

Information on investment instruments and the associated risks

This information is being made available to the Client based upon the Czech Capital Markets Act (Act No. 256/2004 Coll., as amended - the "Capital Markets Act"), European Directive 2014/65/EU on markets in financial instruments ("MiFID II"), Commission Delegated Regulation (EU) 2017/565 supplementing MiFID II as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of the above-mentioned Directive (the "Regulation"), and the relevant measures of the Czech National Bank (ČNB).

Introductory provisions

This document describes the basic risks of investment instruments which may be involved in the investment services which 42FS is licensed to render, and gives a general description of the nature of the individual types of investment instruments. In no case may this document be understood to give an exhaustive description of the risks and the workings of every existing product.

This material has been prepared in view of the fact that 42FS provides its services exclusively to professional Clients – central counterparties, who as a matter of course have sufficient knowledge and expertise as to the function and behavior of the individual investment instruments. This is also the reason why all financial instruments are designed to be traded by all Clients.

Capitalized terms have the meaning assigned to them in the OTF Rulebook.

General information on risks

The present document may not be considered complete and exhaustive advice on all risk aspects associated with trading in investment instruments. It is the Client's responsibility to familiarize themselves as thoroughly as possible with the risks of the Trade or Transaction contemplated by them, and to consult such Trade or Transaction with their financial, legal, accounting, or tax advisors if anything is unclear or if they have further questions or, as the case may be, to obtain additional information from the Bank. The Bank must provide the Client with objective information only, but not give the Bank's own assessment of the Investment Instrument or Investment Service.

Any Trade or Transaction involving Investment Instruments involves risk. Generally speaking, the higher the expected yield and/or duration of the trade or transaction, the higher the potential risk of loss. Past performance of individual investment instruments are no guarantee of further results of the same investment instrument.

Trading in investment instruments is associated with the risk that expected returns are not achieved – i.e., with the risk of financial loss. Unless the Client fully understands the terms on which trades or transactions carried out, and the scope of the potential loss of invested funds (or, in the individual case, furthergoing loss in excess of the invested funds), they should not engage in the given trades or transactions. The Client is aware that in the case of trading in derivatives and in leveraged instruments (such as futures contracts, options), the risk is not limited to the value of the invested funds but may in fact exceed this value (i.e., the loss may be higher than the volume of invested funds). For this reason, trading in investment instruments of the derivative type requires specific skills and experience.

The size of the risk (expressed as the ratio between potential loss and the par value or present value of the investment instrument) may also vary depending on the type of investment instrument. Generally speaking, financial derivatives are among the riskiest investment instruments, in that a small change of the market conditions (i.e., of the market price of the underlying asset) may trigger a large change of the value of the derivative. Shares and similar securities and commodity instruments are also considered high-risk instruments. Relatively less risk-fraught are debenture bonds and notes, and similar securities representing the right to repayment of an outstanding debt, in particular government bonds and debenture bonds issued by central banks.

Risk overview

The main risks in connection with investment instruments in the capital market are the credit risk, the market risk, the concentration risk, the liquidity risk, and the operational risk. Market risk in turn covers the risks of interest rate and exchange rate changes, equity and commodity risk in particular, though it may also be said to include the risk of inflation, the correlation risk, and the volatility risk. Below we give a detailed overview of the individual types of risk, including examples as to how to mitigate them.

Aside from the above-mentioned risks, which to a greater or lesser degree have influence on all investment instruments, there exist also risks which are specific to the individual investment instrument and arise from its specific nature and from the manner in which the given investment instrument is being traded.

Credit risk

Credit risk is among the more basic financial risks. It represents the possibility that the debtor may not honor their obligations (i.e., fail to repay their debt), be it because of their inability or their unwillingness to pay. A mere downgrade of the credit rating of the debtor may already be a source of credit risk.

The inability to pay or the unwillingness to pay of debtors may arise with respect to due instalments of loan principal or interest, securities, guarantees, exchange transactions, money market transactions, or other contractual relationships.

The causes for a debtor's inability or unwillingness to pay may be either internal – i.e., on the part of the debtor, or because of the credit rating it earned – or external – i.e., a crisis of the economy as a whole or of the given industry.

Credit risk may be mitigated in particular by an in-depth assessment of the debtor's creditworthiness and its ability to repay debt, and by limiting one's exposure to any one specific debtor.

Concentration risk

Concentration risk describes the risk of loss inherent in a substantial concentration of exposure to counterparties (or groups of counterparties), the likelihood of whose failure is influenced by a risk factor common to all of them – as will be the case e.g. for counterparties who do business in the same industry or in the same geographic region, or pursue the same activity or trade in the same commodity, or belong to the same group – whereas this risk may also arise from the use of credit risk mitigation techniques, i.e., in particular, the risk associated with a large indirect commitment (exposure) vis-a-vis one and the same issuer of collateral.

Market risk

Market risk is the risk of loss due to a change of conditions in the market (i.e., a change of market prices, interest rates, foreign exchange rates, or commodity prices) which lead to a change in value of the given investment instrument or to an imbalance of a certain kind between the investment instrument and the sources from which it is financed. All investment instruments are exposed to market risk. Market risk comprises a host of factors, among them not only the financial development of the given company (issuer of the given securities) but also e.g. the expectation of a recession, structural changes across the economy, political reverberations, or shifting consumer preferences.

Depending on the specific market factor which could trigger the change in the value of the given investment instrument, 'market risk' will be understood to mean, in particular, interest risk, exchange risk, equity risk, or

commodity risk. Depending on the actual situation in the market, and the manner in which transactions are carried out in the given market, further market risks may be identified.

Interest risk: causes fluctuations of the rate of return of the given investment instrument due to fluctuating interest rates. These changes have inverse impact on debt-based Investment Instruments which respond to increasing interest rates by declining market prices, and vice versa. The risk level depends on the specific Investment Instrument, its susceptibility to the interest rate, and various other factors.

Exchange risk: when investing into investment instruments noted in a foreign currency, the risk, and the potential gain or loss, depends not only on the overall market development for the given investment instrument but also on the development of the exchange rate. An adverse development in exchange rates may have negative influence on the overall development of one's investment even if the given investment instrument itself is doing well.

Equity risk: expresses the risk of an adverse change of the market price of stock-based Investment Instruments (or, as the case may be, financial derivatives based on them). The main source of this risk is stock trading.

Commodity risk: expresses a change in the price or yield of an investment instrument correlating to the price of a commodity (such as raw materials, rare metals, or energy). Commodity risks are particular to investment instruments whose underlying asset is a commodity; with that being said, commodity risks will to some degree influence any investment instrument, depending on the vulnerability of the economy (or of the issuer of the investment instrument) on the development of the given commodity price.

Inflation risk: influences the actual rate of return of investment instruments, in that inflation (i.e., a drop in the purchasing power of money) will reduce the "real" yield of the investment. High inflation may in fact cause the client to generate a negative total rate of return, if the earnings generated from the Investment Instrument are consumed by inflation.

Market liquidity risk

Market liquidity risk is the risk of loss due to insufficient depth or breadth of the market. Such a situation is marked by a lower number of sellers or buyers, larger differences between purchase prices and sales prices, larger differences between the various quotations, and a lack of liquidity on the individual of individual price quotations. These adverse conditions may trigger orders to trade, or actual trades, in the investment instrument for a price which is very different from the mid-price quotation or, as the case may be, the best buy/sell quotation; alternatively, it may be that such orders or trades cannot be placed at all due to the lack of liquidity.

Operational risk

Operational risk describes the possibility of loss due to lack or failure of internal procedures, of the human factor, or of systems in place at the issuer of the investment instrument or at a third party, or due to an external event, including IT risks and legal risks. In order to illustrate operational risk, we may give such examples as a money transfer to the wrong account, the physical loss of a trade agreement, the erroneous calculation of interest, loss of electronic data due to a power outage or a fire, etc.

Specific risks of derivative instruments

The value of investment instruments of the derivative type depends on or, as it were, derives from, the value of the underlying asset (i.e., in particular, stock, market indexes, stock baskets, currency pairs, interest rates, or commodities). The names given to various derivative investment instruments may be inaccurate or misleading, which is why one must always carefully study the document which contains the terms governing the given investment instrument that circumscribe its structure, and its behavior when market conditions change.

Non-standard markets

Certain transactions, trades, markets, or investment instruments are not subject to standardized terms and rules

– for instance, the terms of derivative transactions or of trades in bonds outside the regulated markets, known as OTC transactions/trades. Given the nature of such transactions or trades, and given the non-existence of regulated markets, the Client cannot expect that it will under all circumstances have the opportunity to buy an investment instrument or close their position, or terminate their investment early at the price which they expect. In the extreme case, there may be no price available at all, during which time period the Client will be unable to proceed with the requested transaction or to dispose of a previous transaction or operation involving the investment instrument. The Client ought to familiarize themselves in detail with the terms of each non-standard transaction (or manner of trading), which may involve obtaining assistance from their financial, tax, or legal advisors.

Financial instruments

What follows is a description of the character of the various financial instruments, along with their definition and the associated risks.

Commodities

Commodities are goods traded in the market without any quality differences: deliveries from various suppliers are mutually substitutable. In order to make commodity trading possible, each market (commodity exchange) imposes what characteristics are required of the commodity, and in what volumes it may be traded. 42FS pairs orders on the market for electricity and gas.

The standard contracts are these:

Futures contracts may be described in straightforward terms as an agreement between two parties that they will buy/sell, at a certain future date and for the given price, a standardized volume of a given commodity in a pre-agreed quality. Futures contracts may only be traded in organized markets – commodity exchanges. They are a fixed deal, i.e., as the agreed date arrives, one party *must* buy and the other party *must* sell. The settlement of futures lies in the hands of a clearing house which ensures that the deal will be settled – which is the main merit of a futures contract.

By contrast, an **option** is a contract which gives the buyer of the option the right (but not the obligation) to buy or sell a given commodity, asset, or futures contract for a pre-agreed price during an agreed time period. Options are conditional deals, because the buyer of the option is at liberty to decide whether or not to actually buy or sell in the future. If the buyer makes use of the option, the seller (issuer) of the option must always honor its commitment.

Forward contracts are principally identical to futures contracts, with the only fundamental difference that (barring a few exceptions) forward contracts are traded outside the commodity exchange. This in turn gives rise to further differences: the futures contract is standardized in terms of volume, type of commodity, and maturity, so that only the price is determined by the market, whereas forward contracts are an individual affair, and the terms on which they are agreed depend on the arrangement reached by the two parties.

Commodity risk represents the susceptibility to rising or declining commodity prices.

Commodity yield

There is a difference between the buying/selling price of commodities. The yield is the difference between the price for the purchased/sold commodity and its spot price. The buyer will make a profit if the spot price is less than the strike price. The amount of potential profit/loss is in no way contained.

Risks associated with commodities

Market risk: The commodity price depends on the economic performance of the producer of the given commodity. Assuming a positive market development and a positive price development within the commodities market, there is no limit to the potential gain from the investment. In the event of a market decline or collapse, the investor will sustain loss whose amount cannot be predicted. Other factors which have impact on the commodity price are the overall economic development, the economic cycle, and the development of the given

industry.

Exchange risk: Unless the commodity is listed in the base currency in which the investor's income and expenses are denominated, there exists the risk of an unfavorable development of the exchange rate between the commodity's foreign currency and the investor's base currency.

Liquidity risk: As long as the commodity is traded in regulated markets, the liquidity risk is eliminated by the larger number of market participants. In the case of commodities accepted for trading in several regulated markets, or in the case of commodities with a narrow market, issues may arise as to the tradeability of the commodity in the requested volumes.

Emission allowances

The EU defines emission allowances thus: "The emission allowance represents a permit to emit one tonne of carbon dioxide (or its volume equivalent) for a specified period." Emission trading is a public policy instrument, designed to motivate producers of greenhouse gases to cut back their emissions in the most efficient possible manner. Entities which find that they can cut their emissions at lower cost may sell the emission allowances (or other emission credit) to those for whom such a reduction of emissions would be more costly. Trading is possible between Annex I signatories to the Kyoto Protocol, within the context of the flexible International Emission Trading mechanism (IET); the largest such emission trading scheme is the European Union Emission Trading Scheme (EU ETS) in which the Czech Republic participates as an EU member state.

The EU ETS comprises more than 11 000 installations from among power supply companies, the iron and steel industry, the pulp and paper industry, the glass and ceramics industry, the chemical industry, refineries and air transport in 31 countries and covers approx. 2bn tons of CO₂ per annum. In 2020, emissions within the EU ETS will be lower by 21 %, compared to the year 2005.

Yield

The yield is the difference between the buying/selling price of the allowances and the present value. Potential earnings/losses are unlimited.

Risks associated with allowances

Market risk: The price of allowances is dependent on demand and supply in the market for emission allowances. Assuming a positive market development and a positive price development within the allowances market, there is no limit to the potential gain from the investment. In the event of a market decline or collapse, the investor will sustain loss whose amount cannot be predicted.

Exchange risk: Unless the emission allowance is listed in the base currency in which the investor's income and expenses are denominated, there exists the risk of an unfavorable development of the exchange rate between the allowance's foreign currency and the investor's base currency.

Liquidity risk: As long as the emission allowances are traded in regulated markets, the liquidity risk is eliminated by the larger number of market participants. In the case of allowances accepted for trading in several regulated markets, or in the case of commodities with a narrow market, issues may arise as to the tradeability of allowances in the requested volumes.

Debenture bonds

Bonds are a debt security which express this issuer's obligation towards the creditor. They are substitutable securities in which a right to payment of a certain amount of debt, a right to the payout of the stipulated yield, and the obligation of the issuer to fulfill all obligations are vested. The rights and obligations of the bond issuer and the bond holder (i.e., the investor) are usually set out in a bonds issue term sheet. Bond holders do not vouch for liabilities of the company.

There is no legal guarantee of payout of the par value and yield on bonds. Banks and security traders who issue bonds are by law required to participate in a Guarantee System which allows bond holders to recoup their investment at least to some part if the issuers should end up in financial distress.

Selected types of bonds:

By issuer:

Government bonds – the issuer is the state (or a state agency, i.e., in the case of the Czech Republic, the Czech ministry of finance).

Municipal bonds – the issuer is a territorial self-governing entity (i.e., the municipality).

Corporate bonds – the issuer is a company who wishes to raise capital. Corporate bonds vary as to their degree of risk, which is reflected in the size of the coupon.

Bank bonds – the issuer is a financial institution.

Treasury bills – short-term obligations backed by the state or a central bank.

By coupon:

Fixed-coupon bonds – the coupon agreed at issue date does not change throughout the life of the bond. The advantage is that the yield on maturity is easily calculated; the disadvantage is that clients forego higher earnings in the event of rising interest rates.

Variable-coupon bonds – their coupon is dependent on the reference rate (often an interbank rate such as PRIBOR, LIBOR, EURIBOR). A premium in a certain amount will be added to the reference rate in order to compensate for the higher risk, compared to the interbank market. The advantage of variable coupons lies in the higher earnings of the client if interest rates are rising. The drawback of variable coupons is the fact that the yield for the client is smaller if interest rates are dropping.

Zero-coupon bonds – No coupon payouts take place during the lifetime of these bonds. Bond holders generate earnings by buying the bond at a discount (i.e., below par value); on maturity; the issuer will pay the par value.

Yield of bonds

The coupon yield in bonds is generated upon cashing in the (fixed or variable) coupon. Another way for bond holders to earn on their investment is to profit from the difference between the prices at which they bought and sold the bond, respectively.

Risks associated with investments into bonds

Credit risk: The risk that the debtor will be unable to honor its obligations, i.e., that it will be unable to pay interest and the face value of the bond. In the case of commercial entities (corporations), this risk may be substantial, but in the case of government bonds of a country with a high rating or bonds issued by international organizations, this risk is substantially lower.

Interest risk: This risk follows from the change of interest rates depending on the maturity of the bond and the type of coupon. The higher the interest rates, the lower the market price of fixed-coupon bonds, so as to ensure that the actual yield at maturity of the bond is equal to the market interest rate.

Exchange risk: If the bond is denominated in foreign currency, there is a risk of fluctuation of the foreign exchange rate vis-a-vis the Czech crown. A weaker crown will mean that the investment appreciates, whereas if the crown is strengthening, part of the investment may evaporate.

Liquidity risk: Bonds are for the most part traded in the OTC market, where there is no guarantee of sufficient volumes for execution of the deal. The liquidity risk will be different from bond to bond, depending on the issuer, its rating, the issued volume of bonds, and other specific factors.

Ways in which to protect oneself against specific risks:

The market risk associated with bonds is generally lower than in the case of stock. The investor may take influence on the credit risk by choosing bonds of an issuer with a high rating. The liquidity risk may be brought down by investing into bond which are tradeable in the secondary market. As in the case of stock, exchange risks may be eliminated by buying only bonds in the investor's domestic currency. In order to protect oneself against the interest risk of bonds which carry variable interest, one may perform an IRS.

Generally speaking, it is fair to say that the higher the yield from the bond, the higher the risk associated with the investment.

Repurchase (repo) agreements, reverse repo, sell/buy and buy/sell operations

Repo, reverse repo, sell/buy and buy/sell operations (hereinafter collectively referred to as "Repo") are purchase agreements with a repurchase clause. In the case of Repo and Reverse Repo, a single purchase agreement

is made, whereas Sell/Buy or Buy/Sell are two purchase agreements made concurrently in the same moment.

In a Repo transaction, one party (the buyer) buys an agreed volume of securities from the other party (the seller) for an agreed price, and undertakes to sell the same volume of securities back to the seller for the purchase price plus an agreed mark-up (the yield).

Repo transactions serve to deposit or lend cash funds. The interest is expressed as the difference between the price of the security at the beginning and at the end of the Repo transaction.

Such operations may be performed with such subject matters as e.g. treasury bills, government bonds, stocks, etc. In the case of securities with significant price fluctuations (i.e., typically, stock), the loan is not made available for the entire volume (present market value times number of shares), but only with respect to a certain part of e.g. 80 %, which is being referred to as "hair cut".

Repo operations – The advantage for the client lies in the ability to raise funds in a relatively short time. The quality and liquidity of the securities is influenced to a substantial degree by the interest and by the volume of securities needed for the pledge.

Yield

The Yield for this transaction is known in advance. Interest is the difference between the initial and the final price.

Risks

Liquidity risk: These are overwhelmingly illiquid transactions, i.e., premature closing is not possible. The original owner therefore reacquires the ownership title to the securities they once held only at maturity. Correspondingly, the provider of the funds for this transaction will only receive them at maturity. Early termination of the deal may be associated with additional costs.

Credit risk: Neither the buyer nor the seller need to be able to honor their resale/repurchase obligation in the event of default. Moreover, the value of the transferred securities may deteriorate if the creditworthiness of their issuer is downgraded, or due to other market influences.

Ways in which to protect oneself against specific risks: It follows from the very nature of these transactions, and from the purpose for which they are made, that the hedging possibilities are very slim. The only way in which to mitigate the above risks is to pick quality securities which are the subject of a security assignment.

Derivatives

A derivative is an investment instrument whose value is derived from an underlying asset, such as securities, currencies, interest rates, commodities, indexes, etc. An important characteristic of derivatives is their term character and the leverage associated with it. By 'term character', we refer to the fact that the transaction will only be executed in the future. Agreeing on the transaction requires only a relatively small initial investment, or even none at all. Compared to standard spot investments, derivatives thus allow for a much higher return (though this is of course counterbalanced by the higher potential loss).

In practice, derivatives may be used for different purposes:

Hedging - The idea behind hedging is that derivatives allow one to fix the price of the underlying asset as at an agreed future date. In other words, one agrees on a transaction on the futures market for a given specific position whose profitability (or opposite thereof) will mirror the success or failure of the said position. It is fair to say that the gain or loss from the market revaluation of the underlying asset is being eliminated by the loss or gain of the market revaluation of the agreed derivative.

Speculative trading - The speculator buys the derivative with the goal to profit from the price development of the underlying asset. To simplify somewhat, he or she counts on the price of the underlying asset being lower or higher than the spot price of the underlying asset at maturity for which they may sell or buy this instrument in the spot market.

Arbitrage - This is an exploit of price imbalances which may arise in terms of different territories and/or time zones.

Selected types of derivatives: Forward rate agreement (FRA), FX forward, FX swap, Interest rate swap (IRS), Currency option

Risks associated with investments into derivative transactions

Market risk: The risk that the real value of the derivative may drop under the influence of a changing value of the underlying asset. This risk is material especially in speculative transactions, but may also manifest in hedging transactions – especially if the original assumption based upon which the hedging was taken out is shown to be false. In extreme cases, the potential loss may exceed the nominal value of the contract.

Liquidity risk affecting the underlying asset: Most derivatives are not traded in regulated markets, which is why the investor may find that they are not necessarily able to close or change their position. For more information, see Section 2.9 of this document.

Credit risk: The counterparty may become insolvent and thus be unable to honor its obligations (i.e., default) at the time at which the derivative is to be settled.

Forward Rate Agreement (FRA)

A fixed agreement between two parties which allows them to fix the interest rate on a loan or deposit in the future, or to change a variable interest rate applying to a receivable or debt to a fixed rate (or vice versa). This is an interest-rate derivative in the form of an individual, non-standardized contract made on the OTC market. Settlement simply consists of balancing the difference between the two rates. FRAs do not trigger any other costs or commission fees.

These transactions are carried out in the interbank market, and are not governed by any standardized terms. As opposed to interest rate futures, FRA are customized Investment Instruments in terms of the principal, the currency, and the interest period.

Parties involved in the FRA:

FRA buyer - secures a fixed interest rate for his future floating-rate liabilities, or hedges against rising interest rates in the future (or, as it were, speculates for a rise of market interest rates).

FRA seller - secures a fixed interest rate for his future floating-rate receivables, or hedges against falling interest rates in the future (or, as it were, speculates for a decline of market interest rates).

Examples of how FRAs can be used:

FRA seller - Hedging capital which was invested into interest-rate instruments that are susceptible to the development of the market interest rate against a dropping interest rate.

FRA buyer - Hedging his anticipated future capital needs against rising interest rates.

Yield

The FRA buyer/seller attains a fixed interest rate thanks to the purchase/sale. If the reference interest rate on maturity is higher than the agreed interest rate (FRA rate), the buyer receives compensation for the interest rate fluctuation. If the reference interest rate on maturity is below the agreed interest rate (FRA rate), compensation goes to the seller.

Risks associated with investments into FRAs

Market risk: The market risk is inherent in the uncertainty as to future changes of the interest rates in the market. The higher the volatility of these interest rates, the higher the risk.

Credit risk: The credit risk associated with FRA lies in the possibility that the counterparty fails to perform, as a consequence of which the positive value of the FRA drops relative to the market situation, and the necessity to cover the transaction by making a purchase in the market for a less favorable price.

Interest Rate Swap (IRS)

An interest rate swap (IRS) is an agreement between two parties to swap their cash flow at a certain moment in time, arising as a rule from a floating and a fixed interest rate. All that is swapped is interest, i.e., the par value (i.e., the capital flow) is not being touched. The par value of the IRS merely serves to deduct the size of the interest payments. The fixed rate is the rate used to determine the fixed-rate interest payment, and the floating rate (which is expressed by way of reference to the PRIBOR, LIBOR, etc.) is the rate used to determine the floating-rate interest payment. In the case of non-standard contracts, the par value may change during the existence of the contract.

IRS are not a standardized product. Deal execution details must be sorted out beforehand in a contract. These are "bespoke" products, which is why it is of the utmost importance to obtain accurate information on the terms of the given IRS, especially as regards par value, maturity, agreed interest rate, and other parameters.

Yield

The buyer of the IRS (payer of fixed interest) profits from rising interest rates. The seller of the IRS (acquirer / recipient of fixed interest) profits from dropping interest rates. The yield of IRS cannot be determined beforehand.

Risks associated with investing into IRS

Market risk: The market risk follows from the uncertainty regarding future changes of the interest rates in the market. The buyer/seller of the IRS is exposed to the risk of loss as the interest rate levels rise/fall.

Credit risk: The credit risk is inherent in the possibility that the counterparty may not honor its obligations because of default. The lower the creditworthiness of the counter party, the higher this risk.

Foreign Exchange Forward (FX Forward)

FX Forward is an agreement based upon which one party sells to the other a pre-agreed volume of foreign currency at a certain fixed date for a certain fixed rate (the forward rate).

The buyer is obliged to buy, at the stipulated future date, the agreed volume of currency for another currency at the agreed forward rate.

The seller is obliged to sell, at the stipulated future date, the agreed volume of currency for the other currency at the agreed forward rate.

A practical use example:

An exporter wishes to hedge his liability against a future strengthening of the EUR against the domestic currency (Czech crowns –CZK). In order to do so, he today contracts an FX Forward, set at the future date on which his future liabilities become due, and on which the parties will be entitled and obliged to buy euros for crowns at the pre-agreed rate. On maturity of the said liabilities, the contract is being settled at the agreed forward rate.

An exporter expects payment from its supplier abroad, which will be made in EUR. The exporter fears that the domestic crown might appreciate, which is why he today enters into an FX Forward, effective as at the date on which his receivables become payable, and on which the parties will be entitled and obliged to sell euros for crowns at the pre-agreed rate. On maturity of the said receivables, the contract is being settled at the agreed forward rate.

Yield

The yield is represented by the difference between the price set in the agreement and the spot price of the underlying asset. The buyer earns a profit if the current exchange rate is less favorable than the strike rate. There is no limitation to potential gains/losses.

Risks associated with FX Forward

Market risk: The FX forward value is influenced by the spot foreign exchange rate, the interest rates in both currencies, and other market influences. Because of all this, the forward price fluctuates depending on the market parameters of these variables.

Credit risk: The credit risk is inherent in the possibility that the counterparty may not honor its obligations because of default. The lower the creditworthiness of the counter party, the higher this risk.

Foreign Exchange Swap (FX SWAP)

An FX Swap is an agreement under which one party sells to the other a pre-agreed volume of foreign currency, effective as of a fixed date (i.e., usually, within two days from the date on which the transaction is made) for the spot rate, and the buyer resells to the seller the same agreed volume of currency as of a fixed future date at a fixed rate (the forward rate).

This transaction takes the form of two independent currency conversions: the original sale of funds by the client to the counterparty at the spot rate, and the future resale at the forward rate.

Risks associated with investments into FX swaps

Market risk: If the FX SWAP was agreed for speculative purposes, there is a market risk inherent in the fluctuations of currency exchange rates and interest rates.

Credit risk: The credit risk is the risk of inability of payment or insolvency, and thus the risk of a temporary or permanent inability to discharge the obligations inherent in the swap; in such a case, the transaction would have to be covered by means of the free market.

FX options

An agreement between the parties according to which the owner (buyer) of an option has the right (but no obligation) to buy (call option) or sell (put option) the agreed currency at a previously stipulated strike price, either by a pre-agreed date (or dates) or within a certain time interval.

Possible applications of FX options:

- hedging against exchange risks
- speculative investment with the goal to profit on anticipated market developments

Yield

At the moment in which the option is agreed, the strike price of the underlying asset is even now being agreed (ahead of time). In the case of a call option, the buyer generates profit if the agreed price of the underlying asset is higher than the price on the date on which the option was exercised. In the case of a put option, the price of the underlying asset as at execution date must be lower than the agreed price in order to achieve a profit. If the difference between the pre-agreed price and the current price is unfavorable for the option holder, they are not required to exercise the option. Their loss is thus limited to the amount of the option premium paid. Earnings may also be made from selling the option itself. As the price of the underlying asset (depending on the type of option: put or call) and the strike price change, the value of the put/call option itself also rises or falls.

Risks associated with investments into FX options

Market risk: The market price of these options is tied to the movements of foreign exchange rates, interest rates, fair values, and above all the volatility of all these variables.

Credit risk: See the section on derivatives.