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Description of Financial Instruments and Related Risks

Introduction

This document is addressed to the Luminor Bank AS (**Bank**) clients or potential clients (Clients) in the sense of Directive 2014/65/EU of the European Parliament and the Council on markets in financial instruments (**MIFID II**) and Commission Delegated Regulation (EU) 2017/565.

Pursuant to the requirements of applicable legal acts and in order to enable the Client to take an investment decision on an informed basis, the Bank hereby presents a generalized description of the character of financial instruments' types and risks inherent to them. A particular financial instrument may have additional conditions and risk factors inherent to that particular financial instrument.

This description is provided with a purpose to explain the nature of the specific type of instrument concerned, the functioning and performance of the financial instrument in different market conditions, including both positive and negative conditions, as well as the risks particular to that specific type of instrument in sufficient detail.

The Client should review this description prior to making an investment decision. This document does not constitute investment advice (nor any other advice of any nature) and is not intended as a personal recommendation to invest in the financial instruments. Before making an investment decision, the Client should consider whether such investment could be suitable taking into account his/her knowledge and experience in the financial instrument market, financial situation and investment objectives and, if necessary, seek appropriate professional advice.

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1. General Provisions

The Client is personally responsible for a decision to invest in one or another financial instrument. The Client needs to carefully study this document and to take into account the contexts hereof when making investment decisions, and also to avoid any investment and transaction, for which he or she considers that he or she lacks the necessary knowledge or necessary experience. The Client is solely responsible for monitoring the status of his or her investments regularly, irrespective of whether he or she has been given investment advice in respect of a certain investment or not. The Client should use all the information accessible to him in order to monitor price changes and to follow the value of his investments, including data provided by information providers (e.g., trading systems, Reuters, Bloomberg, and other information facilities), or collected by the Client personally or provided by the Bank.

Investments in financial instruments entail risks. Despite the fact that the escalation of such risks differs, according to several factors that will be described briefly below, performing investments on financial instruments always implies exposures to risks that cannot be fully covered. Such risks include, in general, a decline in the value of the investment or even the loss of the invested amount. Under certain circumstances specifically, the Client may be obliged to provide further amounts in addition to those initially invested, to cover a loss that may arise.

2. General Investment Risks

This is an overview of the general risks related to various financial instruments and investment services. Please note that this is not an exhaustive list of investment related risks and other risks may occur to the Client in the course of the transaction. It is the Client's responsibility to analyse and evaluate, based on the circumstances, all the risks and possible consequences of a particular transaction.

These risks are characterized as general because they are inherent to the way the capital market operates and in general the financial system, while they emerge under circumstances that cannot be predicted or excluded by anyone.

2.1. Risks and features – definitions

Market risk – is a risk that the investor suffers losses due to overall adverse price movement in the securities market or in a certain segment thereof. Adverse price movement may be caused, for instance, by poor economic indicators of the relevant state or branch of the economy, unstable economic environment, unstable securities market, etc.

Liquidity risk – is associated with the market risk and means primarily that the investor may suffer losses due to the absence of liquidity in the respective regulated market, which impedes the sale of securities at the time desired by the investor or the securities cannot be sold at a price close to the market price or at a price desired by the investor.

Currency risk – may arise if an investor invests in financial instruments in a currency which is not the main currency of the investor. For investors, the smallest risk lies in investing in their base currency, unless they have sufficient knowledge of currency risks.

Price risk – is a risk that the investor suffers losses on adverse changes in the value of a financial instrument or other asset in which they have invested. The price of securities may decrease as well as increase.

Credit risk – is a risk that the investor may suffer losses due to the fact that the value of financial instruments acquired by them decreases due to the poor financial performance, economic difficulties, or other similar indicators of the issuer of the securities. The issuer's poor economic performance may cause, among other things, the inability of the relevant issuer to perform obligations arising from the securities before the investors.

Interest risk – is related to the market risk and means that the investor may suffer losses from adverse developments on the market, which may be manifested in changes in interest rates, interest rate volatility, interest rate gap between investment objects of different risk levels, early repayment of loans, etc.

Exit cost risk – certain financial instruments may contain restrictions on when they can be exited and / or may contain additional charges if the investor wishes to exit the transaction or contract before the end of the agreed term. These costs are referred to as exit or break costs and will be disclosed to an investor prior to any investment.

Financial leverage risk – is a risk that the value of the asset will change due to leverage at a much larger extent than the market price of the asset. A change in the market price of leveraged assets can thus cause significant damage.

Concentration risk – is a risk undertaken by the investor that places all of his or her investments in only one financial instrument. It is the opposite of risk diversification, when the investor places his or her capital in more financial instruments with different characteristics, which also have complementarity.

Inflation risk – is a risk that the real income of the investment is lower due to the general increase in prices. Negative real income means that even though the investment may be nominally profitable, the purchasing power of the placement has decreased during the investment period.

Counterparty risk – there is a risk that the person who has made a transaction with the investor via a bank does not perform its obligations arising from the transaction.

Settlement system risk – is the possibility that (primarily) technical failures in the systems and accounts or communications channels of registers of securities, stock exchanges, clearing houses, and other institutions or other problems may cause the cancellation of transactions, delay of post-transaction settlements, false transfers, and other events, which may result in losses for the investor.

Legal risk – is a risk of incurring additional expenses or loss by the investor due to adverse restrictions or duties, which occurred after acquisition of the financial instruments as the result of changes in including, but not limited to legislation, mandatory regulations or guidelines issued by competent authorities and judicial decisions.

Information risk – is a risk that the investor may not have the chance to receive adequate and correct information about the securities or the receipt of such information is difficult, as a result of which the investor may not have the opportunity to make reasoned decisions regarding their investments.

Political risk – international developments on a political, diplomatic and military level affect the course of money markets and capital markets. Political developments in one country may (i.e. political anomalies, election of government and specific governmental choices in critical sectors of social and economic life), therefore affect the price of financial instruments that are traded in such a country or of companies that are based or operate there.

Tax risk – depending on the regulation or practice applicable on a specific market or to the services provided by the depository operating on the relevant market, the investor may not always be able to use the incentives arising from a double taxation prevention treaty made between their state of residence and the state where the securities are kept. In addition, taxation may be influenced by the fact that the investor's securities are kept, with the investor's consent, on an account opened in the depository in the name of the bank, as a result of which the investor's securities are treated as those of the bank.

3. Product Specific Risks

3.1. Stocks

General description

A stock (also called a share) is a financial instrument that represents a proportional share in the stock capital of a public limited company and provides its owner, the stockholder, with various rights.

There are two main types of stocks:

- **Common stock** – mostly a regular stock with voting rights. A stockholder earns profit from the increase in the stock price and from the dividends paid by the company. Many stocks are freely exchange-traded on regulated markets.
- **Preferred stock** – the voting right is limited or there is no voting right at all at the general meeting of stockholders. The owner of a preferred stock usually cannot participate in the management of a company; however, preferred stock gives preferential rights compared to common stock at the distribution of dividends and division of the assets remaining at the dissolution of the public limited company.

In addition to the above, stocks are classified based on the company's size, style and sector as well (growth stocks, income stocks, cyclical stocks, blue-chip stocks, penny stocks, large-cap stocks, small-cap stocks).

Investing in stocks may provide an investor a return either through the dividends paid from the issuers' profits or increase in the share price of the issuer. Stocks are a high-risk investment where the investor participates fully in the issuers' economic risk.

The value of shares may fluctuate and income is not guaranteed. The investment may not increase in value, and an investor may lose some or all of his or her investment.

Risk and complexity classification

All the stocks are considered to have high investment risk level.

Stocks listed on a regulated market or are trading on a multilateral trading facility are treated as less- or non-complex investment instruments.

Stocks, which are not listed on regulated markets or which are not tradable or are traded over-the-counter (OTC) are treated as complex investment instruments.

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Product specific risks

- **Company risk** –stock purchaser does not lend cash to the company, but investor becomes a co-owner of the corporation. He or she thus participates in its development as well as in chances for profits and losses, which makes it difficult to forecast the precise yield on such an investment. An extreme case would be if the company went bankrupt, thereby wiping out the total sums invested.
- **Market Risk** – the value of stocks may fluctuate significantly in a short period of time exposing investors to a high level of risk. Income from the investment is not guaranteed and the investor could get back less than he or she invested. If the issuer fails, then investments in its equity can become worthless and the investor may lose up to 100% of his or her investment.

  Market risk in stocks markets can materialise due to macroeconomic or issuer specific factors, and may impact a single issuer, issuers within an industry, or the market as a whole.

  The value of shares and the dividends they distribute are determined by the financial performance of the company issuing the shares, but can also be influenced by the performance of similar companies in the same sector, takeover activity, social or governmental issues in the home country of the corporation, and by financial analysis recommending investors to undertake a specific course of action (e.g., buy, sell, hold).
- **Volatility Risk** – in adverse market conditions the value of stocks may be affected by increased volatility and quick changes to value.

  The volatility of stock markets cannot be assumed to follow historic trends.

  Certain shares can be very volatile, especially those of smaller companies listed on junior stock markets (frontier and / or emerging markets).

  A small change in the company's financial performance can have a big impact on its value and smaller companies tend to have fewer resources to overcome financial difficulties.
- **Dividend risk** – the dividend per stock mainly depends on the issuing company's earnings and on its dividend policy. In case of low profits or losses, dividend payments may be reduced or not made at all.
- **Liquidity risk** – certain stocks can be illiquid which can lead to a big difference between the buying price and selling price, and it may be difficult to dispose of shares. This may be especially the case for smaller companies listed on junior stock markets (frontier and / or emerging markets).

  If an investor needs to sell illiquid shares at short notice, the investor may get back significantly less than he or she invested.
- **Credit risk** – while the credit strength of the company in which an investor has bought shares may impact the stock price and the expected dividend payments, the investor is not exposed to any direct credit risk against the issuer as a result of investing in companies shares.

  In the event of insolvency of the issuer, recovery of stock investment will be superseded by claims by creditors of the issuer.

- **FX risk** – stocks may trade in different currencies and, as such, an investor may be exposed to fluctuations in FX rates when invested in shares priced in foreign currencies.

  Potential profit or loss of an issuer which derives its revenues in foreign currency from transactions on foreign markets may be affected by fluctuations in currency exchange rates.

- **Concentration risk** – holding large, concentrated positions in a narrow pool (e.g., sector) of stocks may carry a concentration risk and expose investor to potential loss of capital in an event of a downturn of a specific industry sector or stock.

- **Dilution risk** – in the absence of any restrictions in the incorporation documents of the company or other agreement, an issuer may issue more of its shares, thereby potentially reducing the value of the holding and putting downward pressure on the amount of dividends per share.

- **Termination of listing** – where the stocks are listed or admitted to trading, the relevant issuer will not be obliged to maintain the listing or trading. Shares may be suspended from trading and/or de-listed at any time in accordance with applicable rules and regulations of the relevant stock exchange(s). This may result in reduced liquidity or a reduction in the value of the shares.

3.2. Bonds

General description

A bond is a financial instrument that incorporates a pledge, monetary or other, of the issuer towards the beneficiary of the bond, mainly the bondholder. This obligation usually consists in paying the principal capital of the bond at maturity and the coupon payments during the periods defined in the issue terms.

Bonds can be issued either by governments (sovereign bonds) or by companies (corporate bonds). According to this definition, bonds are a form of government or corporate borrowing.

Investing in bond markets provides an investor with an exposure to an issuer and may provide a return through the fixed coupon paid by the issuer, or through an increase in the bond price. Bonds are a high-risk investment where the investor takes direct credit risk exposure against the issuer.

The value of bonds may fluctuate and income is not guaranteed. The investment may not increase in value, and investor may lose some or all of his or her investment.

Types of bonds

- **Unsecured bonds** – bondholders have a claim against the issuer as do other creditors of such issuer, on the total assets of the issuer.
- **Secured bonds** – linked to collateral provided in favour of bondholders. The claim of bondholders is secured in this case i) by collateral in favour of such bondholders that is placed on specific assets of the issuer, ii) by third party guarantees, iii) by assignment of receivables etc. Furthermore, bondholders may enjoy additional protection as a result of specific agreements with the issuer or due to their privileged placement against other bondholders or creditors.
- **Subordinated bonds** – in case of default of the issuer the bondholder is redeemed after all other creditors of the issuer – if there are remaining assets, as specifically defined in the bond loan.

- **Convertible bonds** – such bonds entail the right for conversion in shares or other financial instruments or the right for exchange with other financial instruments.

Coupon

- **Fixed interest rate bonds:**
  The amount repaid is larger than the principal;
  Coupon is fixed and interest is paid regularly;
  If an investor holds a bond until the maturity date, its return is known.
- **Floating interest rate bonds:**
  The amount repaid is larger than the principal;
  Coupon is floating and interest is paid regularly;
  The coupon is based on an index or other rate for each relevant period.
- **Discounted bonds:**
  The amount repaid is equal to the principal;
  No coupon payments are made;
  The price bonds are sold is lower than the principal.

Risk and complexity classification

Very low risk level bonds can be identified as investment grade bonds quoted in main currencies, issued by a state or by a 100% state-owned company or a with 100% guarantee of the state and with maturity less than 3 years.

Low risk level bonds can be identified as investment grade bonds quoted in main currency, issued by a state or a 100% state-owned company or with a 100% guarantee of the state and with maturity more than 3 years or are issued by a company with any maturity.

Medium risk level bonds can be considered bonds that are non-investment grade bonds that are quoted in main currency or investment grade bonds that are not quoted in main currency.

High risk level bonds are non-investment grade bonds that are not quoted in main currencies.

Subordinated bonds and convertible bonds are treated as complex financial instruments.

Product specific risks

- **Market risk** – market risk in bond markets can materialise due to macroeconomic or issuer specific factors, and may impact a single issuer, issuers within an industry, or the market as a whole.
  The value of the bond or the interest payments they distribute are determined by the financial performance of the issuer but can also be influenced by the performance of similar companies in the same sector, social or governmental issues in the home country of the corporation.
- **Default risk** – occurs when the issuer will not be able to make the required interest payments or redeem the principal at the redemption date. In case of a default of an issuer, investor can lose everything he had invested.
  For government bonds, the issuer is less likely to become insolvent than for corporate bonds.
  For investment grade bonds, the issuer is less likely to become insolvent than for high yield bonds.
- **Volatility risk** – investor will be exposed to volatility risk if he or she chooses to trade a bond on the secondary market.

A change in the issuers' financial performance can have an impact on the value of the bond.
Different bonds are subject to different volatility risks. This may depend on the credit rating of the issuer, the size of the issue, the liquidity in the market and other factors.

- **Liquidity risk** – if investor wishes to sell the bond on the secondary market, prevailing market conditions may reduce the demand of the product, this could impair the market price and the bond may be described as illiquid.
  Certain bonds may be illiquid which can lead to a big difference between the buying price and selling price, and it may be difficult to dispose of certain bonds.
  This may be especially the case for smaller issues.
- **Credit risk** – a reduction in creditworthiness may affect the issuers' ability to meet fixed income payments.
- **Reinvestment risk** – appears for a callable bond, since the issuer may call back the bond before maturity date and the investor may be forced to reinvest the received funds in securities with a lower yield.
- **Early redemption risk** – the issuer of a bond may include a provision allowing early redemption of the bond if market interest rates fall. Such early redemption may result in a change to the expected yield.
- **Termination of listing risk** – where the bonds are listed or admitted to trading, the relevant issuer will not be obliged to maintain the listing or trading. Bonds may be suspended from trading and/or de-listed at any time in accordance with applicable rules and regulations of the relevant stock exchange(s). This may result in reduced liquidity or a reduction in the value of the bonds.
- **Equity risk** – on exercise of the conversion rights, holders are exposed to the risks relating to shares (as described above) in respect of the relevant equity securities.
- **Conversion risk** – conversion of the bond into shares or other financial instruments may only be possible during certain periods of time and may also be subject to certain other conditions. This may mean that the holder is unable to exercise its conversion right at the most advantageous time, which may result in reduced profits or increased losses.
- **FX risk** – bonds may trade in a currency other than the currency, which is most relevant to the investor, there is an increased risk that the movement in exchange rates will affect the returns the investor receives from investment in the bond.
- **Interest Rate risk** – this risk may impact on bond prices in the secondary market and may also impact the credit standing of the issuer.

3.3. Investment funds

General description

An investment fund is a pool of assets established for collective investment and generally with no maturity. An investment fund usually has numerous investors and the fund is managed by a management company in accordance with the investment objectives of the fund. Funds can be either open-ended or closed-ended. Open-ended funds are valued on the basis of the value of the assets held. Closed-ended funds are valued on the basis of what investors are prepared to pay/sell.

The value of the investment fund's assets can change during the investment period and can be higher or lower compared to the total amount initially invested depending on the prevailing market conditions. The funds units' net asset value (NAV) is calculated by the management company. The funds units' net asset value is based on the price developments of the financial

instruments included in the fund's assets and this determines the issue and redemption price of the fund units. The investor does not know the exact price of a fund unit upon placing a purchase or sale order.

Types of funds

- **UCITS Funds** – are subject to strict requirements, which are related to the fund's investment strategy and diversification of risks (requirements have been established in the Directive 2009/65/EC of the European Parliament and of the Council (UCTIS Directive)). Information regarding the fund is disclosed in the fund prospectus, conditions and key investor information document.
  For UCITS funds the net asset value (NAV) is generally calculated on a daily basis.
- **Non-UCITS Funds** – are funds, to which the requirements of the UCITS Directive do not apply.
  For Non-UCITS funds the net asset value (NAV) may be calculated on a monthly or a quarterly basis.
- **Alternative Investment Funds (AIF)** – are not restricted by statute to instrument restrictions (as, for example, UCITS are), so no investor protection arrangements are in force.
  For Alternative Investment Funds (AIF) the net asset value (NAV) may be calculated on a monthly or a quarterly or a semi-annually basis and is defined in the funds statute.

Risk and complexity classification

Investment funds do not guarantee a rate of return. The return and risk are closely tied. The higher is the possible return, the higher is the risk of losing substantial part of initial investment. Investment fund's past performance is not a reliable indicator of future performance, but it can help to assess the volatility of the fund units over time.

UCITS Funds units, except structured UCITS Funds units, are treated as non-complex investment instruments.

Structured UCITS Funds units, non-UCITS Funds units and Alternative Investment Funds units are treated as complex financial instruments.

Product specific risks

- **Issuer risk** – the possibility that the value of the instrument may significantly fall due to deficiencies in the activity of the management company.
- **Market risk** – the value of an interest in a fund depends on the value of the assets it holds. If general market conditions deteriorate, it is likely that the value of the investment in the fund will also deteriorate.
- **Liquidity risk** – open-ended funds may not be able to liquidate their assets and return invested funds to investors in the event that there is poor liquidity in the market generally or in the specific sector in which the fund invests. Ongoing costs to service those investments could lead to increased losses or reduced profits for investors in the fund. UCITS Funds are intended to be easily transferable and redeemable, but in the event of poor performance of the fund, liquidity may be drastically reduced and investors may be unable to realise their investments without incurring losses or reduced returns. Closed-ended funds can be subject to risks of low trading and therefore provide limited liquidity, making it difficult for an investor to realise its investment. AIFs may have lock-up periods or may otherwise be illiquid, so realising your investment can be difficult.

- **Limited diversification risk** – unless the fund is subject to investment restrictions and diversification requirements, the number and diversity of investments held by a fund may be limited. Limited diversification means that an investor may be highly exposed to poor market conditions in the relevant sector.
- **Asset allocation** – AIFs can invest in a very wide range of investments. Some AIFs will invest in highly speculative or very illiquid assets; this may increase the risk of losing some or all of the investment in the AIF or making it difficult to relive the value of the investment.
- **Restrictions on subscription** – an investor in the fund's units may be prevented from subscribing and redeeming such units, either at the official net asset value (for example, as a result of the imposition of any charges by the fund) or at all, or the prescribed notice period, timing cut-offs and minimum/maximum amounts in respect of subscriptions and redemptions for the fund's units/shares may be changed.
- **Compulsory redemption risk** – the fund may compulsorily redeem the shares/units upon the occurrence of certain events (for example, if, following the insolvency of the investment manager, the fund becomes unable to fulfil its investment objections).
- **Changes to portfolio** – the composition of the fund's portfolio of investments may change from time to time. Such changes may have an impact on the value of the fund.
- **Interest rate risk** – a leveraged fund will be exposed to interest rate rises. This could reduce the returns that investors receive, or even lead to losses.
- **Currency risk** – if investments in the fund are denominated in a currency other than that in which the investor's initial investment was made, returns could be reduced (or losses incurred) due to currency fluctuations.
- **Sub-funds segregation** – the sub-funds of the fund may be segregated as a matter of the law of the fund's home jurisdiction and, as such, the assets of one sub-fund will not be available to satisfy the liabilities of another sub-fund. However, the fund may operate or have assets held on its behalf or be subject to claims in other jurisdictions other than its home jurisdiction which may not necessarily recognise such segregation. There can be no guarantee that the courts of any jurisdiction outside its home jurisdiction will respect the above limitations on liability.
- **Leverage risk** – AIFs can be highly leveraged. This means that small falls in the value of the investments they hold can have significant impact on the value of the fund.
- **Country risk** – the value of a foreign investment may decline because of political changes or instability in the country where the foreign investment was issued.
- **Counterparty risk and service provider risk** – the insolvency of any institution providing services to the fund, such as safekeeping of assets or acting as counterparty to the fund in derivatives or other instruments, may expose the fund to financial loss.
- **Derivatives risk** – a fund may utilise instruments in the form of warrants, futures, options, forward contracts and swaps to seek to enhance investment returns. While this can potentially have the effect of enhancing the fund's performance, it can also be detrimental if there are losses on the derivatives.
- **Operational risk** – an investment in a fund can involve operational risks arising from a wide range of possible operational errors, including system breakdowns, human errors or external events and errors caused by service providers such as the investment manager, which may affect the value of the fund and (if applicable) its ability to pay redemptions within the scheduled timeframe.

3.4. Exchange Traded Funds (ETF)

General description

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An exchange-traded fund (ETF) is similar to a regular investment fund because it is a pool of financial instruments or other underlying assets, but unlike a regular investment fund, ETF units are traded on the stock exchange similarly to corporate stocks. The underlying assets of an ETF may be specific shares (stocks), bonds, derivatives, commodities, foreign currency and other assets. An ETF may follow a specific index and acquire only assets within the composition of the index, e.g. shares belonging to certain indices. There are ETFs that invest only in certain industry or geographical region. There are also ETFs that are always not related to one index or sector. In the case of such ETFs, investments are managed actively and the composition of their underlying asset may change over time. The information regarding ETF is disclosed in the fund documents, including key investor information document.

There are ETFs:

- that enable changes in the value of underlying asset twice or more times (leveraged ETF);
- the value of which moves in the opposite direction to the value of underlying asset (inverse ETF);
- which leverage the opposite movement to the value of underlying asset (leveraged-inverse ETF);
- the underlying assets of which are other funds traded at the market.

ETFs are valued as mutual funds using net asset value (NAV) of unit, however unlike regular funds, their purchase and sale price is formed on a stock exchange likewise to stocks. The value of ETF unit can change during the investment period and can be lower or higher compared to the amount initially invested depending on the market conditions. Selling and buying ETF units works only through major exchange market at any time on trading day. The system with bid and ask price is the same as it is for ordinary stocks.

ETFs that follow and are established according UCITS Directive are called UCITS ETFs.

Risk and complexity classification

ETF does not guarantee a rate of return. The higher is the possible return, the bigger is the risk of losing substantial part of initial investment.

Past performance of ETF is not a reliable indicator of future performance, but it can help to assess the volatility of ETF unit price over time.

Units of ETFs are treated as complex financial instruments, except UCITS ETFs that are treated as non-complex financial instruments.

Product specific risks

- **Market risk** – typically, an ETF will seek to replicate a stock market index, market sector, commodity or other basket of assets. Accordingly, the investor is exposed to the market risk of the underlying assets.
- **Index-linked risk** – an ETF may seek to track and replicate a specific index (e.g., a stock index) to achieve returns that correspond to value of that underlying index. There is a risk that, where the provider of such index has not compiled, composed or calculated the index accurately, the investor may be exposed to the risks associated with that index and its inaccurate or erroneous composition.
- **Liquidity risk** – is associated with the market risk and lies primarily in the fact that the investor may suffer losses due to absence of liquidity in the respective regulated market, which impedes the sale of securities at the time desired by the investor or the securities cannot be sold at a price close to the market price or at a price desired by the investor.

Despite of underlying assets and their liquidity, the ETF unit/share may in some situations become illiquid and therefore selling, buying or redeeming thereof can become complicated or impossible. It is also complicated or impossible to buy, sell or redeem the units/shares of ETFs close to net value level. The possibility to sell the units/shares ETFs is not guaranteed.

- **Performance risk** – investors in an ETF may rely on the manager to track the performance of the underlying indices or assets, or the ETF may track the underlying assets passively (i.e., without the active involvement of the manager). In practice, the ETF's performance will differ from the performance of those indices or assets. More specifically, this may be the result of an ETF tracking error (being the difference between the returns of the ETF and its reference index or asset) may occur owing to a number of factors including rebalancing, restrictions/limitations (e.g. emerging market accessibility), method of replication and the costs/expense ratio (higher costs may lead to a greater tracking error).Therefore, an investor may receive lower returns than it would have had it invested directly in those underlying assets.
- **Interest rate risk** – a leveraged ETF will be exposed to interest rate rises. This could reduce the returns that investors receive, or even lead to losses.
- **Country risk** – the value of a foreign investment may decline because of political changes or instability in the country where the foreign investment was issued.
- **FX risk** – if the underlings in the ETF are denominated in a currency other than that in which the investor's initial investment was made, returns could be reduced (or losses incurred) due to currency fluctuations.
- **Changes to portfolio** – the composition of the ETF portfolio of investments may change from time to time. Such changes may have an impact on the value of the ETF.
- **Counterparty risk and service provider risk** – the insolvency of any institution providing services to the ETF manager, such as safekeeping of assets or acting as counterparty to the manger in derivatives or other instruments, may expose the manager or the ETF to financial loss.
- **Derivatives risk** – ETF managers may employ a synthetic structure to provide the stated return, whereby the return is based on a derivative executed with counterparty. The return may therefore be dependent on the credit quality of the counterparty and/or the collateral held to support the position. Investors may also be exposed to the risks outlined below in respect of derivatives.
- **Compulsory redemption risk** – the units of the ETF may be compulsorily redeemed upon the occurrence of certain events (for example, the insolvency of the investment manager).
- **Authorised participant (AP) concentration risk** – in the ETF market, only an AP is permitted to engage in the creation/redemption of transactions directly with the ETF. Since the ETF may only permit for a limited number of institutions to act as an AP, there is the risk that, where an AP exits the business, or is otherwise unable to proceed with the creation/redemption transactions, it was instructed to carry out, and no other AP is able to step in to give effect such creation/redemption transactions, the ETF shares/units may be more likely to trade at a premium price or a discount to the net asset value of index or assets it seeks to replicate, and as a result the ETF may be subject to trading halts and/or delisting.

3.5. Structured bonds (Index Linked Bond)

General description

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A structured bond (Index Linked Bond) is a debt instrument that typically consists of one or several bonds and one or several derivative instruments. The derivative instrument changes the investment risks associated with the bond in order to give an investor a chance to benefit in price movements of some other, often unrelated financial instrument or an asset. The value of a structured bond will depend on both the components – the bond and the derivative. A feature of some structured bonds is a guaranteed principal, which offers protection of principal if held to maturity, however there might be structured bonds which offer only partial principal guarantee or no guarantee at all. For structured bonds, quite common is that no pay-outs are made before the maturity date of the bond. The terms and conditions of structured bonds may significantly differ, and the investor should definitely get acquainted with the conditions before making the subscription or trade.

Generally, a structured bond (Index Linked Bond) can be sold before its maturity for the price it is quoted on the secondary market, less any applicable service fees. The value of a bond is linked to the price of underlying assets (index) that may fluctuate over time that makes difficult to predict the future value of the bond.

There is no guarantee that full nominal value and risk premium will be recovered when selling a structured bond with capital protection before its maturity date. Structured bonds without capital protection are aimed at offering better returns compared to capital protected structured products however in adverse market movements the investor may lose the entire amount invested.

Risk premium is a non-refundable additional sum to be paid upon subscription aimed at receiving higher return.

Risk and complexity classification

Very low risk level – structured bonds quoted in main currency with full capital protection at maturity.

Low risk level – structured bonds quoted in main currency with partial capital protection at maturity (loss may occur as a result of losing up to the 10% risk premium).

Medium risk level – structured bonds quoted in main currency with partial capital protection at maturity (loss may occur as a result of losing up to the 25% risk premium).

High risk level – structured bonds quoted in any currency without capital protection.

All structured bonds (Index Linked Bond) are treated as complex instruments.

Product specific risks

- **Market risk** – is prevalent in all investments, and for a structured bond, the market risk can be high. The price for structured bonds in the secondary market depends on changes in the value of the derivative, interest rate changes, time remaining until the redemption date, supply and demand of the specific structured notes on the market and other factors.
- **Liquidity risk** – means that investors may incur losses if they want to sell their structured bonds as quickly as possible or are unable to sell them for a certain time interval. The opportunity to sell structured bonds before the redemption date depends on their liquidity in the secondary market.
- **Credit risk** – the investor may suffer losses due to the fact that the value of financial instruments acquired by it falls, since the issuer of the securities may exhibit poor financial performance, economic difficulties or other similar indicators. The issuer's poor economic

performance may cause, among other things, the inability of the relevant issuer to perform obligations arising from the securities before the investors.

- **Interest rate risk** – interest rate may change the price of a structured bond. The interest risk is related to the market risk and lies in the fact that the investor may suffer losses from adverse developments on the market, which may be manifested in changes in interest rates, interest rate volatility, interest rate gap between investment objects of different risk levels, early repayment of debts, etc.
- **Default risk** – occurs when the issuer will not be able to make the required interest payments or return principal. In case of a default of an issuer, investor can lose everything he had invested.
- **Reinvestment risk** – appears for a callable structured bond, since the issuer may call back the structured bond before maturity date and the investor may be forced to reinvest the received funds in securities with a lower yield.
- **FX risk** – structured bonds may trade in a currency other than the currency, which is most relevant to the investor, there is an increased risk that the movement in exchange rates will affect the returns the investor receives from investment in the bond.
  Currency fluctuations may affect the level, price or value (as applicable) of the underlying(s) in complex ways. If the level, price or value (as applicable) of the underlying is denominated in a currency that is different from the currency of the bond, investors in the bond may be subject to increased foreign exchange risk. If such currency fluctuations cause the level, price or value (as applicable) of the underlying to decrease, the value of the bond may fall. Accordingly, an investor in the bond may suffer a greater loss on his or her investment than an investor in a product which is linked to an underlying that is denominated in the same currency.

3.6. Derivatives

General description

Derivatives are complicated and complex financial instruments, the characteristics of which vary depending on the underlying instruments, namely the financial instruments on which the derivatives are structured. A derivative may include a broad range of underlying instruments, with different variations and combinations. This means that there is an indefinite number of types of derivatives that exist and that can be created. Derivatives usually are created in the form of contracts between counterparties, under which mutually undertaken obligations are to be fulfilled on one or more predefined future dates. The value of derivatives depends on the value of the underlying instruments, which may be shares, securities, exchange rates, interest rates, commodities and financial indices and any combination of such. A derivative can be traded “over-the-counter” (OTC) or on an exchange. Banks and other financial intermediates may provide non-standardised financial instruments and other OTC derivatives. The basis of an investment decision in derivative instruments is the expectation of a specific future development in the price of the underlying assets over a certain period of time. The investor should therefore have a clear picture of the expected market movements. In addition, the investor must have a clear understanding of the purpose of the investment (whether this is hedging, highly-geared investing or arbitrage). Only when these preconditions are fulfilled it is possible for the investor to choose the derivative instrument type or a combination of instruments with the appropriate risk profile. The basic types of derivatives are futures or forward contracts, options and swaps. The aforementioned basic types of derivatives are described briefly below.

- **Forwards and futures** – are standardized contracts for the purchase or sale of a defined quantity and quality of an underlying instrument on a future date and at an agreed price, which are specified when the contract is concluded. Based on the above, one counterparty undertakes the obligation to sell to the other counterparty a specific quantity of a financial instrument (i.e., a share) and/or a currency or commodity on a specific future date at a predefined price. A corresponding obligation is undertaken by the buyer. Therefore, the date the transaction is made differs from the date the obligation is fulfilled.
  In the case of a forward, the underlying assets are either delivered physically, or any profits and losses are settled in cash. In the case of futures, profits and losses are monitored on a daily basis for the duration of the respective contract period, which may have consequences for any collateral which is required for the conclusion of the respective contract. Forwards can only be settled on the end date, whereas futures may normally be settled (i.e., "closed out" with the counterparty) at any time before the end date.
  Underlying assets may include, among others, shares, exchange rates, interest rates, bonds, equity indices. Both counterparties are obliged to fulfil the obligations that emanate from the contract on the settlement date.
- **Options** – options provide to a party the right to purchase or sell a specific underlying instrument at a predefined price on a predefined future date. This right of such party corresponds to an obligation of the other counterparty to place the agreed transaction if the former exercises his right. Underlying instruments may include currencies, interest rates, equity indices, shares, securities and money market instruments.
  In contrast to futures, the buyer of the option has the right, but not the obligation to proceed with the specific transaction in the future. He purchases this right for a price, namely the right to proceed with the transaction in the future. On the other hand, the other counterparty, the seller (writer of the option) has the obligation to fulfil his obligations which result from the contract, if the other party (the buyer of the option) exercises his right.
  The value of an option may be determined based on more techniques that are developed by specialized product engineers and analysts. Such methods may also specify the manner in which the value of an option may be affected by a possible change in specific conditions related to the option.
  Therefore, it is possible to understand and handle the risks connected to investing in options and holding such options accurately.
  There are two kinds of options:
  - an American option entitles its holder to exercise the option at any day before its term;
  - a European option may only be exercised at the end of its duration.
- **Swaps** – swap include the purchase of a financial asset at a spot price and the simultaneous agreement to sell this asset at a predefined date at a forward price.
  There are two legs in a swap: a) a spot rate transaction, usually on two days (short leg) and b) a forward transaction (long leg) that reverses the first transaction. Usually, swaps include an agreement to swap financial flows. This derivative is often used to cover risks that result from changes in prices, interest rates or for expectations on changes in the underlying prices.
- **A cross currency swap** – is a type of interest rate swap, where the swap is done across two currencies - interest payments denominated in one currency are swapped against interest payments denominated in another currency. The mutual interest payments can be fixed or floating. The parties may agree on an exchange of principal amounts at the start and maturity date of the swap. Cross currency swaps are used mainly in case a company has cash flows and obligations in different currencies.

- **A warrant** – is a special kind of put or call option. A warrant usually has a duration of a year or longer, and entitles, but does not oblige, its holder to buy or sell a certain share or a selection of different shares at a predetermined price at a particular date.
  On a warrant being exercised, the exercising party will either pay for, and/or take delivery of, the share(s) in question, or (which is the usual case where an index is involved) will be involved in a cash settlement.
  If the market price of the share or a selected set of shares at the end date is
  - higher than the price stipulated in a warrant to buy, the holder of the warrant receives the difference between the stipulated price and the market price;
  - less than the price stipulated in a warrant to buy, the warrant shall expire without payment.

  The reverse is true for a warrant to sell.
  Normally, the intention of the warrant issuer is not to purchase the underlying share or basket of shares. The contract is thus normally settled in cash in those instances where the warrant would otherwise be exercised.

Risk and complexity classification

While investing directly in the underlying instruments, the investor may, in a worst-case scenario, lose the entire investment, but when investing in certain type of derivative instruments, the investor may in addition to losing the investment incur also additional monetary obligations.

Another characteristic of derivative instruments is that changes to the instrument's market value are generally swifter and sharper than changes with other financial instruments. It is therefore necessary that investors of derivative instruments not only fully understand the risks involved, but that they are also constantly prepared to take action to avoid severe losses if the market develops unfavourably.

The value of a derivative instrument is dependent on both movements in the price of the underlying assets, as well as on the remaining duration of the contract. Depending on the characteristics of the instrument, a movement in the price of the underlying asset will often result in a larger movement in the price of the derivative instrument. The relative change in the price of the derivative is therefore often larger than the change in the underlying asset. This is known as the leveraged effect, and it may lead to higher yields on the invested capital than the same amount invested in the underlying assets would have produced.

A successful investment may quickly multiply the invested capital several times. Conversely, the leveraging effect may work to the investor's disadvantage, resulting in a bigger loss on the derivative instrument than would have been the case for an investment in the underlying assets.

If the price of the underlying assets develops differently than expected, the entire invested capital may be lost. The potential for profit and loss varies with the set-up and use of the derivative instrument. The duration of derivative instruments may vary from very short to several years. This affects the leverage effect, and therefore also the risk associated with the investment. For example, price movements are most often the biggest when only a short period of duration remains.

Derivatives with a probability of losing the initial investment (such as purchase of call or put options) are classified as high-risk level financial instruments.

Luminor

Derivatives with a probability of losing more than the initial investment (futures, forwards, options and other products with a high-risk level and high degree of complexity, for which financial leverage could be used) are classified as very high risk level financial instruments.

All derivatives are treated as complex financial instruments.

Product specific risks

- **Market Risk** – derivatives are priced on the basis of an underlying asset or other value, the investor will be exposed to the market risks that affect the underlying. However, the economic return of a derivative transaction may not be identical to the economic return of holding the underlying, and may include an adjustment for fees or commissions, financing charges, hedging costs or break costs. “Stop loss” or “stop limit” orders intended to limit losses may not be effective if market conditions make it impossible to execute such orders.
- **Counterparty credit risk** – where the derivative transaction is uncleared and uncollateralised, the counterparties are exposed to the credit risk of the other party. The investors’ entire investment could be lost in the event of default by, or the insolvency of, its counterparty.
- **Loss of investment** – risk that the investor is paying an upfront amount, but never receives any benefit from the transaction. An example of this could be if an option purchased is not in-the-money at the time it can be exercised.
- **Contingent liabilities risk** – derivatives such as credit default swaps or options may involve contingent liabilities. This can result in the investor incurring losses much greater than its original investment or premium received should certain conditions be met, such as the occurrence of a credit event or an asset reaching a strike price.
- **Unlimited loss risk** – Losses under certain derivatives can theoretically be unlimited. In the context of an interest rate or FX swap, for as long as the interest or exchange rate continues to rise, so too will the investor’s loss if it is required to pay the variable rate under the transaction.
- **Leverage risk** – derivatives may be entered into on a highly geared or leveraged basis. This may mean that even a relatively small movement in the value of the underlying asset or other specified factor(s) could result in a disproportionately large movement, unfavourable or favourable, in the amount payable between the parties to the transaction.
- **Margin risk** – a relatively small market movement will have a proportionately larger impact on the margin an investor has deposited or will have to deposit: this may work against the investor as well as for them. An investor may sustain a total loss of initial margin funds and any additional margin deposited with the firm to maintain their position. However, if the market moves against their position or margin levels are increased, the investor may be called upon to pay substantial additional collateral on short notice to cover losses incurred under the futures contracts and maintain their position. Failure to provide collateral may lead to the contracts being closed out which could crystallise a loss position.
- **Legal risk** – if counterparty goes into default and the derivative is terminated, the ability to recover value from the transaction is ordinarily dependent on netting gains against losses across different transactions and the value of the transactions against the value of the collateral. If the legal netting mechanism is not recognised in any jurisdiction, it may be that losses will be incurred.
- **Collateral risk** – parties to derivatives contracts are often required to post collateral to mitigate their credit exposure to one another. If the market value moves against their position, the investor may be called upon to pay substantial additional collateral on short

notice. Failure to post collateral may lead to the contracts being closed out, which could crystallise a loss position. There is no guarantee that collateral which is posted by the investor will be returned to the investor. Where collateral is held by a third-party custodian, the return of such collateral is subject to the credit and operational risk of that custodian.

- **Basis risk** – where a derivative transaction has been entered into to hedge price or other risks arising from ownership of a particular underlying, the performance of the derivative and the performance risk of the underlying may not be perfectly correlated, resulting in residual "basis" risk.
- **Operational risk** – losses may occur due to the failures of processes and systems used in monitoring derivative transactions, including calculating and making payments or deliveries, exercising rights (such as options rights) before their expiry, monitoring lifecycles events and delivering notices in a timely manner. Such failures in third party systems may be subject to limitations on liability.
- **Delivery risk** – if the investor has entered into a physically settled derivative than the investor may be obliged to deliver/take delivery of the relevant asset. In respect of commodities and natural resources, this may require significant operational resources to achieve.
- **Early termination** – derivative transactions may be subject to early termination due to a voluntary or agreed early termination, "events of default" or "termination events" in relation to the investor or the provider (e.g. failure to pay, insolvency, force majeure, illegality, tax events) or extraordinary events relating to the underlying (e.g. merger nationalisation or delisting of an equity, market disruptions, cancellation of an index, disruptions in the ability of one or more parties to hedge the transaction). Such events may be outside the control of the investor and such termination may, depending on the value of the transaction at such time, result in a substantial payment due from/to the investor (even where the provider is in default, or the termination arises from an external event). Investor may not be able to establish replacement transactions, or may incur significant costs in doing so, such as charges for early termination even where such early termination is voluntary or agreed between the parties.
- **Liquidity risk** – uncleared derivative contracts can be amended or transferred only pursuant to their express terms or by agreement of the parties. Where consent of the dealer to transfer or unwind an OTC derivative transaction is required, it may not provide such consent, for reasons which it is not obliged to disclose. In addition, there may not be another dealer who is willing to provide the same or a similar transaction. OTC derivative transactions on standardised terms will be more liquid than bespoke transactions. OTC derivative transactions may involve greater risk than investing in exchange-traded derivatives because there is no exchange market on which to close out an open position. It may therefore be impossible to liquidate an existing position, to assess the value of the position arising from an off-exchange transaction or to assess the exposure to risk.
- **Risk of Adjustments** – the occurrence of certain events relating to the underlying of the derivative transaction may trigger the right of the calculation agent to make certain adjustments to the economic terms. Such adjustments may involve an element of discretion on the part of the calculation agent. Exposure to an underlying via a derivative may not correspond in all cases with exposure obtained by holding the underlying directly.
- **Clearing risk** – cleared OTC derivatives are OTC derivatives which have been submitted to and accepted for clearing by a clearing house. Such cleared derivatives are subject to the rules of the clearing house, including collateral arrangements required by the clearing house. Therefore, participants may be required to post collateral on short notice to cover

losses incurred under the cleared OTC derivative contracts. Failure to post collateral may lead to the contracts being closed out, which could crystallise a loss position. The terms and conditions of cleared OTC derivatives contracts, including the strike or forward price, may be modified by the clearing house without notice to reflect changes or events in respect of the underlying asset or otherwise.

- **Changes to exchange or clearing house rules** – the terms and conditions of OTC derivatives contracts, including the strike or forward price, may be modified by the exchange or clearing house to reflect changes or events in respect of the underlying asset or otherwise.

4. Foreign markets and foreign denominated financial instruments

Investments in foreign markets will involve additional inherent risks over and above investments within investor home market. Foreign markets are regulated by the relevant supervisory authorities, the requirements of which may differ from those applicable in investor home market. The investors may incur additional losses due to different requirements.

The potential for profit or loss from transactions on foreign markets or in foreign denominated contracts and securities will be affected by fluctuations in foreign exchange rates.

Investments in emerging markets are exposed to additional risks, including accelerated inflation, exchange rate fluctuations, adverse repatriation laws and fiscal measures, and macroeconomic and political distress.

For any investment in a currency other that investors own base currency, investor should always consider the risk inherent in the product as well as translation risk, which is the risk of fluctuation in the FX markets.

5. Contingent liability transactions

A contingent liability transaction is a transaction under the terms of which the investor will or may be liable to make further payments at the time when the transaction is due to be completed or upon the earlier closing out of the investor position. These payments may or may not be secured by an amount in money or in securities deposited with a counterparty or a broker as a provision against loss on transactions made on account (a “Margin”, and “Margined” shall be construed accordingly).

Contingent liability investment transactions for which a Margin is deposited (which are Margined) require the investor to make a series of payments against the purchase price instead of paying the whole purchase price immediately.

If the investor trade in futures, contracts for differences or sell options, the investor may sustain a total loss of the Margin he or she deposit with counterparty or a broker to establish or maintain a position. If the market moves against the investor, he or she may be called upon to pay substantial additional Margin at short notice to maintain the position. If the investor fails to do so within the time required, the investors’ position may be liquidated at a loss and he or she will be responsible for the resulting deficit.

Even if a transaction is not Margined, it may still carry an obligation to make further payments in certain circumstances over and above any amount paid when the investor entered the contract.

6. Risks related to trading facilities

Nowadays, all trading facilities are computerized to greater or lesser extent, i.e., the placement, registration, and execution of orders, as well as other necessary operations, is carried out electronically. As with other electronic systems, the operation of the trading facility might be temporarily interrupted due to causes beyond the control of the Bank. Consequently, the execution of orders might be temporarily interrupted, or they might not be executed to the fullest extent, or an investor may fail to receive essential information on a real time basis. Should an investor incur losses due to interruptions of this nature, he or she can expect to recover only a limited amount of the losses, with the precise amount being determined by the Bank, other market intermediaries, or a clearing house.

7. Warning regarding the likely return on some of the financial instruments

Those financial markets which function based on the principle when the profit of some investors is covered by the same loss of other investors (zero-sum game) are not able to ensure capital gain for all participants. The total value of invested capital does not change but gets regularly distributed among the participants of the market (excluding the commission fees paid to intermediaries). Such are currency, option, and futures markets. The likely return in such markets in long perspective is close to zero.

8. Risks related to the collateral of financial instruments and investment of borrowed funds

- **The market risk** – when financing investments, or a portion thereof, using funds borrowed from third parties, the risk emerges of losing not only one's own and borrowed capital which has been directed to the corresponding investments, but also of incurring additional losses with respect to the borrowed funds, e.g., pay interest on the loan.
- **Interest** – borrowed funds usually require payment of a given interest. Therefore, an investor may lose a portion of the invested funds and/or incur additional losses if the return on investments is lower than the interest to be paid on the loan.
- **The collateral value risk** – the market value of pledged financial instruments may fluctuate significantly. In the case of a decrease in the value of the pledged financial instruments, the creditor may require an increase of the security by means of monetary contributions or by financial instruments it deems acceptable. In the case of a failure to increase the security within the stipulated time (which may be 1 working day), the creditor may terminate the credit agreement and cover the loan from the funds raised by selling pledged financial instruments/debiting cash. If the funds received from the sale of the financial instruments/debiting cash are not sufficient to cover the loan, interest, and other amounts payable, the investor is obliged to cover the outstanding debt.

Considering aforementioned, in the case of a sharp drop in the market value of the financial instruments, the investor may lose not only the pledged financial instruments, but also the additional funds. The pledge value risk is especially relevant in a case where non-liquid financial instruments are pledged since their market price may fluctuate considerably. In economic and market terms, repo transactions are loans with the pledge of financial instruments, while financial instruments purchased from the investor are held as a security.