Funding Value Adjustments∗

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Abstract

We demonstrate that large funding value adjustments (FVAs) being made by derivatives dealers to the disclosed valuations of their swap books are not consistent with any coherent notion of fair market value. Essentially the same funding cost adjustment is a reduction in the dealer’s equity value. This reduction in equity value is exactly offset by the sum of an upward adjustment to a dealer’s debt valuation (as a wealth transfer from shareholders) and a change in the present value of the dealer’s financial distress costs. While others have already suggested that FVA accounting suffers from coherence problems, this paper is the first to identify and characterize these problems in the context of a full structural model of a dealer’s balance sheet. In addition to giving an appropriate theoretical foundation for funding value adjustments, our model shows how dealers’ bid and ask quotes should be adjusted so as to compensate shareholders for the impact of both funding costs and the dealer’s own default risk. We also establish a pecking order for preferred swap financing strategies, characterize the valuation effects of initial margin financing (known as “MVA”), and provide a new interpretation of the standard debit value adjustment (DVA).

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