Payment intermediation risks

- *Credit risk* is when a participant who is liable to pay a specified amount is unable to do so.
- *Liquidity risk* is when a participant who is liable to pay a specified amount is unable to do so in a suitable form. Funds may be available, but not in the form needed to meet the liability. For example, payment may be stipulated in Deutschmarks but the only funds available are dollars, which cannot be converted into Deutschmarks within the stipulated time.
- *Settlement risk* is a collective term for credit risk and liquidity risk.
- *Systemic risk* is when default by one participant produces a chain reaction among the others, preventing the completion of settlements. Two main methods are used to reduce systemic risk: *Collective responsibility* among all system participants for a default on the part of one participant, whose net debit is then shared out according to specified rules. However, this arrangement may lead to defaults by other participants. *Unwinding*, which may conceivably lead to defaults by other participants who expected the delivery of substantial funds from the defaulting party.
- *Gridlock* mainly occurs in real time gross settlement systems where insufficient credit is available. It occurs when participants expecting payments make payments of their own, in the faith that the expected payment will be delivered before their own accounts are debited. If the payment order is refused or queued, this can produce a chain reaction in which all participants are left waiting for the others. Since this is not a default, unlike systemic risk, the gridlock can be unblocked with temporary measures, e.g. technical netting of the queue.
- *Moral hazard* is a false sense of security among participants, whereby the general market has an unfounded faith that, for example, the central bank or state will come to the system's rescue in the event of any trouble. The risk is that participants acting in such faith will make decisions in order to take advantage of the situation.
- *Technical risk* is when a technical failure leads to substantial disruption of the payment flow and/or settlements. Technical risk can also lead to lack of confidence in the system as such and uncertainty regarding its finality and efficiency.
- *Herstatt risk* is named after the German bank Bankhaus Herstatt, which was closed at short notice in 1974. This is a form of credit risk, whereby delivery and payment do not take place simultaneously and one party to the transaction can cancel either delivery or payment. This risk occurs mainly in foreign exchange trading.