



# The Institute of International Payments

## Risk Management

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# Agenda

- Risk Management Overview and Framework
- Payments Risk
- Risk Management Policy
- Q&A

# **Risk Management Overview and Framework**

# What is risk?

Risk \Risk\, n. [F. risque; cf. It. risico, risico, rischio, Pg. risco, Sp. riesgo, and also Sp. risco a steep rock; all probably fr. L. resceare to cut off; pref. re- re- + secare to cut; -- the word having been probably first used among sailors. See {Section}.] 1. ... **exposure to loss, injury, or destruction.** [1913 Webster]

# Risk Management

**Risk Management** is the process of measuring, or assessing risk and developing strategies to manage it. [Wikipedia]

# The Risk Management Process

- Determine scope and objectives
- Identify the risk
- Assess the risk
- Determine approach
- Develop the plan
- Implement
- Measure results
- Review and modify as necessary

# Risk Management Strategies

- Avoidance
- Reduction (mitigation)
- Retention
- Transfer

# Traditional Payments Risk

- Credit Risk
- Operating Risk
- Fraud Risk
- Systemic Risk

# International Payments Risk

- Credit Risk
- Operating Risk
- Fraud Risk
- Systemic Risk
- FX Risk
- Sovereign Risk

# **Risk Management**

**Credit risk** is risk due to uncertainty in a counterparty's (also called an **obligor's** or **credit's**) ability to meet its obligations.  
[riskglossary.com]

- Probability of default
- Total exposure
- Recovery potential

# Sovereign Risk

**Sovereign risk** is the risk of interference in the settlement or payment of a foreign transaction by a foreign government.

This may include:

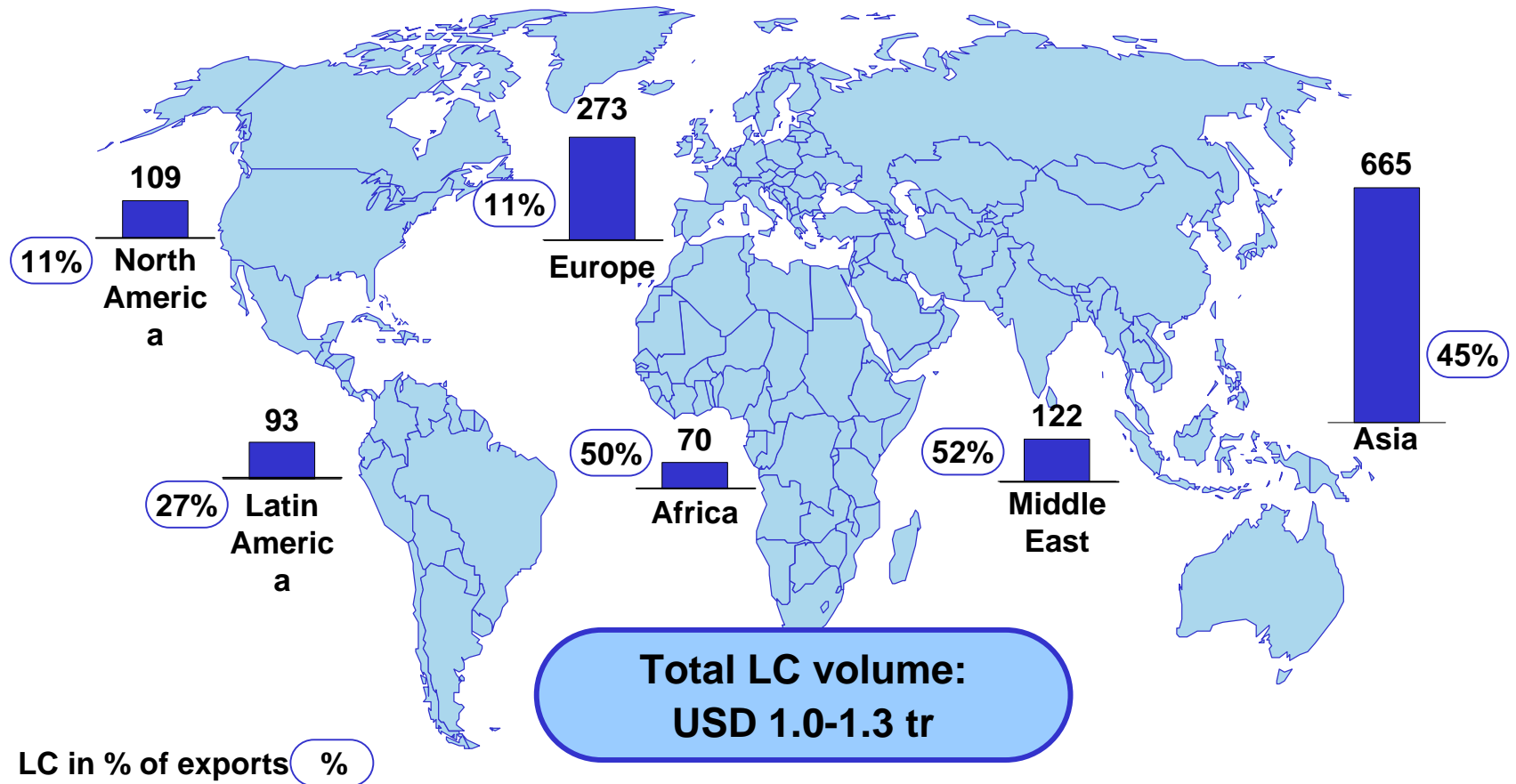
- Imposition or alteration of foreign exchange controls,
- Government default on loan guarantees,
- Nationalization of financial or other assets,

# International Credit Tools

- Documentary Collection
- Letters of Credit (L/Cs)
- Bankers Acceptance (BAs)
- Countertrade
- Forfaiting
- Foreign Credit Insurance

# Global LC Volume

Regions: Global trade handled by LCs [USD bn] – Approximation



Source: WTO, SITPRO LC Report 2003, Roland Berger 2003

# Credit Risk Insurance

- Export Credit Agencies (ECAs)
  - Export-Import Bank of the United States (ExIm Bank)
  - Export Credits Guarantee Department (ECGD, UK)
  - Organization for Economic Cooperation & Development (OECD)
- Insurance Groups
  - Foreign Credit Insurance Association

# Systemic Risk

**Systemic risk** is the risk that the inability or unwillingness of one participant in a clearing and settlement system to settle its commitments will cause other participants in the system to be unable to settle their commitments.

Operational risk adds an additional component in terms of the ability of the payment system itself to execute transactions in a timely fashion.

# BIS Core Principles

## Core principles for systemically important payment systems

- I. The system should have a well-founded legal basis under all relevant jurisdictions.
- II. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
- III. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.
- IV.\* The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.
- V.\* A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
- VI. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk.
- VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.
- VIII. The system should provide a means of making payments which is practical for its users and efficient for the economy.
- IX. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
- X. The system's governance arrangements should be effective, accountable and transparent.

**FX Risk is** 1. The risk of an investment's value changing due to changes in currency exchange rates. 2. The risk that an investor will have to close out a long or short position in a foreign currency at a loss due to an adverse movement in exchange rates. Also known as "currency risk" or "exchange-rate risk". [Investopedia]

**Transaction exposure** is the risk that currency exchange rates will change after you have already entered into a financial obligation, e.g. accepted a purchase order.

**Translation exposure** occurs when your non US\$ assets and liabilities are not equal.

# FX Risk Tools

- Leading and lagging
- Balance sheet management
- Internal Hedging
- Forward Contracts
- Options
- Centralized Treasury/Internal Bank
- Multilateral netting

***Don't forget the tax implications!***

# **Risk Management Policy**

# Elements of an FX risk policy

- Policy statement
- Priorities
- Scope
- Permitted strategies and instruments
- Performance measurement criteria
- Responsibilities and authorities
- Reporting requirements
- Management oversight

# Key points

- Policy must be written
- Reviewed on a regular basis
- Centralize trading and risk management
- Measure and report performance
- Hire qualified people

# Questions?



# For further information:

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