



Financial Market Products and Their Risks

Interest Rate Products

Valid and effective from 08.02.2022

Contents

Introduction	3
Explanatory notes	4
Description of risks	4
General	4
Characteristics of options	5
List of abbreviations	6
The risk of loss on a trade	6
Taxes	6
Description of financial instruments: Interest Rate Products	6
Product complexity level 2	7
Repo operations	7
Forward Rate Agreement (FRA)	8
Interest Rate Swap (IRS)	9
Cross-Currency Interest Rate Swap (CCIRS)	11
Cap/Floor (plain vanilla)	13
Swaption	14
Product complexity level 3	15
Interest Rate Swap – Alternative variants	15
Barrier options	16

Introduction

The aim of the document is to provide the client with information about the nature of the Investment instruments for risk hedging purposes (hereinafter “hedging products”) offered by Československá obchodní banka, a. s., and about the risks of these products so that the client can make a qualified decision on purchasing/selling based on sufficient information.

Hedging products are classified into product groups/classes by the type of the underlying asset:

- Foreign Exchange and Money Market Products (FX).
- Interest Rate Products (IR)
- Investment Products – Debt instruments ¹
- Other Products (including products linked to commodities, credit or ownership interests).

We give the main characteristics, risk profile and a summary of variants derived from the basic product for every hedging product type.

Hedging products are grouped by the level of complexity that may reach values of 1 to 3 (structures). The higher the group level the higher the product complexity. Please note that the higher complexity does not automatically mean that the risks of this product are higher. However, the structure complexity may mean that the product and its performance in various situations is more difficult to understand.

Československá obchodní banka, a. s., has set three complexity levels for hedging products to allow for the client's knowledge and experience needed for every combination of product group and complexity.

Product group\ Complexity level of products within a group	Level 1	Level 2	Level 3
FX	x	x	x
IR		x	x
Other		x	

This brochure defines two reasons for using hedging products:

1. **Hedging:** The client buys a hedging product with the structure and **maturities so as to exactly eliminate the risks to which the client is exposed**. The purpose of this hedging product is to eliminate/remove the negative influence of a particular risk. Using hedging products such as options incurs costs (the premium), but from the overall position of the hedging party the risk of losing the entire underlying amount is completely eliminated.
2. Active risk management: is managing basic risk positions, provided that
 - a) these positions remain temporarily open; or
 - b) these positions are partly hedged; and/or
 - c) hedging deals will be closed with maturities and amounts that may not fully match the maturities and amounts of the hedged items.

The active risk management risk is the risk of hedging and investment.

The information in this document is of a general nature and may not be considered as an offer under Section 1732 of Act No. 89/2012 Coll., the Civil Code, as amended (hereinafter the “Civil Code”) or as a public offer under Section 1780 of the Civil Code to invest in any instrument mentioned or as investment advice.

This document contains information that is the property of Československá obchodní banka, a. s. This document or any part of it may not be reproduced, published, distributed or otherwise used without the express consent of Československá obchodní banka, a. s.

¹ The Structured Deposit product only

Explanatory notes

Description of risks

Credit risk

The risk of the counterparty's inability to fulfill its obligations. In most cases, this is caused by the counterparty's poor financial situation or imminent threat of bankruptcy.

Liquidity risk/Limited market availability

The risk of a hedging product being difficult to trade for a reasonable price (before maturity) or a hedging product being difficult to trade at any price.

Currency risk

The risk of the value of a hedging product being influenced by exchange rate movements.

Interest rate risk

The risk of the value of a hedging product being influenced by interest rate movements.

Risks of external influences

The risk of the value of a hedging product being influenced by external factors such as a tax regime, etc.

Commodity risk

The risk of the value of assets being influenced by price movements on the commodity market.

Inflation risk

The risk of the value of a hedging product being influenced by price level movements.

General

OTC ("over the counter")

A product traded over the counter is a hedging product traded outside regulated markets.

Leverage effect

The rate of change in the price of a hedging product as a result of a change in the price of the underlying asset.

Volatility

Variability in the price of a security, funds, a market, an index or an interest rate within a specified period.

Settlement with delivery

The trade is settled with the delivery of the underlying asset (physical delivery).

Settlement in cash

The trade is settled in cash (in the main currency), as opposed to the settlement with physical delivery.

Settlement without delivery

The trade is settled in cash (in the main currency), because the underlying asset is not convertible.

Complexity level of products within a group

ČSOB divides its products by their level of complexity (1 = least complex, 2 = moderately complex, 3 = most complex).

Characteristics of options

These characteristics are related to option financial products (with a complexity level of products within a group of 2 or higher).

European

The holder can exercise the option only at the exactly defined option maturity date (Option Exercise Date).

American

The holder can exercise the option at any time during the contract term.

Barrier

A barrier is a predetermined limit on a market parameter of the underlying asset, potentially affecting the outcome of a contract.

Different product parameters can be defined y using barriers:

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

Knock-in

The option does not come into effect until a barrier is breached (suspensive condition).

Knock-out

The option is effective until a barrier is breached; once a barrier is breached, the option will cease to be effective (dissolving condition).

One touch

A contract feature stipulating that if a predetermined level (of the price of the underlying asset) is reached, then a predetermined payout will be made.

No-touch

A contract feature stipulating that if a predetermined level (of the price of the underlying asset) is not reached, then a predetermined payout will be made.

Range

A contract feature stipulating that the outcome of the contract depends on the price of the underlying asset either staying within or outside a predefined range.

List of abbreviations

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

The risk of loss on a trade

The client should assess the risk of a loss with regard to the risks of the underlying asset (type of product, see “Introduction”).

Taxes

The taxes on financial instruments depend on the characteristics of the product and the individual situation of each client and may vary by country.

A client with doubts about taxes is recommended to consult an independent financial or tax advisor. Investors should also take into account that tax regulations and their consequences interpreted by the competent authorities change over time. Therefore, the exact future tax impact on the investment cannot be predicted.

Description of financial instruments: Interest Rate Products

In addition to the basics described below, ČSOB also offers a wide range of complex structures (composed of these basics). As the range of these structures frequently changes, this brochure only contains a selection of available products. More accurate information and a more detailed description of the risks can be found in the detailed descriptions of available products (“termsheet”).

Product complexity level 2

Repo operations

Description

A repurchase transaction (repo) is a transaction where one party (the "Seller") agrees to sell securities and financial instruments ("Securities") to the other party ("Buyer") for an agreed price. The Buyer agrees to resell to the Seller Securities equivalent to the original Securities on a defined date or on demand, for the original price of the Securities plus a return for the use of cash ("repo rate").

OTC product	Yes
Volatility	Low
Leverage (and its influence)	Low
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	2 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Low
Liquidity risk/Limitations on available markets	Low
Currency risk	Low
Interest rate risk	Low to Medium (Proportionate to maturity)
Risks of external factors	N/A
Structure risks compared to the risks of individual parts	N/A

Variants

Reverse standard

This is a reverse repo agreement that involves a third party (a clearing house or custodian bank) that handles the administrative aspects of the repo deal between the Seller and Buyer.

Buy/Sellback

A buy/sellback transaction is similar to a repo, i.e. an agreement between two parties first to sell securities and then to buy them back at an agreed future date.

The main differences from a repo are that:

1. a buy/sellback transaction combines two transactions executed simultaneously; and
2. the buyer keeps the income (coupon) payment on the securities but takes it into account when calculating the sellback price.

Forward Rate Agreement (FRA)

Description

FRA is an agreement between two parties on the interest rate for a specific future period. No actual loan is provided and no actual deposit is accepted between the parties. The parties only exchange the difference between the interest agreed under the FRA rate and the current market interest rate determined on the financial market in an agreed future period. The nominal value of the FRA is only used to derive the payment resulting from the FRA trade and there is no exchange of nominal values.

OTC product	Yes
Volatility	Low
Leverage (and its influence)	Low
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	2 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Low
Liquidity risk/Limitations on available markets	Low
Currency risk	N/A
Interest rate risk	High (Proportionate to maturity)
Risks of external factors	Low
Structure risks compared to the risks of individual parts	N/A

Variants

Interest Rate Swap (IRS)

Description

An Interest Rate Swap is a financial contract between two parties that exchange two interest payments. Generally, fixed interest payments are exchanged for variable interest payments ("fixed against floating"), but both interest rate payments can also be variable ("floating against floating"). Interest payments are made in the same currency. No principal is exchanged and the parties contractually agree to settle or exchange each other's interest payments.

OTC product	Yes
Volatility	Low
Leverage (and its influence)	Low (Proportionate to maturity)
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	2 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Low
Liquidity risk/Limitations on available markets	Low / Medium (if the frequency is not the same for both interest payments)
Currency risk	N/A
Interest rate risk	Medium to High (Proportionate to maturity)
Risks of external factors	Low
Structure risks compared to the risks of individual parts	N/A

Variants

Forward start

A forward start IRS is a swap transaction entered into today but does not start until some future date, e.g. a three-year two-year forward interest rate swap begins two years from now and ends five years from now.

Zero coupon

A zero coupon swap is an IRS where fixed rate interest payments are not made periodically throughout the swap but only one fixed payment is made on the expiry date of the swap, whereas floating interest payments are made periodically throughout the swap. Zero coupon swaps involve a high credit risk for the party receiving the fixed interest payment.

Year on year

A Year on Year swap is an IRS where the fixed interest rate payments are made annually.

Compounding swap

A compounding swap is an IRS where the fixed interest rate payments are not made on every fixing date but when a number of payments are capitalized. Payments are made on predetermined dates during the contract.

Fixing up front

The floating interest rate is fixed at the beginning of the contract.

In arrears

The floating interest rate is not fixed at the beginning but at the end of the fixing period.

Flexible IRS

A flexible IRS is an IRS where the principal or notional amount /and interest payments change over an individual interest period. Example: an Amortizing IRS with a gradually decreasing principal or notional amount.

Constant Maturity Swap (CMS)

A Constant Maturity Swap is a variation of a regular interest rate swap where the floating interest portion is reset periodically according to a fixed maturity market rate of a product with a duration extending beyond that of the swap's reset period.

Cross-Currency Interest Rate Swap (CCIRS)

Description

CCIRS is an interest rate swap where cash flows are in different currencies. When initiating a cross-currency swap, the counterparties can make an initial exchange of notional amounts in two currencies. During the swap, each party pays interest (in the currency of the principal received) to the other. On the maturity of the swap the parties make a final exchange of the initial amounts, reversing the initial exchange at the same spot rate.

OTC product	Yes
Volatility	Low
Leverage (and its influence)	Low
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	2 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Medium
Liquidity risk/Limitations on available markets	Low
Currency risk	Low to High (depending on the specifications/characteristics of the contract)
Interest rate risk	Medium to High (Proportionate to maturity)
Risks of external factors	Low
Structure risks compared to the risks of individual parts	N/A

Variants

With initial and final exchange

This involves a low currency risk.

Without initial exchange

This involves a high currency risk (as it is a long-term outright forward contract).

Forward start

A forward start CCIRS is a swap transaction entered into today but does not start until some future date, e.g. a three-year two-year forward interest rate swap begins two years from now and ends five years from now.

Fixing up front

The floating interest rate is fixed at the beginning of the contract.

In arrears

The floating interest rate is not fixed at the beginning but at the end of the fixing period.

Amortizing CCIRS

An Amortizing CCIRS is a CCIRS where the principal or notional amount (and interest payments) gradually decreases over the duration of the swap.

FX Reset

An FX Reset is a CCIRS where, in each reset period, the amount of the floating leg is reset to the actual FX spot rate. As a result, the credit risk is lower than with a normal CCIRS.

Cap/Floor (plain vanilla)

Description

Cap

A Cap is an interest rate option where, if the market reference rate (e.g. EURIBOR, PRIBOR) is higher than the Cap rate the holder will receive the difference between them on the settlement date. If the market rate is lower than the Cap rate the seller will not make any payment.

Floor

A Floor is an interest rate option where, if the market reference rate (e.g. EURIBOR, PRIBOR) is lower than the Floor rate the holder will receive the difference between them on the settlement date. If the market rate is higher than the Floor rate the seller will not make any payment.

OTC product	Yes
Volatility	Low
Leverage (and its influence)	Low
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	2 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Low
Liquidity risk/Limitations on available markets	Low
Currency risk	N/A
Interest rate risk	Medium (Proportionate to maturity)
Risks of external factors	Low
Structure risks compared to the risks of individual parts	N/A

Variants

Swaption

Description

A swaption is an option that gives the buyer the right, but not the obligation, to enter into an Interest Rate Swap. The buyer and the seller agree on the strike rate, the length of the option period, the terms of the swap, the notional amount, amortization and settlement frequency.

OTC product	Yes
Volatility	Low
Leverage (and its influence)	Low
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	2 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Low
Liquidity risk/Limitations on available markets	Low
Currency risk	N/A
Interest rate risk	Medium
Risks of external factors	Low
Structure risks compared to the risks of individual parts	N/A

Variants

Product complexity level 3

Interest Rate Swap – Alternative variants

Description

For a definition of an Interest Rate Swap see the standard Interest Rate Swap description (Product Complexity Level 2). Because of their specifications/characteristics some IRS variants are categorized as Product Complexity Level 3.

OTC product	Yes
Volatility	Low
Leverage (and its influence)	Low (Proportionate to maturity)
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	3 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Low
Liquidity risk/Limitations on available markets	Low / Medium (if the frequency is not the same for the two interest payments)
Currency risk	N/A
Interest rate risk	Medium (Proportionate to maturity)
Risks of external factors	Low
Structure risks compared to the risks of individual parts	N/A

Variants

Callable IRS

A callable IRS is an IRS that can be cancelled on a predetermined date by one of the parties, as specified in the contract, at no additional cost when the call is exercised.

Inflation-linked swap

An inflation-linked swap is a swap where the exchanged cash flows depend on the price of the underlying inflation indices.

Barrier options

Description

A barrier option is an option where the buyer can exercise its right depending on whether or not the underlying interest rate has hit or exceeded a predetermined level ("barrier") either during the contract or on the maturity date.

OTC product	Yes
Volatility	Low
Leverage (and its influence)	High
Prospectus (Statute)	N/A
Guarantee	N/A
Financial obligations and other additional duties	N/A
Product complexity level	3 on a scale of 1 to 3 (structured)

Risk profile

Credit risk	Low
Liquidity risk/Limitations on available markets	Low
Currency risk	N/A
Interest rate risk	Medium
Risks related to external factors	Low
Structure risks compared to the risks of individual parts	N/A

Variants