Box 1 Types of foreign exchange transaction risk[1]

Credit risk/exposure: the risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter.

Replacement risk/replacement cost risk: the risk that a counterparty to an outstanding transaction for completion at a future date will fail to perform on the settlement date. This failure may leave the solvent party with an unhedged or open market position or deny the solvent party unrealised gains on the position. The resulting exposure is the cost of replacing, at current market prices, the original transaction.

Systemic risk: the risk that the failure of one participant in a transfer system, or in financial markets generally, to meet its required obligations when due will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of financial markets and confidence in the market.

Legal risk: the risk that a counterparty will incur damage because laws or regulations are inconsistent with the rules of the settlement system, settlement arrangements or other interests entrusted to the settlement system. Legal risk is also created by unclear or unsystematic application of laws and regulations.

Liquidity risk: the risk that a counterparty (or participant in a settlement system) will not settle an obligation for full value when due. Liquidity risk does not imply that a counterparty or participant is insolvent since it may be able to settle the required debit obligations at some time thereafter.

Market risk: the risk that an institution or other trader will experience a loss on a trade owing to an unfavourable exchange rate movement.

Foreign exchange settlement exposure: the amount at risk when a foreign exchange transaction is settled. This equals the full amount of the currency purchased and lasts from the time that a payment instruction for the currency sold can no longer be cancelled unilaterally until the time the currency purchased is received with finality.

Operational risk: the risk of incurring interest charges or other penalties for misdirecting or otherwise failing to make settlement payments on time owing to an error or technical failure.

Foreign exchange settlement risk: the risk that one party to a foreign exchange transaction will pay the currency it sold but not receive the currency it bought. This is also called *cross-currency settlement risk* or *principal risk*; it is also referred to as *Herstatt risk*.

1. See CPSS (1996), pp. 63-65.