 tcj@illinois.edu

Questions about DVA

You work in the Chief Investment Office (CIO) of a medium sized U.S. commercial bank that is active in derivatives markets. The Board of Directors has recently determined that the bank will recognize debit-value adjustments (DVA) on its financial statements. The Board has not, however, made a decision about whether or not the bank should hedge fluctuations in the DVA. It has left that decision to the bank's Risk Management Committee, which reports to the CIO. You have been asked to draft a report to the Committee on this subject.

In particular, your report should address the following issues:

- **Question 1.** Explain what DVA is and how it should DVA be computed for a derivatives position like a currency swap. What information is needed? What assumptions are required to perform the calculation? Illustrate with some simple exampls.

- **Question 2.1** Most of the bank's liabilities are either (i) customer deposits or (ii) wholesale funding via bond issuance. How should DVA be computed for these?

- **Question 2.2** When considering the bank's derivatives positions, some of them are cleared through a CCP, and some other non-cleared trades are subject to margining by third-party custodial banks. If these positions are not subject to default risk, is their DVA zero?

- **Question 3.** Suppose the Risk Committee determines that it does want to hedge DVA exposure. What are the possible ways it could choose to implement this hedge? Which ones would you recommend. Why?

- **Question 4.** What are the arguments for and against hedging that DVA exposure? Does it matter that the bank already hedges it CVA exposure? Do you recommend hedging or not?

In preparing your report, you will want to read the articles from *Derivatives Week* and *Risk* and the reports from *Ernst & Young* and *SunGard* that are on the Compass site. Be sure to appropriately cite the source of any information that your report utilizes.