Funding Valuation Adjustment
Funding Valuation Adjustment Introduction

- Funding valuation adjustment is introduced to capture the incremental costs of funding uncollateralized derivatives.
- Funding valuation adjustment is the difference between the rate paid for the collateral to the bank’s treasury and rate paid by the clearinghouse.
- Funding valuation adjustment can be thought of as a hedging cost or benefit arising from the mismatch between an uncollateralized derivative and a collateralized hedge in the interdealer market.
Master Agreement

- Master agreement is a document agreed between two parties, which applies to all transactions between them.
- Close out and netting agreement is part of the Master Agreement.
- If two trades can be netted, the credit exposure is
  \[ E(t) = \max(V_1(t) + V_2(t), 0) \]
- If two trade cannot be netted (called non-netting), the credit exposure is
  \[ E(t) = \max(V_1(t), 0) + \max(V_2(t), 0) \]
CSA Agreement

- Credit Support Annex (CSA) or Margin Agreement or Collateral Agreement is a legal document that regulates collateral posting.
- Trades under a CSA should be also under a netting agreement, but not vice versa.
- It defines a variety of terms related to collateral posting.
  - Threshold
  - Minimum transfer amount (MTA)
  - Independent amount (or initial margin or haircut)
Risk Neutral Simulation: Interest Rate and FX

◆ Recommended 1-factor model: Hull-White

\[ dr_t = \left( \theta_t - \alpha r_t \right) dt + \sigma_t dW_t \]

◆ Recommended multi-factor model: 2-factor Hull-White or Libor Market Model (LMM)

◆ All curve simulations should be brought into a common measure.
  ◆ Simulate interest rate curves in different currencies.
  ◆ Change measure from the risk neutral measure of a quoted currency to the risk neutral measure of the base currency.

◆ Forward FX rate can be derived using interest rate parity

\[ F = S_0 \exp \left( r_s - r_q \right) t \]
Risk Neutral Simulation: Equity Price

- Geometric Brownian Motion (GBM)
  \[
  \frac{dr}{r} = \mu dt + \sigma dw
  \]

- Pros
  - Simple
  - Non-negative stock price

- Cons
  - Simulated values could be extremely large for a longer horizon.
Risk Neutral Simulation: Commodity Price

- Simulate commodity spot, future and forward prices as well as pipeline spreads
- Two factor model

\[
\begin{align*}
\log(S_t) &= q_t + X_t + Y_t \\
\text{d}X_t &= (\alpha_1 - \gamma_1 X_t)\text{d}t + \sigma_1 \text{d}W^1_t \\
\text{d}Y_t &= (\alpha_2 - \gamma_2 Y_t)\text{d}t + \sigma_2 \text{d}W^2_t \\
\text{d}W^1_t \text{d}W^2_t &= \rho \text{d}t
\end{align*}
\]

where $S_t$ is the spot price or spread; $q_t$ is the deterministic function; $X_t$ is the short term deviation and $Y_t$ is the long term equilibrium level

- This model leads to a closed form solution of forward prices and thus forward term structure.
Risk Neutral Simulation: Volatility

- In the risk neutral world, the volatility is embedded in the price simulation.
- Thus, there is no need to simulate implied volatilities.
Credit Exposure Approach Implementation

◆ Obtain the risk-free value $V_f(t)$ of a counterparty portfolio that should be reported by trading systems.
◆ The solution is based on the existing credit exposure framework.
◆ Switch simulation from the real-world measure to the risk neutral measure.
◆ Calculate discounted risk-neutral credit exposures (EEs) and take master agreement and CSA into account.
◆ One can directly compute CVA using the following formula

$$CVA = (1 - R) \sum_{k=1}^{N} [PD(t_k) - PD(t_{k-1})] EE^*(t)$$
Credit Exposure Approach Implementation (Cont’d)

◆ Or one can compute the risky value $V_r(t)$ of the portfolio via discounting positive EEs by counterparty’s CDS spread + risk-free interest rate as the positive EEs bearing counterparty risk and negative EEs by the bank’s own CDS spread + risk-free interest rate as the negative EEs bearing the bank’s credit risk.

$$CVA = V_f(t) - V_r(t)$$

◆ Furthermore, you can compute the funding value $V_F(t)$ of the portfolio via discounting positive EEs by counterparty’s bond spread + risk-free interest rate and negative EEs by the bank’s own bond spread + risk-free interest rate.

$$FVA = V_f(t) - V_F(t) - CVA = V_r - V_F$$
Least Square Monte Carlo Approach Implementation

- Obtain the risk-free value $V_f(t)$ of a counterparty portfolio that should be reported by trading systems.
- Simulate market risk factors in the risk-neutral measure.
- Generate payoffs for all trades based on Monte Carlo simulation.
- Aggregate payoffs based on the Master agreement and CSA.
- Compute the risky value $V_r(t)$ of the portfolio using Longstaff-Schwartz approach.
LSMC Approach Implementation (Cont’d)

- Positive cash flows should be discounted by counterparty’s CDS spread + risk-free interest rate while negative cash flows should be discounted by the bank’s own CDS spread + risk-free interest rate.

\[ CVA = V_f(t) - V_r(t) \]

- Moreover, you can compute the funding value \( V_F(t) \) of the portfolio using Longstaff-Schwartz approach as well.

- Positive cash flows should be discounted by counterparty’s bond spread + risk-free interest rate while negative cash flows should be discounted by the bank’s own bond spread + risk-free interest rate.

\[ FVA = V_f(t) - V_F(t) - CVA = V_r - V_F \]