Risk Description for Trading in Financial Instruments

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This risk description is intended for customers of Landsbankinn hf. who trade in financial instruments on the basis of the Act on Markets in Financial Instruments. This is not an exhaustive list of types of financial instruments or all risk factors related to such transactions but should be viewed as a summary of the main factors that could cause or increase risk in transactions in financial instruments. Landsbankinn advises its customers to acquaint themselves intimately with the financial instruments they intend to trade in and the associated risks.

This description has been compiled with the aim of providing information on key risk factors related to transactions in financial instruments to the customers of Landsbankinn. Investment in financial instruments always involves risk. Landsbankinn advises its customers not to trade in financial instruments unless they are fully aware of the risk entailed in such transactions and have considered both their financial strength and their experience with such investments.

1 General risks

1.1 Economic risk

The price of financial instruments is generally quite vulnerable to economic cycles. Economic cycles vary in length and depth, and in their effects on the various economic sectors. In making investment decisions, investors must consider economic cycles carefully, specifically to include differences between countries and economies.

1.2 Inflation risk

Investments must be assessed with an eye to inflation and the inflation outlook at any given time. In making an investment decision, investors should consider the estimated real return over a given period of time, deducting inflation from the nominal return. Investors should therefore estimate the real value of their assets with reference to the real return that they can be expected to yield.

1.3 Gearing risk

Borrowing money to invest in financial instruments is risky for investors. Leveraged investments are much more sensitive to changes in the price of the instrument purchased than are investments not purchased with borrowed funds. It is common that the lender demands additional collateral if the value of the financial instruments submitted as collateral declines. Under such circumstances, there is the risk that the pledged financial instruments will be sold at the current market value, which may be disadvantageous to the investor and cause the investor to lose on the investment. Furthermore, movements in the share price of hypothecated financial instruments could have a negative effect on the investor’s ability to pay.

1.4 FX risk

Investments in financial instruments denominated in foreign currency are generally accompanied by foreign exchange risk, as the exchange rate of individual currencies can fluctuate sharply. Adverse exchange rate movements can cause investors to suffer a financial loss. Factors that have an effect on the exchange rate of individual currencies include domestic inflation, the interest rate differential between countries, assessment of the economic development of business and industry, and the political situation.

1.5 Liquidity risk

The value of financial instruments could decline if the market for those instruments becomes illiquid. Under such circumstances, investors could suffer financial losses due to that illiquidity. Investors could also lose money if they are unable to sell financial instruments at a given point in time due to illiquidity caused by the characteristics of the instrument in question or the business practices in the market concerned.

1.6 Legal and political risk

Government action, amendments to laws/rules and court rulings can affect the price of financial instruments. For example, changes to taxation legislation or laws on foreign exchange may have a negative impact on the price of financial instruments.

1.7 Subjective risk

The market price of financial instruments is sensitive to various illdefinable factors. Rumours, news, opinions and sentiment can affect market agents’ conduct and the price of financial instruments. Market prices can fluctuate widely as a result of such subjective factors, irrespective of the fundamentals that determine the value of financial instruments, such as the operations or position of listed companies.

2 Risk from individual types of financial instruments

2.1 Bonds

2.1.1 General

A bond is a written declaration through which the issuer pledges unilaterally and without reservation to pay the owner of the bond a specified amount of money at a predetermined time, at the interest terms specified in the bond. Bonds are instruments subject to claims law; that is, the purchaser of the bond (the lender) has a claim against the issuer (the debtor). Bonds are either issued to the bearer (bearer bonds) or registered to specified owner.

The terms and conditions of bonds are always determined in advance, i.e. interest and repayment of the debt. Interest payments can be fixed, variable or convertible, and bonds can be indexed, non-indexed or linked to other benchmarks. The principal of the debt is either repaid with one lump payment on the maturity date or in instalments on pre-determined due dates.

2.1.2 Characteristics

The primary characteristic of bonds is that their yields are determined by interest payments and by changes in the price of the bond itself, if applicable. Bonds can be short-term (issued for up to 4 years), medium-term (4-8 years), and long-term (more than 8 years). The repayment of bonds takes place on previously agreed due dates, with interest subject to the terms of the loan. It is common that bond interest is linked to market interest rates.

2.1.3 Risks

a) Solvency risk

The issuer may become unable to remit interest payments or repay the loan. The issuer's solvency could change due to events directly related to the issuer's operations or industrial sector. Various other factors may affect the issuer's capacity to honour his obligations, such as general economic developments or changes to legislation. If the issuer's cash flow situation deteriorates, this could make a direct impact on the financial instruments he issues.

b) Interest rate risk

Because of uncertainty about future developments of interest rates, purchasers of fixed-rate bonds take the risk that the price of the bond will drop if interest rates rise. The longer the term of the bond and the lower the interest rate, the more sensitive the bond will be to rises in market interest rates.

c) Prepayment risk

Bonds may include a clause authorising the issuer to repay the amount of the bond under certain circumstances, such as if market interest rates fall. Thus, actual returns could be less advantageous to the investor than the estimated return.

d) Risk attached to redeemable bonds

Bonds may include provisions authorising issuers to redeem the bonds prior to the maturity date under certain circumstances, such as if market interest rates fall. Thus, actual returns could be less advantageous to the investor than the estimated return.

e) Risk attached to specified types of bonds

Additional risk may accompany certain types of bonds, such as floating rate notes, reverse floating rate notes, zero coupon bonds, foreign bonds, convertible bonds, index-linked bonds, subordinated bonds, etc.

Investors should familiarise themselves with the terms and conditions of such bonds and should not purchase the bonds until they have assessed all of the risks accompanying the investment.

As regards subordinated bonds, investors should ask about their rights in comparison with the issuer's other obligations. If the issuer becomes insolvent, bonds of this type are not paid until all higher-priority creditors have been paid.

Convertible bonds entail the risk that investors will not receive full repayment in cash but will only receive shares in the issuer.

2.2 Equities

2.2.1 General

A share of stock is a certificate conferring shareholders' rights in the company concerned. These rights are financial ownership rights provided for by law and in accordance with the relevant company's Articles of Association. As negotiable securities, equities are subject to all of the conventional rules governing such securities, including transferability. Equities are, generally speaking, a riskier investment than bonds. The risk arises in particular from the fact that prices of shares fluctuate more than bond prices. Investments in shares are, however, on average more gainful than investments in bonds as a long-term investment. The return takes two forms: Firstly, there is the change in the value or market price of the shares in question and, secondly, owners of limited-liability companies can expect to receive a dividend on their shareholdings. By diversifying their holdings among several different types of companies, investors can substantially reduce the risk involved in investment in individual companies.

2.2.2 Risks

a) Investment risk

Unlike bondholders, shareholders do not have a claim against the issuer of the securities; that is, the company. Shareholders contribute share capital and thereby acquire a share in the potential profits of the company. The investment is therefore dependent on the company's operations, and the investor risks losing his or her entire investment if the company fails.

b) Risk from share price volatility

Share prices are extremely volatile, and this increases the risk that investors will sustain a financial loss on their investment. Fluctuations in share prices, both short-term and long-term, can be unpredictable.

c) Dividend risk

If the company's operations have been profitable, such profits may form the basis for dividend payments to shareholders, provided certain conditions are met. A decision to pay out dividends is taken at a shareholders' meeting. If the company's operating performance is poor and profits are small or non-existent, dividend payments will decline or even be suspended.

2.3 Derivatives

2.3.1 General

Derivatives are financial instruments whose price changes in accordance with changes in the value of the underlying assets. The underlying asset may, for example, be a financial instrument, an index, an interest rate level, a currency, commodity prices or even another derivative. Below is a summary of the most common derivatives contracts and related risks.

2.3.2 Options

a) Characteristics

Options refer to a contract granting one contracting party, the purchaser, the right but not the obligation to purchase (call option) or sell (put option) a specific asset (the object of an agreement) at a pre-determined price (the option price) at a specific time (closing day) or within a specific length of time (validity period of an option). As compensation for this right, the other contracting party, the seller, receives a certain fee indicating the market price of the option at the beginning of the contract period. All changes in the value of the underlying asset cause proportionally greater changes in the price of the option. The seller of an option is obligated to honour the option contract if the purchaser of the option decides to avail himself of the option.

b) Risks

(i) Market risk

It is possible to trade options on stock exchanges or on an over-the-counter (OTC) basis. Options are subject to the principle of supply and demand. Important aspects of option pricing involve market liquidity and the real or expected developments in the price of the underlying asset. Call options vary directly with the price of the underlying asset, while put options vary inversely with the price of the underlying asset. Options prices are not solely dependent on changes in the price of the underlying asset. Other factors can also affect them, such as the duration of the option contract or the frequency and extent of all changes in the value of the underlying asset. As a result, the option premium could plunge even though the price of the underlying asset does not change.

(ii) Leverage risk

Because of leverage effects, changes in options premiums are generally more pronounced than changes in the price of the underlying asset. Thus, the owner of an options contract could make a large profit on a substantial increase but could likewise incur a large loss. The risk accompanying options purchases increases with the weight of the leverage.

(iii) Risk accompanying options purchases

Options purchases are considered a highly volatile and extremely risky investment. The likelihood that the option will be worthless on the expiration date is relatively large. In that instance, the investor loses his entire investment; that is, the price paid for the option plus the commission.

(iv) Risk accompanying options sales

Selling options is generally riskier than purchasing them. It can be said that, even though the price for the option itself is fixed, the potential loss incurred by the seller is theoretically limitless as the seller of an option is obligated to purchase or sell the underlying asset if the purchaser of the option avails himself of his rights. If the market price of the underlying asset moves in an adverse direction, the seller of the option must change his margin in order to retain the position. If the sold option is an “American-style” option, the seller could even be required to fulfil the contract at any time until it expires. If the option involves a standard forward contract, the seller takes a position on the forward market and must fulfil margin obligations. The seller can minimise risk by maintaining a position in the underlying asset (financial instrument, index, or other asset) corresponding to the sold option.

2.3.3 Standard and non-standard forward contracts

a) Characteristics

A forward contract, or futures, is a standardised and transferable contract obligating the contracting party to purchase or sell a certain asset for a specific price at a predetermined time. The value of futures is often calculated on a daily basis and charges entered to the contracting party accordingly. A forward contract is a non-transferable contract obligating the contracting party to purchase or sell a certain asset for a specific price at a predetermined time. The settlement of such contracts can involve the physical delivery of the underlying asset or a cash settlement. Whether the trade involves the purchase of a standard forward contract or the sale of the underlying asset, the original premium is determined at the time the contract is made. The premium is generally expressed as a percentage of the value of the contract. In general, an investor can settle the contract at any time or can close it before the expiration date, either by selling the contract or by making an offsetting contract. Settlement closes out the position that has been taken, and the accumulated profit or loss is paid out. Parties must fulfil contracts that have not been closed by the settlement date. Contracts whose underlying assets have a tangible value can be fulfilled via physical delivery of the asset. If settlement is carried out via physical delivery, the provisions of the contract must be fulfilled in full, while cash settlement need only involve payment of the difference between the contract price and the market price at the time of payment. Therefore, investors must have a larger amount of capital available for contracts involving physical delivery than for those involving cash settlement.

b) Risks

(i) Changes in the value of the contract or the underlying asset

No matter whether it is the price of a forward contract that increases or the price of the underlying asset, the seller must deliver the underlying asset at the originally agreed price, which may be much lower than the current price. For the seller, the risk is equivalent to the difference between the contractually agreed price and the market price on the settlement date. Because the market price can theoretically increase without limit, the seller's potential loss is also limitless and could far exceed his margin. If the value of the contract or the underlying asset declines, the purchaser in a forward contract must nonetheless receive the asset at the contractually agreed price, which could be much higher than the current market price. For the seller, the risk is equivalent to the difference between the contractually agreed price and the market price on the delivery date. Therefore, the purchaser's maximum loss is the originally agreed price. The loss can far exceed the margin, however. The transaction is marked to market on a regular basis. The investor must have constant access to adequate collateral. If the collateral is insufficient during the duration of a forward contract, the investor may be required to submit additional collateral at short notice. If the investor does not comply, the trade is settled prior to the expiration date.

(ii) Illiquidity

In order to prevent excessive price fluctuations, stock exchanges may set limits for specific contracts. Investors must bear in mind that it could prove very difficult – if not actually impossible, on a temporary basis – to sell a contract under such circumstances; therefore, they should ask about such limits. It will not always be possible (depending on the market and the terms of the trade) to sell contracts at any point in time, in order to avoid or reduce the risk of ongoing trades. If it is possible to execute a stop-loss order, it may be that this is only possible during business hours. Such trades do not limit the loss to a specified amount, but they are carried out as soon as the amount limits are reached.

(iii) Short sale

Selling an asset without owning it at the time the contract is concluded (short sale) entails the risk that the seller will be required to purchase the underlying asset at a disadvantageous price in order to fulfil the contract upon settlement and deliver the asset.

(iv) Special risks accompanying trades with non-standard derivatives

The market for standard trading is usually active and transparent; therefore, it is usually possible to sell such contracts. However, there is no market for non-standard transactions. Hence it is only possible to exit a contract with the consent of the counterparty.

2.3 Swap agreements

a) Characteristics

A swap agreement (swap) is a contract stipulating that each of the contracting parties shall pay the other an amount based on the development of two variables respectively during the period of the contract. More specifically, the contracting parties exchange payments based on the underlying variables, such as interest rates or currencies. The contracting parties agree on the frequency of swaps upon conclusion of the contract.

b) Risks

(i) Interest rate risk

Because of uncertainty about future developments in interest rates, purchasers of fixed-rate bonds take the risk that the price of the bond will drop if interest rates rise. The longer the term of the bond and the lower the interest rate, the more sensitive swap agreements will be to rises in market interest rates. Inflation risk applies to swap agreements related to inflation.

(ii) Exchange rate risk

Exchange rate risk applies to currency swap agreements. Because currency exchange rates are subject to fluctuation, investments in foreign currency are also accompanied by exchange rate risk. Tangible factors affecting currency exchange rates include inflation in the country in question, the interest rate differential between the country in question and other countries, assessments of economic developments, global political conditions, and the security of the investments concerned.

2.4 Collective investment undertakings (CIUs)

2.4.1 General

CIUs and investment funds accept funds from members of the public for collective investment in financial instruments and other liquid assets based on risk diversification in accordance with a pre-determined investment strategy.

2.4.2 Risks

a) General

Investment in funds may be less risky than purchasing individual financial instruments, as each fund spreads the investors' risk by acquiring more than one class of financial instrument. Due to the wider investment authorisations of alternative investment funds than UCITS, it is generally riskier to invest in AIFs than UCITS.

b) Management risk

Because the returns on investments in collective investment funds depends in part on the competence and decision-making of the fund’s managers, wrong decisions can result in a loss.

c) Share price risk

Collective investment funds entail the risk of a drop in share price, with the drop reflecting declines in the price of the financial instruments or currencies that constitute the fund’s portfolio. The more diversified the fund’s assets, the less the risk of loss. However, the risk is greater in more specialised investments, as diversification is less. It is therefore important to consider the general and specific risks accompanying the financial instruments and currencies within the fund’s portfolio. Investors can gather information on funds by reading their prospectuses and key investor information, among other things.