

DESCRIPTION OF FINANCIAL INSTRUMENTS AND THEIR RISKS

Financial instruments are shares, bonds, treasury bills, investment fund units, depository receipts, and other financial instruments traded on financial instrument markets.

Financial instruments generally provide a certain return on investment: dividends are paid on shares, interest is paid on bonds, and the market value of financial instruments may increase or decrease. Investors always want to get a higher positive return, but there is always a risk that the return may be negative. Generally, the higher the expected return on investment, the greater the risk assumed. In the event of an unfavorable market situation, the loss on investments may also be significant. Investments in financial instruments inevitably involve certain specific risks that investors must take into account.

INVESTMENT RISKS

Inflation risk

This risk is also known as the risk of a decline in purchasing power. Inflation causes the prices of various consumer goods and services to rise, which reduces the purchasing power of money, meaning that less and less can be bought for the same amount of money. This risk is particularly relevant for uninvested funds or in cases where the return on the chosen investment is lower than inflation.

Capital risk

This is the risk that investors will lose all or part of their invested funds. This risk is directly related to the market characteristics of a particular financial instrument.

Market risk

This risk affects the entire capital market, where the value of investments may decrease due to changes in market factors such as interest rates, exchange rates, the country's economic situation, financial instrument prices, and others. Like capital risk, this risk is not directly related to the issuer; it depends more on macroeconomic indicators.

Liquidity risk

This is the risk that it will not be possible to recover the invested funds without incurring significant losses. When investing in illiquid financial instruments, a situation may arise where it is not possible to sell them at the desired time or they have to be sold at a significantly lower price due to low or no demand.

Interest rate risk

This is the risk that changes in market interest rates will reduce the value of investments in bonds and other fixed-income financial instruments. A general increase in interest rates has a negative impact on fixed-income investments.

Currency/exchange rate risk

This is the risk that the return on investments in financial instruments denominated in a foreign currency may decline significantly due to unstable changes in foreign exchange rates.

Risk of choice

This is the risk that a reasonable decision to invest in a particular financial instrument will, after some time, prove to be unsuccessful or fail to meet expectations.

Investment timing risk

This risk is associated with choosing the wrong time to invest. It is the risk of reducing the return on investment due to choosing the wrong time to invest in financial instruments.

Reinvestment risk

Investments in bonds and other fixed-income financial instruments are intended to generate a steady income over a certain period of time, but there is always a risk that it will not be possible to reinvest the proceeds in financial instruments with the same profitability at that time. This is particularly relevant if the

coupon is paid at a time when the debt market is unfavorable and the funds received can no longer be invested with the same return on investment.

Credit risk

This is the risk of losing some or all of the invested funds due to the issuer's deteriorating financial situation or even bankruptcy. This risk is directly related to the issuer and is particularly relevant when investing in debt securities. Credit risk always increases significantly when investing in long-term bonds, as it is difficult to predict the issuer's financial situation over a long period of time.

Legislative risk

This risk means that changes in the legal regulation of the country in which the investment is made will reduce the return on investment or result in losses. This relates to changes in laws and trading rules that may alter not only the regulation of ownership and settlement, but also the taxation of investments.

Systemic risk

This risk means that the inability of a single institution (credit institution, brokerage firm) to meet its obligations on time may threaten the stability of the entire financial market.

Tax risk

This is the risk that changes in the laws governing the taxation of investments will reduce the return on investments or result in losses. The Bank does not provide advice on tax matters (even if the information provided refers to specific tax aspects) and is unable to manage this risk, therefore the Client must independently assess all tax-related circumstances that may affect the results of their investment decisions.

Counterparty risk

This is the risk of incurring losses due to the counterparty's inability to fulfill its obligations related to the execution of a financial instrument transaction. In order to reduce counterparty risk, the Bank enters into transactions mainly with reliable credit or financial institutions.

FINANCIAL INSTRUMENTS AND RELEVANT RISKS

Shares

Shares are equity securities that certify the owner's (shareholder's) ownership interest in the company and grant the following rights: the right to participate in the management of the company, the right to receive dividends, the right to a share of the company's assets remaining after the liquidation of the company, and other rights established by law.

Shares can be ordinary or preferred. Holders of ordinary shares are granted voting rights, but dividends are not guaranteed. In contrast, preferred registered shares entitle their holders to receive dividends of a specified amount, which are paid out before those of common shareholders, but do not usually grant voting rights at the general meeting of shareholders. In the event of the company's bankruptcy or liquidation, holders of preferred shares have priority over holders of common registered shares in receiving a share of the liquidated company's assets after the company has settled with bondholders and other debt instrument holders.

The market price of shares reflects how the financial market assesses the company's ability to generate profits. Therefore, the price of shares is influenced by market changes, economic trends, technology, legislation, competition, and other factors that affect the company's performance and prospects. The overall macroeconomic situation in the country, its prospects, and general global market trends also have a significant impact on share price dynamics. Price fluctuations are also determined by the liquidity of shares. Shares that are traded frequently on the stock exchange are usually liquid, i.e., there are enough participants in the market for their price to change without significant fluctuations.

Due to the large number of factors affecting the price of a company's shares, shares are generally considered to be riskier financial instruments than deposits, bonds, or investment funds, so when choosing a conservative investment strategy, shares should make up a small part of the overall investment portfolio.

Bonds

Bonds are non-equity securities whereby the issuer undertakes to pay interest to the holders at predetermined intervals and to repay the principal amount – the nominal value – at the end of the bond's term. Interest may be paid at specified intervals throughout the term of the bond or at maturity. Interest may be fixed or variable. Bonds that do not pay interest and are distributed at a lower than par value but are redeemed at a nominal price are called "zero-coupon" or "discount" bonds. Bonds may be issued by governments, banks, or companies.

Bonds issued by governments or municipalities are considered safer than those issued by companies, as the latter are more prone to insolvency. The issuer risk increases even more when investing in long-term corporate bonds, as the financial situation and ability of companies to cover their debts are more difficult to predict in the long term. Therefore, it is very important to pay attention to the credit ratings of bonds and their issuers, which indicate the degree of credit risk.

The market value of bonds is influenced by the market interest rate. As the interest rate rises, the price of bonds falls, and vice versa. The overall level of interest rates is influenced by the monetary policy pursued by central banks, the overall market situation, and the expectations of market participants. Therefore, if you want to sell bonds before the maturity date, there is a risk of a decrease in value or even a loss if the market interest rate has increased and the price of bonds has fallen significantly as a result. Interest rate changes are also associated with reinvestment risk, where the reinvestment of bond interest payments in the market may be unfavourable, i.e. due to a market downturn, it will not be possible to invest funds with the same return on investment.

Money market instruments

Money market instruments are instruments that are traded on the money market and can be easily converted into money. These include bank deposits, treasury bills, short-term (up to 1 year) government securities, and money market fund units.

Money market instruments are short-term investments and therefore carry a low risk that the market price of such instruments will fluctuate significantly during the short investment period, resulting in significant losses for the investor. However, given that the return on money market instruments is not high, investors face the risk that the return earned may be lower than inflation and that the invested capital will lose value.

Investors in money market instruments also face credit (default) risk – the risk of not recovering their deposit due to the possible insolvency of the financial institution that accepted it.

Investment funds

Investment funds are collective investment undertakings. They are assets jointly owned by investors, which the fund management company invests in accordance with a chosen investment strategy. The fund's assets are separate from the assets of the management company. Usually, the fund's documents (prospectus, rules) are approved, and it is necessary to familiarize yourself with them before investing.

The main types of investment funds are equity funds, bond funds, mixed funds, money market funds, index funds, and funds of funds. Funds are also divided into open-ended and closed-ended funds. Open-end funds are more liquid because the management company undertakes to redeem them under the terms set out in the prospectus, while the redemption of closed-end funds may be restricted.

Advantages of investment funds:

- Professional management – the invested funds are managed by professional fund managers.
- Diversification – the funds of the fund participants are invested in different asset classes, thus spreading the investment risk.
- Simplicity – buying and selling investment funds is straightforward, and the minimum investment amount is not high.
- Liquidity – investors can sell their investment fund units to the management company at any time at net asset value.

A fund consists of a large number of financial instruments, each of which affects the value of the fund's

investment portfolio. Therefore, the risk of a fund depends on how risky the financial instruments that comprise it are. Even the lowest-risk investment funds can lose some of their value when market conditions change, so there is a risk of getting back less than you invested. On the other hand, investing in funds is safer and less vulnerable to changes in individual financial instruments, because when the market value of some securities falls, others may mitigate or even offset the decline.

The risk of funds also depends on the reliability of the management company and the professionalism of the manager, so when choosing a fund, it is necessary to investigate the history of its activities.

There are many types of funds, some of which invest in very risky instruments or choose a single sector or region, which greatly narrows diversification.

Exchange-traded investment funds

Exchange-traded funds (ETFs) are investment funds that are traded on the stock exchange, making them easier to buy and sell than ordinary investment funds. These funds are usually not actively managed, and their value is often linked to a specific index (energy resources, technology, other commodities or raw materials, precious metals, etc.), so their price fluctuates accordingly. These funds are becoming increasingly popular in financial markets.

Exchange-traded funds are primarily beneficial to investors because they are easy to purchase and their acquisition costs are usually lower. These funds are generally highly liquid and are traded on the market in real time. However, it is also necessary to pay attention to the risks inherent in these funds. First of all, it is an instrument composed of individual financial instruments, so the market price of a fund unit depends on changes in the overall price level in the market.

If an ETF is linked to an index, the investor faces the risk that the price of an ETF unit may not accurately reflect the selected index. This is particularly relevant in the case of commodity indices. There is also a risk that the value of a fund unit on the stock exchange may differ from its net asset value.

Some ETFs use derivatives, so such funds may have a certain degree of financial leverage, the effect of which may be directly dependent on changes in the price of the underlying asset or index, or inversely proportional to changes in the value of such assets. This feature allows you to earn not only from rising but also from falling financial instruments, as well as to obtain a multiplied return on investment, i.e. the return on the fund may change at a higher rate than the index to which the fund is linked. Due to the increased risk inherent in this type of fund, it is necessary to familiarize yourself with their investment strategy and composition before making an investment decision.

Derivative financial instruments

Derivative financial instruments are transactions or agreements concluded on or related to certain financial instruments or assets. The most common types are options, forwards, futures, and other transactions involving shares, bonds, commodities, precious metals, currencies, interest rates, or other goods. The term of these financial instruments can range from a few days to several years.

Derivative financial instruments can be standardised or non-standardised. Standardised derivative financial instruments are traded on regulated markets, while non-standardised derivative financial instruments are negotiated between the parties and traded on unregulated markets.

Derivative financial instruments are generally used to hedge against unfavorable changes in asset prices. When derivatives are used for trading purposes, high volatility is encountered because derivative prices tend to fluctuate more. Price fluctuations intensify as the expiration date of the contract approaches.

Derivative financial instruments are characterized by financial leverage, which means that changes in the price of the underlying asset result in a larger change in the price of the derivative contract. Therefore, investments in derivative financial instruments may yield higher returns than direct investments in the assets underlying the contract. However, it is important to note that financial leverage can also increase losses – an investor may incur a greater loss than if they had invested directly in the underlying asset.

A forward deal is a complex derivative financial instrument linked to currency exchange rates, where at the end of the transaction the bank credits the customer with the amount of currency purchased, and the customer pays the bank the amount of currency sold. The settlement amounts are fixed at the time the transaction is concluded. By concluding the transaction, the parties undertake to buy or sell the currency on an agreed date in the future at a predetermined exchange rate. The transaction must be executed regardless of the exchange rate prevailing on the market at that time. This instrument can be used to hedge your assets, income, liabilities, and/or expenses in foreign currency against the risk of exchange rate fluctuations, as well as to try to profit from expected changes in the exchange rate. However, transactions of this nature are very risky and the Client risks losing more than they invested in the transaction due to additional obligations arising if the market situation changes unfavorably.

The main risks associated with transactions include market risk, where exchange rates may change in a direction unfavorable to the Client, as well as credit risk, where the counterparty may fail to fulfill its obligations. Such transactions are subject to liquidity risk, as they cannot be easily terminated or transferred.

A non-deliverable forward deal is a complex derivative financial instrument linked to currency exchange rates, where only the difference between the price agreed on the date of conclusion and the price on the settlement date is paid. By entering into a transaction, the parties undertake to buy or sell currency on an agreed date in the future at a predetermined exchange rate. The transaction must be executed regardless of the exchange rate prevailing on the market at that time. This product can be used to hedge your assets, income, liabilities, and/or expenses in foreign currency against currency risk, as well as to try to profit from expected currency rate changes. However, transactions of this nature are very risky and the Client risks losing more than they invested when entering into the transaction.

The main risks associated with transactions are market risk – possible losses due to unfavorable currency exchange rate changes – and credit risk – the possibility that the counterparty will not fulfill its settlement obligations. There is also liquidity risk, as these instruments are not standardized and their secondary market is limited.

Options allow you to profit from both positive and negative changes in the price of the underlying asset. Call options are generally considered to be less risky than put options, as when purchasing an option, the only risk is the premium paid. Call options are often used to hedge against unfavorable changes in the price of an asset. When selling an option, there is a risk that losses due to a possible unfavorable change in the price of the underlying asset will exceed the premium paid. In this case, the option seller may incur almost unlimited losses, as there is no upper price limit for them. This risk is similar to the risk incurred by an investor when selling borrowed financial instruments (short selling).

Repurchase (repo) agreement

A repurchase (repo) transaction is an agreement whereby one party lends money for a fixed period in exchange for collateral (financial instruments), while the other party undertakes to pay interest and repurchase the financial instruments on an agreed date. For the party selling the financial instruments, this will be a repurchase transaction, and for the party acquiring them, a reverse repurchase transaction. The difference between the sale and repurchase price of the financial instruments is the agreed interest.

This is a convenient way to lend (sell) financial instruments to a bank or another party and obtain a short-term loan. However, if the investor uses these funds to purchase new financial instruments and repeats this process several times, they can create a financial scheme where even small changes in the collateral value of the financial instruments can result in the loss of the entire investment.

The risk arising from repurchase agreements depends heavily on the collateral—the type of financial instruments and their price sensitivity. The more the price of the collateralized financial instruments fluctuates, the greater the likelihood that the other party will demand an additional collateral or unilaterally terminate the contract if that collateral is not provided or its market value declines rapidly.

Investors should be aware that the interest paid on the repurchase agreement reduces the return on the transaction. This is particularly relevant when the cash proceeds from the transfer of financial instruments are reinvested and the return on the investment is lower than the interest payable.

Investors may also be exposed to risk if the issuer whose financial instruments have been transferred as collateral goes bankrupt. In such cases, the lender may seek to recover the debtor's obligations under the repurchase agreement from other assets.

When concluding this type of agreement with banks, it is usually stipulated that the client himself is obliged to monitor the value of his collateral and, if it falls, to replenish the guarantee deposit account with cash or financial instruments within a specified period without a separate warning from the bank. Otherwise, the bank reserves the right to sell the financial instruments used as collateral and/or terminate the repurchase agreement.

Before entering into a repurchase agreement, investors are advised to familiarize themselves thoroughly with the terms and conditions of the agreement and to assess their ability to maintain the collateral for the agreement and assume all the risks of such an agreement.