

## DERIVATIVE RISK NOTICE

### Introduction

National Irish Bank considers that it is important for customers engaged in derivative transactions to have a clear understanding of the risks associated with these types of product.

For the purposes of this notice 'derivatives' are over the counter (non exchange traded) products including interest rate swaps, cross currency swaps, options (both interest rate and currency, caps, floors, collars, swaptions and bond options), forward rate agreements, forward foreign exchange contracts and commodity derivatives.

This brief Notice does not disclose all of the risks and other significant aspects of trading in derivatives. It is intended to provide you with guidance and an indication of prudential requirements with respect to derivatives.

### Before Dealing

This notice does not disclose all of the risks and other significant aspects of derivative products. You should not deal in derivatives unless you understand the nature of the contract you are entering into and the extent of your exposure to risk. You should also be satisfied that the contract is suitable for you in the light of your circumstances and financial position. Before dealing in derivatives you should ensure that you understand the following points:-

- ◆ the terms and conditions of the specific derivative product which you are trading and associated obligations.
- ◆ the products characteristics, benefits and risk.
- ◆ your powers under legislation to undertake derivative transactions.
- ◆ your ability to monitor the position.
- ◆ the extent of the risk of loss which you are exposed to as a result of entering into a derivative transaction.
- ◆ the accounting and tax consequences of entering into such derivative products.

### Inherent Risk

Whilst derivative instruments can be utilised for the management of investment risk, some investments are unsuitable for many investors. Different instruments involve different levels of exposure to risk, and in deciding whether to trade in such instruments you should be aware of the following derivative risks:

#### ***Market Risk***

Market risk is the risk of loss arising from adverse changes in the value of a derivative instrument as a result of movements in the underlying market rate.

#### ***Credit Risk***

Credit risk is the risk that a counterparty may fail to meet its contractual payment obligations through insolvency or default. For derivatives, the amount at risk is not the face value of the transaction but the positive fair value or replacement value of the transaction.

### **Liquidity Risk**

Liquidity risk is the risk of losses attributable to a lack of liquidity (i.e. very few market participants) in a particular market. This is usually indicated by wide bid/offer spreads and very few transactions being done in a particular product or market. The risk is that changes in the underlying market price may be infrequent but very large, and that an open position in the market is not able to be effectively hedged.

### **Pricing Risk**

For complex derivative transactions, pricing is completed using various assumptions and mathematical models. Pricing risk is the risk that these models do not accurately reflect conditions in the market, and that this mispricing causes a loss.

### **Operational Risk**

Operational risk is a wide-ranging area of risk. It can cover risks such as, but not limited to, the following:-

- ◆ transactional details are not accurately input into computer systems;
- ◆ computer systems break down;
- ◆ computer files are lost;
- ◆ experienced staff leave the organisation;
- ◆ documentation relating to a transaction is incorrect.

### **Other Considerations**

#### **Commissions**

Before you begin to trade, you should obtain details of all commissions and other charges for which you will be liable. If any charges are not expressed in money terms (but, for example, as a percentage of contract value), you should obtain a clear written explanation, including appropriate examples, to establish what such charges are likely to mean in specific money terms. In the case of futures, when commission is charged as a percentage, it will normally be as a percentage of the total contract value, and not simply as a percentage of your initial payment.

#### **Suspension of trading**

Under certain trading conditions it may be difficult or impossible to liquidate a position. This may occur, for example, at times of rapid price movement if the price rises or falls in one trading session to such an extent that under the rules of the relevant exchange trading is suspended or restricted. Placing a stop-loss order will not necessarily limit your losses to the intended amounts, because market conditions may make it impossible to execute such an order at the stipulated price.

### **Summary**

This brief notice does not disclose all of the risks and other significant aspects of trading in OTC Derivatives.

In light of the risks, you should undertake such transactions only if you understand the nature of the contracts (and contractual relationships) into which you are entering and the extent to your exposure to risk.

You should carefully consider whether trading is appropriate for you in light of your experience, objectives, financial resources and other relevant circumstances.

In our opinion, the following issues applicable to trading in derivatives should be addressed prior to dealing in such instruments:

1. You should establish **an effective policy for the use of derivatives** which is consistent with the strategy, commercial objectives and risk appetite of the underlying business of the organisation.
2. You should establish a **clear written procedures for implementing the derivatives policy** covering such matters as dealing authority, reporting lines, risk limits, counterparty and documentation approvals and valuation procedures and should regularly review their operation and effectiveness.
3. You should ensure that derivative activities are properly supervised and are subject to **an effective framework of internal controls and audits** to ensure that transactions are in compliance with both external regulations and internal policy.
4. You should establish **a sound management function** providing, wherever possible, for an independent framework for reporting, monitoring and controlling all aspects of risk, valuing exposures, assessing performance, imposing monitoring and enforcing position and other limits, stress testing and contingency planning.
5. Procedures should be in place to provide for a **full analysis of all credit risks** to which the organisation will be exposed.
6. Procedures should be in place for the monitoring and **management of legal risk**.

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