Financial instruments and related risks

Interest Rate products

Index

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	Level 1	Level 2	Level 3
FX			
RV			
VR			
Other			

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: Interest Rate 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 2

Repo

Description

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

Prospectus	**N/A**
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	**Low**
Liquidity risk/Limitations on the available market	**Low**
Currency risk	**Low**
Interest-rate risk	**Low to Medium (Proportional to maturity)**
Risk related to external factors	**N/A**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

Standard
Standard variant

Tri-party agreement
A tri-party agreement involves a third party (a clearing house or custodian bank) which handles the administrative aspects of the repo between Seller and Buyer.

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

Reverse tri-party
A tri-party is a reverse repo agreement that involves a third party (a clearing house or custodian bank) acting as custodian between the cash borrower and the cash lender.

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 with a repo are that:
(1) a buy/sellback transactions combines 2 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

The FRA is an agreement between two parties about the interest rate for a specified period of time in the future. It is similar to a forward forward, but no actual loan or deposit is made on the start date of the contract. Instead the parties will settle at the starting date of the hypothetical deposit or loan. The gain or loss in cash is the discounted value of the difference between the contracted forward interest rate and a reference rate, calculated on the notional amount of the FRA.
The contract will determine the rates to be used along with the termination date and notional value.

Prospectus	**N/A**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**Low**
OTC product?	**Yes**
Complexity level	**2C 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**
Interest-rate risk	**High (Proportional to maturity)**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

N/A

Interest Rate Swap (IRS)

Description

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

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

Risk profile

Credit risk	**Low**
Liquidity risk/Limitations on the available market	**Low** **Medium if the frequency is not the same for the two interest rate payments**
Currency risk	**N/A**
Interest-rate risk	**Medium to High (Proportional to maturity)**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

Forward start
A forward start IRS is a swap transaction which is 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 the fixed rate payments are not made periodically throughout the life of the swap. Instead, only one fixed payment is made on the expiry date of the swap, whereas floating payments are made periodically throughout the life of the swap.
Zero coupon swaps have a high credit risk for the party that receives the fixed payment.

Year on year
A year on year swap is an IRS where the fixed rate payments are made on a yearly basis.

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

Fixing up front
The fixing of the floating Interest rate is done at the beginning of the contract.

In arrears
The fixing of the floating rate is not made 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) changes in steps over the duration of the swap. Example is an amortising IRS with decreasing principal or notional.

Constant Maturity Swap (CMS)
A Constant Maturity Swap is a variation of the 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

A cross-currency interest rate swap is an interest rate swap in which the cash flows are in different currencies. Upon initiation of a cross-currency swap, the counterparties can make an initial exchange of notional principal amounts in the two currencies. During the life of the swap, each party pays interest (in the currency of the principal received) to the other. And when the swap matures, the parties make a final exchange of the initial principal amounts, reversing the initial exchange at the same spot rate.

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

Risk profile

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

Variants

With initial and final exchange
This variant has a low currency risk.

Without initial exchange
This variant has a high currency risk (as it is a long-term outright forward contract).

Forward start
A forward start CCIRS is a swap transaction which is 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 fixing of the floating Interest rate is done at the beginning of the contract.

In arrears
The fixing of the floating rate is not made at the beginning, but at the end of the fixing period.

Amortising CCIRS
An amortising CCIRS is a CCIRS where the principal or notional amount (and interest payments) decreases in steps 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, in the event that the market reference rate (e.g., EURIBOR, LIBOR) is higher than the cap rate, the holder receives the difference between both on the settlement date.
When the market rate is lower than the cap rate, the seller makes no payment.

Floor
A Floor is an interest rate option where, in the event that the market reference rate (e.g., EURIBOR, LIBOR) is lower than the cap rate, the holder receives the difference between both on the settlement date.
When the market rate is higher than the cap rate, the seller makes no payment.

Prospectus	**N/A**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**Low**
OTC product?	**Yes**
Complexity level	**2C 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**
Interest-rate risk	**High (Proportional to maturity)**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

N/A

Swaption

Description

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

Prospectus	**N/A**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**Low**
OTC product?	**Yes**
Complexity level	**2C 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**
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

Cash settled/Delivery
See definitions

European/American
See definitions

Knock-in/Knock-out
See definitions

Double knock-in/Double knock-out
See definitions

Structured deposits

Description

A structured deposit is a deposit product where the interest depends on the progress of rates, prices and other parameters of financial market instruments. The deposit enables the client to participate in the financial market progress with the guarantee of the invested amount.

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

Variants

Currency
Interest –rate
Equity
Commodity (

Complexity 3

Interest Rate Swap – Exotic variants

Description

For the definition of an Interest Rate Swap, see the standard Interest Rate Swap description (Complexity level 2)
Based on their specifications/characteristics, some IRS variants are categorised as Complexity 3 products.

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

Risk profile

Credit risk	**Low**
Liquidity risk/Limitations on the available market	**Low** **Medium if the frequency is not the same for the two interest rate payments**
Currency risk	**N/A**
Interest-rate risk	**Medium (Proportional to maturity)**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

Callable IRS
A callable IRS is an IRS that can be cancelled, on predetermined dates, 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 are dependent on the price of underlying inflation indices.

Quanto
A Quanto swap is an interest rate swap between two interest rates in different currencies, but where the payments are settled in the same currency.

Leveraged swap
A leveraged swap is a swap where the interest on 1 of the legs is calculated as a multiple of a notional amount or index. The leverage is proportional to the multiple.

Exotic interest options – for example: 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 price (“barrier”) either during the life of the contract or on the maturity date.

Prospectus	**N/A**
Guarantee	**N/A**
Financial commitments and other additional obligations	**N/A**
Volatility	**Low**
Leverage (and its effects)	**High**
OTC product?	**Yes**
Complexity level	**3A 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**
Interest-rate risk	**Medium to High (Proportional to maturity)**
Risk related to external factors	**Low**
Risk related to structure compared to risk related to each building block	**N/A**

Variants

Knock-in/Knock-out
See definitions