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CREDIT RISK RESULTING FROM BANK GUARANTEES – DEVELOPMENT OF A RISK ADJUSTED PRICING

Abstract: *This paper focuses on the credit risk of bank guarantees from the perspective of banks. Bank guarantees represent a specific type of credit instruments. Issuance of a bank guarantee means a potential asset for a bank. So, the bank guarantees are treated as an off-balance sheet transaction. After the agreed event occurs, the potential receivable becomes a real receivable – a balance sheet asset. As the bank guarantee is a credit instrument, it is joined with a credit risk. The bank faces the risk that the customer will not meet his obligations (default). This fact can lead to negative impact on banking business and so it is important to pay sufficient attention to this risk and implement an effective risk management. The level of the credit risk is determined by the quality of the customer's business or the bonity of the customer. The goal of the paper is to calculate the credit risk of bank guarantees given by the banks. The calculation is based on the classical spread analysis (as done in [8] pp. 17) and the migration matrix of S&P. The first part of the paper contains the definition of the bank guarantees and their characteristic features. The next part is devoted to the credit risk resulting from bank guarantees. There is stated a basic formula of the risk premium and the method for calculation of the costs of guarantee. After that, the calculation of the credit risk is done. A final conclusion sums up the main results of the article.*

Keywords: *bank guarantee, credit risk, risk premium, risk adjusted pricing, spread*

JEL : G 21, G 24, G 32

1 Introduction

The business environment is associated with a wide range of risks which market participants must face. One of the most important risks is the counterparty's default. To eliminate this risk, the contractual subjects can arrange a bank guarantee. Bank guarantees are an effective instrument for risk management, especially in the field of the international trade. The risk can be substantially decreased.