in the future. The FRA purchaser undertakes to pay to the FRA seller the interests determined as fixed interest rate and the FRA seller undertakes to pay to the FRA purchaser the interests determined as reference interest rate. In both payment, the basis is the same volume of funds in the same currency and in the same period in the future. On the date of fixing the FRA, the fixed interest rate is compared with the reference interest rate. The parties do not exchange the principals, and the settlement of the trade is based only on the comparison, the agreed volume of funds, the number of days between the date of fixing the FRA, and the end of the interest period of FRA and the discounted volume of funds for the interests period of the FRA.

Risks Connected with Trading with Forwards for Interest Rate

FRA purchase is connected with the risk of the liability to pay to the FRA seller an amount calculated from the principal, the time period, and the difference between the fixed and reference interest rates in the event the fixed interest rate is higher than the reference interest rate. The loss from the FRA purchase is growing with the decreasing reference interest rate. Maximum loss (in the event of zero reference interest rate) represents the difference between the fixed and reference interest rate multiplied by the discounted principal and the relevant time period. FRA sale is connected with the risk of the liability to pay to the FRA seller an amount calculated from the principal, the time period, and the difference between the reference and fixed interest rate in the event the reference interest rate is higher than the fixed interest rate. Potential loss is unlimited and is growing with the growing reference interest rate.

- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rate agreed in the agreement which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

9. Interest Swaps

Description Interest Swap

- **Interest swap** (Plain Vanilla Swap, Interest Rate Swap – IRS) means an agreement between two parties on mutual exchange of agreed interest payments in the same currency. The IRS purchaser undertakes to pay to the IRS seller the interests determined by an agreed fixed interest rate, and the IRS seller is obligated to pay to the IRS purchaser the interests determined by the agreed reference interest rate. The principals are not exchanged. Payments are made on

regular basis in each reference period during the whole term of IRS and are calculated from the agreed volume of funds (principal), the difference between the fixed and reference interest rate, and the reference time period. Usually, only the difference between both payments is paid to the party which pay the lesser of the payments. In the event the fixed rate is higher than the reference interest rate, the difference between the payments is paid by the IRS purchaser to the IRS seller, and vice versa, the IRS seller pays to the IRS purchaser. If the rates are identical, no exchange of payments is made.

Risks Connected with Trading with Interest Swaps

IRS purchase is connected with the risk of the liability to pay to the IRS seller an amount calculated from the principal, the reference time period, and the difference between the fixed and reference interest rates for each reference period when the fixed interest rate is higher than the reference interest rate. The loss from IRS purchase is growing with the decreasing reference interest rate. Maximum loss (in the event of zero reference interest rate) is the difference between the fixed and reference interest rates multiplied by the principal and the term of IRS.
IRS sale is connected with the risk of the liability to pay to the IRS purchase an amount calculated from the principal, the reference time period, and the difference between the reference and fixed interests rate for each reference period when the fixed interest rate is lower than the reference in-
terest rate. The loss from the IRS sale is growing with the growing reference interest rate. Potential loss is unlimited and is growing with the growing reference interest rate.

- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rate agreed in the agreement which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

10. Currency Interest Swaps

Description of Currency Interest Swap

- **Currency interest swap** (Cross currency swap) means an agreement between two parties on mutual exchange of agreed interest payments in two various currencies. Either party will provide to the other party the agreed volume of funds (principal) in various currencies, for which they will pay to each other, on regular basis during the whole existence of trade, the interest rates according to the determined reference interest rates for each currency or from the reference interest rate for one currency and the fixed interest rate for the other currency, or from fixed interest rates determined for each currency separately. In the end of the period of the currency interest swap, the principals are re-exchanged back by a pre-agreed rate.

Risks Connected with Trading with Currency Interest Swaps

Trading with the currency interest swap is connected with the risk of movement of reference interest rates and movement of the spot rare of the currencies in which the principals are denominated. The loss incurred from the currency interest swap may represent a combination of both factors and is growing with the reference interest rate, for which the party pays the interest, with the decreasing reference interest rate for which the party receives the interest, and with movement of the spot rate to the detriment of re-exchange of principals in the end of the period of the currency interest swap. Potential loss is unlimited.

- **Currency risk** means the risk of drop in value of the derivative as a result of changed exchange rate which is the underlying of the derivative,
- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rate agreed in the agreement which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

11. Interest Options

Description of Interest Options

- **Interest option** means a financial instrument, the holder of which is entitled but not obligated to request the seller to settle the interest option on a precisely determined date.
- **Cap or Interest Rate Cap** means a series of individual interest options **Caplets**. The settlement of the cap is realised on regular basis in the end of each reference period until the agreed due date of the cap based on comparison of the reference interest rate and the pre-agreed fixed interest rate **(cap strike)** applicable in the beginning of the reference period (subject to the condition that the reference interest rate is higher than the cap strike) and is determined on individual basis for each caplet according to the pre-agreed volume of funds (nominal). The amount of settlement of the caplet is calculated as the ratio of the number of days of the relevant reference rate and the base (e.g. 365 days) multiplied by the nominal of the caplet and the difference between the reference interest rate and the cap strike.
- **Floor or Interest Rate Floor** means a series of individual interest options **Floorlets**. The settlement of the floor is realised on regular basis in the end of each reference period until the agreed due date of the floor based on comparison of the reference interest rate and the pre-agreed fixed interest rate **(floor strike)** applicable in the beginning of the reference period (subject to the condition that the reference interest rate is lower than the floor strike) and is determined on individual basis for each floorlet according to the pre-agreed volume of funds (nominal). The amount of settlement of the floorlet is calculated as the ratio of the number of days of the relevant reference rate and the base (e.g. 365 days) multiplied by the nominal of the floorlet and the difference between the floor strike and the reference interest rate.
- **Collar** means a combination of the cap and the floor. The collar purchaser buys the cap and sells the floor, the collar seller buys the floor and sells the cap. In both cases, the cap strike must be above the level of the floor strike and both the cap and the floor must have the same reference rate and the nominal. The floor purchaser protects himself against possible growth of interest rates above the level of the cap strike (compensation according to the settlement of the cap), and in the event of decreased interest rates below the level of the floor strike, he must pay the balance (according to the settlement of the floor).
- **Digital Cap or Digital Interest Rate Cap** means a series of individual interest digital options **Caplets**. The settlement of the digital cap is realised on regular basis in the end of each reference period until the agreed due date of the digital cap based on comparison of the reference interest rate and the pre-agreed fixed interest rate **(cap strike)** applicable in the beginning of the reference period (subject to the condition that the reference interest rate is higher than the cap strike) and is determined in the same way for each digital caplet as a pre-agreed volume of funds.
- **Digital Floor or Digital Interest Rate Floor** means a series of individual interest digital options **Floorlets**. The settlement of the digital floor is realised on regular basis in the end of each reference period until the agreed due date of the digital floor based on comparison of the reference interest rate and the pre-agreed fixed interest rate **(floor strike)** applicable in the beginning of the reference period (subject to the condition that the reference interest rate is lower than the floor strike) and is determined in the same way for each digital floorlet as a pre-agreed volume of funds.
- **Digital Collar** means a combination of the digital cap and the digital floor. The digital collar purchaser buys the digital cap and sells the digital floor, the digital collar seller buys the digital floor and sells the digital cap. The settlement of the digital collar means a combination of settlement of the digital floor and the digital cap, as described above.

Risks Connected with Trading with Interest Options

Purchase of cap is connected with the risk of loss of the value of the option in the event of drop of the

reference interest rate or drop of the volatility of the reference interest rate. Maximum loss represents the premium for which the cap was purchased.

Purchase of floor is connected with the risk of loss of the value of the option in the event of rise of the reference interest rate or drop of the volatility of the reference interest rate. Maximum loss represents the premium for which the floor was purchased.
Purchase of collar is connected with the risk arising from purchase of the cap and sale of the floor. Maximum loss represents the premium for which the collar was purchased and the amounts of the nominals of floorlets multiplied by the floor strike and the maturity period of the floor in years. Purchase of digital option (digital cap, digital floor or digital collar) is connected with the risk of loss of the premium for which the digital option was purchased. Sale of cap is connected with the risk of the liability to pay to the cap purchaser the volume of funds according to the settlement of the individual caplets in the event the reference interest rate is above the cap strike. Potential loss from sale of the cap is unlimited. Sale of floor is connected with the risk of the liability to pay to the floor purchaser the volume of funds according to the settlement of the individual floorlets in the event the reference interest rate is below the floor strike. Maximum loss from sale of the floor represents the nominals of the floorlets multiplied by the floor strike and the maturity period of the floor in years. Sale of collar is connected with the risk arising from sale of the cap and purchase of the floor. Potential loss from sale of the collar is unlimited.

Sale of digital option (digital cap, digital floor or digital collar) is connected with the risk of the liability to pay to the purchaser a pre-agreed volume of funds for each reference period when the purchaser exercises the digital option. Maximum loss represents the number of reference periods multiplied by the given volume.

- **Interest risk** means the risk of drop in value of the derivative as a result of changed agreed interest rate which is the underlying of the derivative,
- **Volatility risk** means the risk of drop in value of the derivative as a result of changed volatility of the interest rate which is the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

12. Futures

Description of Futures

- **Futures** means a contract between the stock exchange and the party on future sale or purchase of the underlying asset according to the pre-agreed conditions. The conditions contain also a precisely defined volume, maturity, and the price for which the trade will be realised. The futures are standardized forward trades realised in the stock exchange. The underlying asset may be for example the currency, the share, the share index, the notes, the note index, the interest rate, the commodity, etc.

Risks Connected with Trading with Futures

Trading with futures is connected with the risk of loss in the event of movement of the price for the underlying asset to the detriment of the obligation to realise the purchase or sale according to the agreed conditions. For example, trading with the futures for a currency bears the risk as described in the currency forwards.

- **Currency risk** means the risk of drop in value of the derivative as a result of changed exchange rate which is the underlying of the derivative,
- **Equity or index risk** means the risk of drop in the value of the derivative as a result of changed share price or index price which are the underlying of the derivative,
- **Commodity risk** means the risk of drop in value of the derivative as a result of changed commodity price which is the underlying of the derivative,
- **Credit risk** means the risk of drop in value of the derivative due to changed market perception of the creditworthiness of the issuer and the risk of failure to fulfill the obligations by the issuer of the debt security which is the underlying of the derivative,

- **Political risk** means the risk of loss of value of the derivative due to any changes in the political situation in individual countries or regions, which may have negative effect on the value of the debt security which is the underlying of the derivative,
- **Interest risk** means the risk of drop in value of the derivative as a result of changed interest rates for the respective currencies of the exchange rate which are the underlying of the derivative or interest rate or the debt security as the underlying of the derivative,
- **Liquidity risk** means the risk that the derivative will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives.

13. Tatra Premium Deposit

Description of Tatra Premium Deposit

On the value date, the client will deposit in the bank, by bank transfer, on the account in the primary (secondary) currency, an amount in the primary (secondary) currency for the period until the due date. The client is not authorized to claim, prior to the due date, payment of the amount in the primary (secondary) currency, deposited by the client in the bank.

The bank has the right to decide, on the determined day, whether the amount in the primary (secondary) currency deposited by the client in the bank will be paid to the client on the due date to the account in the primary (secondary) currency or whether it will be paid to the client on the due date in the secondary (primary) currency to the account in the secondary (primary) currency at the agreed exchange rate of the main and secondary currency, i.e. as an amount in the secondary (primary) currency.

The bank will also pay to the client, on the due date, in the primary (secondary) currency, to the account in the primary (secondary) currency, the interests on the amount in the primary (secondary) currency deposited by the client in the bank at the agreed interest rate for the period from the value date (inclusive) until the first day preceding the due date.

Risks Connected with Tatra Premium Deposit

Tatra Premium Deposit is connected with the risk of vested derivate. In the event the client deposits an amount in the primary currency, he is exposed to the risk of loss of the value of the deposited amount in the event the spot rate of the primary and secondary currency is higher than the agreed rate on the due date and in precisely determined time. In the event the client deposits an amount in the secondary currency, he is exposed to the risk of loss of the value of the deposited amount in the event the spot rate of the primary and secondary currency is lower than the agreed rate on the due date and in precisely determined time. Maximum loss theoretically represents the deposited amount.

- **Currency risk** means the risk of drop in value of the investment as a result of changed exchange rate which is the underlying of the derivative embedded into investment,
- **Interest risk** means the risk of drop in value of the investment as a result of changed interest rates for the respective currencies of the exchange rate which are the underlying of the derivative embedded into the investment and for the currency of deposit,
- **Volatility risk** means the risk of drop in value of the investment as a result of changed volatility of the exchange rate of the currency pair which is the underlying of the derivative embedded into the investment,
- **Liquidity risk** means the risk that the derivative embedded into the investment will not be able to be turned into cash on the market in time or at an appropriate price,
- **Market risk** means the risk of drop in value of the investment as a result of total drop of the market with derivatives,
- **Inflation risk** causes that the deposited amount in the particular currency has the lower real value than at the time of the investment due to the higher inflation rate of this currency.

Types of Tatra Premium Deposit:

- Tatra Premium Deposit (TPD) – classic
- The Tatra Premium Deposit European Knock-In (TPD EKI) – in comparison with the classic TPD, has a more conservative configuration, consisting in an inbuilt European-type knock-in

barrier. The Bank's right to convert the deposited amount into a different (agreed) currency switches on only upon the knock-in barrier being reached (on a set day).
- Tatra Premium Deposit Knock-In (TPD KI) – is similar to the TPD EKI, but the inbuilt knock-in barrier is American-type. This means that the Bank's right to convert the deposited amount into a different (agreed) currency switches on only upon the knock-in barrier being reach at any time during the observation period (not solely on the day, as in the case of the TPD EKI).
- Tatra Premium Deposit PLUS – is similar to the TPD, and moreover, if, during the whole observation period, the respective reference rate lies in the range between barrier #1 and barrier #2, the Client will, in addition to the basic interest yield, be paid also the bonus interest yield.

14. Leverage Effect Risk

It is the risk which is characterized by the amount of investment required for trading with a financial instrument versus the nominal value of that financial instrument. The higher the nominal value of the investment versus the invested funds, the higher the risk or sensitivity of change in the market value of the trade to the change in the price for financial instruments. Via the leverage effect, the client may enter into trades with much higher nominal than the funds available to the client.

The leverage effect may be described as a mechanism when a small percentage change in the price for financial instruments results in much higher percentage change of the profit or loss of the client's own invested money, and thus the client may lose much more funds than was the amount of his initial investment.

15. Investment certificates

Description of investment certificates

Investment certificates are structured securities issued, as a rule (normally), by an investment bank, or its branch office. They are usually a combination of an interest component (e.g. a bond) and a derivative. Depending on the ratio of the interest component to the derivative component, the resulting investment certificate payment profile can range from conservative to aggressive; depending also on the selected derivative strategy, the investor can subsequently participate in the growth, decline or stagnation of the underlying asset (or basket of underlying assets), which may, for example, consist of equities, equity indices, commodities, bond indices, interest rates or currency pairs, or a basket of individual assets.

Investment certificates may have a defined fixed maturity.

With investment certificates, we are talking about debt securities whose repayment the issuer guarantees with its assets. The issuer's creditworthiness is, therefore, one of the most important parameters that the investor should take into account when choosing an investment certificate.

Investment certificates are usually traded on a regulated exchange (e.g. Frankfurt or Stuttgart), or can be traded through the purchaser directly with their issuer (over-the-counter or OTC). Securities issuers, as a rule, normally, quote buy as well as sell rates for issues of certificates accepted on regulated exchanges, though issuers are not legally bound to provide this service, and so an investor should be prepared to hold a certificate up until its ordinary or early maturity.

We distinguish between these basic types of investment certificates:

- Guaranteed certificates
- Bonus certificates
- Discount Certificates
- Turbo certificates
- Express certificates

Guaranteed certificates

The securities issuer or guarantor offers a guarantee of repayment of a predetermined level of the nominal value of the certificate and concurrently gives the investor the opportunity to participate in the positive development of the underlying asset in the form of bonus interest. However, due to the guarantee of the minimum payout value at the certificate's maturity, the rate of positive participation is usually lower in

comparison with direct ownership of the underlying asset concerned.

Bonus certificates

Bonus certificates can be a solution for investors who want to fully participate in the development of the value of the underlying asset and concurrently expect growth in its value, stagnation of the price, or even a slight decline in its value.

The bonus certificate represents a product with a conditional guarantee and a fixed maturity. The payable value of the bonus certificate at its maturity depends on the development of the value of the underlying asset during the life of the bonus certificate, as well as on the final value of the underlying asset at its maturity. During the lifetime of the bonus certificate, the investor waives certain rights relating to the holding of the underlying asset, such as voting rights, interest income or dividends paid by the underlying asset, since the issuer uses them for financing the bonus certificate's payout profile.

Discount Certificates

Discount certificates represent a fixed-term investment instrument in which the investor participates in a limited scope in the development of the underlying asset. The underlying asset is, as a rule, an equity or equity index that the investor acquired by means of the discount certificate at a discount, i.e. for a value lower than it trades on the stock market. On the other hand, the investor waives unlimited participation in the development of the value of the underlying asset, as well as ongoing yields (e.g. dividends), that the underlying asset in the course of the life of the certificate pays out to their owners and which the issuer uses for financing the payout profile. Discount certificates can thus be a solution for investors who expect a slight growth in the value of the underlying asset, stagnation in its price, or even a slight decrease in its value.

The payable value of the discount certificate as at its maturity depends on the development of the value of the underlying asset during the life of the discount certificate, as well as on the final value of the underlying asset at its maturity.

Turbo certificates

Turbo certificates are a speculative investment instrument in which the investor participates in the development of the value of the underlying asset, this all, with a lower initial investment than in the case of purchasing the underlying asset itself. A turbo certificate, through its construction, represents a combination of the investor's investment with a credit part provided by the issuer. Thanks to the lower initial investment and the credit provided by the issuer, leverage effect is achieved, whereby the investor can achieve a relatively high (above average) return or, conversely, a relatively high (above average) loss. Turbo certificates can thus be a solution for investors who have a clear idea of the future development of the underlying asset – they expect its value to grow (turbo long), or its value to fall (turbo short) and concurrently they do not expect that the value of the underlying asset will, over the course of the life of the turbo certificate, achieve the value of the barrier or lower value (turbo long), or will not achieve the barrier value or higher value (turbo short). The issuer usually has the right to declare early maturity of the turbo certificate.

Express certificates

Express certificates have a fixed final maturity, though their advantage lies mainly in the possibility that they will mature much earlier.

The Strike price, which must be reached or exceeded in order for the express certificate to mature early, is determined for the given underlying asset (e.g. equity, basket of equities, or index) as early as at the time of issue. The Strike price may increase or decrease at individual observations, which impacts the express certificate's overall yield potential. If the price of the underlying asset on one of the predetermined observation days (usually half-yearly or yearly intervals are concerned) is higher than or equal to the Strike price, the express certificate matures immediately and the investor is paid the nominal value of the certificate, together with the bonus, which is determined according to a predefined payout scheme.

If early maturity of the express certificate does not occur, this need not necessarily mean a loss for the investor, as most express certificates have an inbuilt additional protection of the principal, the aim of which is to provide protection against moderately falling prices of the underlying asset. If the price of the underlying asset over the duration of the investment never reaches or falls below the predefined barrier (or in the case of a European-type barrier, if the

maturity does not reach the barrier level, or lower value) the security is repaid in an amount equalling the certificate's nominal value, this all, even despite the underlying asset's overall negative development. When the barrier is breached, the investor, at the express certificate maturing, is fully exposed to the risk of a loss, the overall amount of which depends on the level of the relative fall in the price of the underlying asset as compared to its initial value, as well as depending on the purchase value of the security.

Risks associated with trading in investment certificates

- **interest-rate risk** is the risk of a decrease in the value of an investment due to a change in interest rates,
- **issuer risk** is the risk of a change in the value of the certificate due to a change in the market perception of the issuer's creditworthiness or, the issuer's default itself. Therefore, the loss of all funds invested is possible,
- **market risk** is the risk of a fall in the value of an investment due to an overall decline in the market for investment instruments forming the underlying asset of the investment,
- **inflation risk** causes the level of the issuer's obligation to repay the debt in a given currency has, due to increased inflation of this currency, a lower real value than at the time of the investment,
- **liquidity risk** is the risk that it will not be possible to monetise the asset contained in the portfolio on the market in time or at reasonable price,
- **secondary market risk** – the investor has no guarantees that the secondary market will be liquid under all circumstances. Even if the issuer provides a secondary market for the financial instrument, the situation might arise in which the secondary market will not function effectively, or will be suspended. If financial instruments are not traded via a stock exchange, information on the price might not be easily available, thus influencing the financial instrument's price and liquidity,
- **currency risk** is the risk of a decrease in the value of an investment expressed in the domestic currency in consequence of a change in the domestic currency's exchange rate against another currency. Despite the fact that a financial instrument may be denominated in euros, the price of the underlying asset of the investment may be traded also in other currencies, and thus, the investment is associated with currency risk,
- **volatility risk** is the risk of a decrease in the value of an investment on the basis of a change in the volatility of the underlying asset,
- **equity risk** is the risk of a fall in the value of the investment due to a fall in the value of the equity that constitutes the underlying asset of the investment – in the case that the underlying asset is an equity,
- **commodity risk** is the risk of a fall in the value of an investment due to a change in the price of the commodity that constitutes the underlying asset of the investment – in the case that the underlying asset is a commodity.