Financial instruments and related risks

Capital Markets products

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Introduction

This document describes the nature of the financial products that are distributed by ČSOB, and their associated risks, in order to enable the client to take investment decisions on an informed basis. It is first and foremost intended for hedgers and investors that are in direct contact with the ČSOB dealing room.

The financial instruments are grouped in different product classes based on the type of underlying asset:
- Foreign Exchange products (FX)
- Interest Rate products (IR)
- Fixed Income instruments (FI)
- Other (including credit, equity and commodity related products)

For each type of financial instrument, the brochure describes the main features, the risk profile and also provides an overview of the variants of the basic products.

The financial products are grouped in levels of complexity, ranging from 1 to 3 (structures). The more complex financial instruments are linked to a higher level of complexity. Please note, however, that a higher level of complexity does not automatically mean that the risk associated with the financial instrument is higher.
ČSOB has defined three levels of complexity in order to make it possible to assess the knowledge and experience a client requires for every possible combination of product class and complexity.

Product Class\Complexity t	Level 1	Level 2	Level 3
FX			
RV			
VR			
Other			

The volatility and leverage of the financial instruments have been assessed from the perspective of a hedger. These risk profiles may differ considerably if seen from a speculative point of view.

This brochure defines three reasons for concluding transactions:

1) *Hedging*: the conclusion of a contract with the same amounts and duration as a predetermined underlying risk. The purpose of the use of financial instruments is to eliminate the possible negative impact on the results of that risk. The use of financial instruments like options has a cost (premium), but from the point of view of the entire position of a hedger, there is no “risk of losing the entire underlying amount.

2) *Active risk management*: the managing of underlying risk positions by keeping them temporarily open or hedging them partially or by concluding hedging contracts with durations and amounts which are not exactly covering maturity and amounts of the underlying risk. The risk related to active risk management lies between the risks associated with hedging and investment.

3) *Investments*: the placement of available money into financial instruments in order to make a return.

Definitions

Risk definition

Credit risk	Risk that a financial counterparty will fail to fulfill its obligations. In most cases, this will be because of its poor financial status or imminent bankruptcy.
Liquidity risk/Limitations on the available market	Risk that an instrument may prove difficult to be dealt in at a reasonable price (prior to maturity).
Currency risk	Risk that the value of an investment or product is impacted by currency movements.
Interest-rate risk	Risk that the value of an investment or product is impacted by interest rate fluctuations.
Risk related to external factors	Risk that the value of an investment or product is impacted by external factors, such as the tax regime, etc.

General

OTC ("over the counter")
Financial instruments traded over the counter are instruments that are traded outside a regulated market.

Leverage
The degree that the price of a financial instrument changes due to a change in the price of the underlying assets.

Volatility
The variability of the price of a security, fund, market index or interest rate over a given period of time.

Deliverable
The contract is settled through delivery of the underlying assets (physical settlement).

Cash settled
The contract is settled in cash (in a major currency), as opposed to being physically delivered.

Non-deliverable
The contract is settled in cash (in a major currency), because the underlying currency is non-convertible.

Complexity
ČSOB divides products according to the scale of complexity /1 = the least complex, 2 = more complex, 3 = the most complex/

Option-related features

The features are typical properties of optional financial instruments (Complexity level 2 or above).

European

A property of a contract or feature meaning that it can be exercised only at maturity.

American

A property of a contract or feature meaning that it can be exercised during the entire duration of the contract.

Barrier

A barrier is a predetermined boundary or limit in the market, potentially impacting the outcome of a contract.

By using barriers, different contract features can be defined:

- Single: the outcome of the contract is potentially impacted by one barrier
- Double: the outcome of the contract is potentially impacted by two barriers
- Standard: the barrier is applicable during the entire life of the contract
- Partial: the barrier is only applicable during part of the life of the contract (window)

Knock-in

A feature where a provision is included in a contract suspending its operation until a specific condition is fulfilled (suspensive condition).

Knock-out

A feature where a provision is included in a contract suspending its operation at the moment that a specific condition is fulfilled (dissolving condition).

One touch

A feature of a contract where a predetermined payout will be made, provided that a certain predetermined level is hit.

No-touch

A feature of a contract where a predetermined payout will be made, provided that a certain predetermined level is not hit.

Range

A feature of a contract where the outcome of the contract depends on the market rate either staying within predetermined levels or exceeding those levels in either direction.

List of abbreviations

FX	Foreign eXchange
FI	Fixed Income
IR	Interest Rate
MM	Money Market
CM	Capital Market
OTC	Over The Counter

Risk of losing entire investment

Depending on the perspectives of the client, the risk of losing the entire investment should be considered in light of the risks associated with the underlying positions (see ‘Introduction’).

Tax Treatment

The tax treatment of financial instruments depends on the characteristics of the financial product, the individual circumstances of each client and may differ from one country to another.

Clients who are in any doubt as to their tax position should consult their financial or own independent tax advisers. In addition, potential purchasers should be aware that tax regulations and their application by the relevant tax authorities change from time to time. Accordingly, it is not possible to predict the precise tax treatment which will apply at any given time.

Description of financial instruments: Capital Markets products

In addition to the building blocks described hereafter, ČSOB offers a wide scope of complex structures (composed of these building blocks). Since the spectrum of the structures changes regularly, this brochure only contains a selection of the available products. For more detailed information and a more detailed risk description, please refer to the term sheets of the available products.

Complexity 1

Bill of exchange

Description

A Bill of exchange is a discounted debt instrument issued by a bank or by any company.

Prospectus	**Yes**
Guarantee	**It depends on the particular case**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**N/A**
OTC product?	**Yes**
Complexity level	**1A on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Low to high (depending on the rating of the issuer)**
Liquidity risk/Limitations on the available market	**High**
Currency risk	**N/A (high risk rating for CSOB performance bill of exchange only)**
Interest-rate risk	**Low**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

ČSOB deposit bill of exchange
A bill of exchange issued by ČSOB

Corporate bill of exchange
A bill of exchange issued by a company based in the Czech Republic administrated by ČSOB

ČSOB performance bill of exchange
See Complexity 3

Treasury Bill, T-Bill

Description

A Bill is a short- term, interest-bearing debt instrument issued by the Czech National Bank or by the Ministry of Finance.

Prospectus	**N/A**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**N/A**
OTC product?	**Yes**
Complexity level	**1B on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Low**
Liquidity risk/Limitations on the available market	**Low**
Currency risk	**N/A (linked to FX transactions)**
Interest-rate risk	**Low**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

N/A

Commercial Paper (CP)

Description

Commercial paper is a short-term, unsecured, debt instrument, issued by large companies (institutional borrowers) in order to satisfy immediate cash needs or to finance accounts receivable, inventories, etc.

Prospectus	**Yes**
Guarantee	**Depending on the CP, a guarantee can be included (see prospectus)**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low (depending on interest-rate trends and supply and demand)**
Leverage (and its effects)	**N/A**
OTC product?	**Yes**
Complexity level	**1C on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Medium (Depending on the rating of the issuer)**
Liquidity risk/Limitations on the available market	**High**
Currency risk	**N/A**
Interest-rate risk	**Low**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

N/A

Bonds

Description

A bond is a debt instrument where the bond holder lends money to the issuer (company or government) for a predetermined period of time and at a predetermined interest rate. The issuer pays interest (coupon) on predetermined dates and repays the principal amount on the maturity date.

Prospectus	**Yes (for some exceptions there is no mandatory prospectus)**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**N/A**
OTC product?	**Yes**
Complexity level	**1C on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Medium (depending on the rating of the issuer)**
Liquidity risk/Limitations on the available market	**Low**
Currency risk	**Low**
Interest-rate risk	**Low to high (proportional to maturity)**
Risk related to external factors	**Medium**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

The list of variants below is not exhaustive:

Public
A public bond is a bond issued for a large number of investors (a prospectus is issued). It is also accessible to small investors.

Private
A private bond is a bond issued to a limited number of investors (no prospectus)

Government bond
A government bond is a bond issued and fully guaranteed by a government

Zero (coupon) bond
A zero coupon bond is a bond where there are no interest rate payments. The bond is traded at a discount price and the full principal amount is repaid on the maturity date.

Capital guaranteed
A capital guaranteed bond is a bond where the principal and sometimes the interest payments are guaranteed by a third party.

Floating rate bond
See Structures - Floaters (Complexity 2)

Step-up/Step-down
A step-up bond is a bond where the interest rate increases/decreases over the life of the bond.

Different coupon frequency
A bond with different coupon frequency is one where interest is not paid on a regular basis.

Perpetual
A perpetual bond is a bond with no maturity date. Coupons are paid forever and the principal amount is not paid back. In most cases, a perpetual bond includes a call option for the issuer to terminate the contract.

Senior/subordinated bonds
Senior bonds have higher priority in case of liquidation. The holders of senior bonds are paid before the holder of subordinated bonds. Because of the higher risk, subordinated bonds usually have a lower credit rating than senior bonds.

Linked bonds
See Structures – Linked bonds (Complexity 2)

Complexity 2

Floater

Description

A floating rate bond is a bond with a variable interest rate, which is calculated based on a money market reference rate (like EURIBOR) and a predetermined spread.

Prospectus	**Yes (in some cases, there is no mandatory prospectus)**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**Low**
OTC product?	**Yes**
Complexity level	**2A on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Medium (depending on the rating of the issuer)**
Liquidity risk/Limitations on the available market	**Low**
Currency risk	**Low**
Interest-rate risk	**Medium**
Risk related to external factors	**Medium**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

Range floater/Range note
A bond whose coupon rate depends on the number of days that a reference rate stays within a predetermined rate.

Reverse floater
A bond whose coupon rate has an inverse relationship with market conditions (short-term interest rates). If the underlying interest rate increases/decreases, the coupon rate decreases/increases.
Also known as an "inverse floater.

Callable Bond

Description

A bond with a call option is one where the issuer retains the right, but not the obligation, to redeem the bond at a predetermined date prior to the original maturity date of the bond. The issuer has a call option on the bond.

A bond with a put option is one where the holder has the right, but not the obligation, to have the bond redeemed at a predetermined date prior to the original maturity date of the bond.
The holder effectively has the right to sell the bond back to the issuer, i.e. a put option.

Prospectus	**Yes**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Medium - in line with interest rate trends**
Leverage (and its effects)	**N/A**
OTC product?	**Yes**
Complexity level	**2A on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Low**
Liquidity risk/Limitations on the available market	**Low**
Currency risk	**Low**
Interest-rate risk	**Low**
Risk related to external factors	**Medium**
Risk related to structure compared to risk related to each building block	**The risk is higher than the risk associated with a normal bond)**

Variants

N/A

Convertible bond

Description

A convertible bond is a bond which may, at the request of the holder, be converted into shares in the company concerned, within a certain period and at conditions determined in advance.

The conversion price (i.e. the price at which bonds may be converted into shares) is fixed in advance and is not affected by changes in the price of the underlying shares.

Prospectus	**Yes**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**High**
Leverage (and its effects)	**Medium**
OTC product?	**Yes**
Complexity level	**2A on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Medium**
Liquidity risk/Limitations on the available market	**Low**
Currency risk	**Low**
Interest-rate risk	**Medium**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**No heightened risk of losing invested money if the share value drops below the bond value**

Variants

Reverse convertible bond
A reverse convertible bond is a bond which may, at the request of the issuer, be converted into cash or shares in the company concerned, at maturity at the price agreed at the time of issue. Issuers will take the latter option if shares are quoted below the conversion price at maturity. To offset this risk of a capital loss, investors receive a high rate of annual interest. Reverse convertible bonds have a short term to maturity.

The conversion price (i.e. the price at which bonds may be converted into shares) is fixed in advance and is not affected by changes in the price of the underlying shares.

Linked bond

Description

A linked bond is a bond where the payment of interest (coupons) is linked to the value of another asset.

Prospectus	**Yes (in some cases, there is no mandatory prospectus)**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**Low**
OTC product?	**Yes**
Complexity level	**2A on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Medium (depending on the rating of the issuer)**
Liquidity risk/Limitations on the available market	**Low**
Currency risk	**Low**
Interest-rate risk	**Low**
Risk related to external factors	**Medium**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

Index linked bond
A bond whose return is indexed to a specific index.

Equity linked bond
A bond whose return is determined by a single equity security, a basket of equity securities or an equity index.

ČSOB high yield promissory note

Description

A promissory note is a discounted debt instrument issued by a bank or by any company.
The ČSOB high yield promissory note includes an option to the drawer of a promissory notel for redemption in a currency different from the original promissory note.
The buyer of the promissory note sells to ČSOB a put option for the conversion of the promissory note amount to another currency.

Prospectus	**Yes**
Guarantee	**No**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**Low**
OTC product?	**Yes**
Complexity level	**2B on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Low to high (depending on rating of the issuer)**
Liquidity risk/Limitations on the available market	**High**
Currency risk	**High**
Interest-rate risk	**Low**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

N/A

Complexity 3

TARN: Target Redemption Note (structure)

Description

A target redemption note is a note where the coupons are based on a floating index.
The contract terminates on the maturity date or can be terminated early when the accumulated coupon has reached a predetermined “target cap” (= guaranteed sum of coupons).

Prospectus	**Yes**
Guarantee	**It depends on the particular case, see the prospectus for details**
Financial commitments and other additional obligations	**N/A**
Volatility	**N/A**
Leverage (and its effects)	**High**
OTC product?	**Yes**
Complexity level	**3A on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Medium**
Liquidity risk/Limitations on the available market	**Medium**
Currency risk	**Low**
Interest-rate risk	**High**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

N/A

Snowball (structure)

Description

A snowball is a bond where consecutive coupons are calculated based on the previous coupon plus (bullish) or minus (bearish) a floating index spread.

Prospectus	**Yes**
Guarantee	**It depends on the particular case, please see the prospectus**
Financial commitments and other additional obligations	**N/A**
Volatility	**High**
Leverage (and its effects)	**High**
OTC product?	**Yes**
Complexity level	**3A on a scale of 1 to 3 (structures)**

Risk profile

Credit risk	**Low to high (depending on rating of the issuer)**
Liquidity risk/Limitations on the available market	**Medium**
Currency risk	**Low**
Interest-rate risk	**High**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

Callable
The contract can be terminated by the issuer.

Combined with TARN feature
See above.