Central Clearing Valuation Adjustment

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Central clearing is becoming mandatory for a vast majority of products.

Variation and initial margins versus mutualized default fund.
Supposed to eliminate counterparty risk, but at the cost for members of funding all the margins.

In this work we study the cost of the clearance framework for a member of a clearinghouse.

CCVA central clearing valuation adjustment.
Outline

1. Clearinghouse Setup
2. Central Clearing Valuation Adjustment (CCVA)
3. Bilateral Valuation Adjustment (BVA)
4. Numerical Results
We model a service of a clearinghouse dedicated to proprietary trading (typically on a given market) between its members, labeled by $i \in N = \{0, \ldots, n\}$.

The portfolio of any member is assumed fixed (unless it defaults).

In practice, transactions with defaulted members are typically reallocated through a gradual liquidation of assets in the market (see Avellaneda and Cont (2013)) and/or through auctions among the surviving members for the residual assets at the end of the liquidation period.

For ease of analysis in this work, we simply assume the existence of a risk-free buffer that is used by the clearinghouse for replacing defaulted members in their transactions with others after a period of length $\delta$. 
Member $i$’s Portfolio Mark-to-Market Pricing Formula

\[ \beta_t P^i_t = \mathbb{E}_t \left( \int_t^{\bar{T}} \beta_s dD^i_s \right), \quad t \in [0, \bar{T}] \]

\[ \beta_t = e^{-\int_0^t r_s ds} \]

- risk-neutral discount factor at the OIS rate process $r_t$
- the best market proxy for a risk-free rate
- reference rate for the remuneration of the collateral

$D^i$ contractual dividends
- viewed from the perspective of the clearinghouse
- $+1$ means 1 paid by the member $i$

$\bar{T}$ a time horizon relevant for the clearinghouse
- if there is some residual value in the portfolio at that time, it is treated as a terminal dividend ($D^i_{\bar{T}} - D^i_{\bar{T}-}$)

But, ignored by the above mark-to-market pricing formula, any member $i$ is defaultable, with default time $\tau_i$ and survival indicator process $J^i = 1_{[0, \tau_i)}$
Breaches

- For every time $t \geq 0$, let $t^\delta = t + \delta$ and let $\hat{t}$ denote the greatest $lh \leq t$.
- For each member $i$, we write
  \[ C^i = VM^i + IM^i + DF^i \]
  \[ Q^i_t = P^i_t + \Delta^i_t \text{ with } \Delta^i_t = \int_{[\tau_i, t]} e^{\int_s^t r_udu} dD^i_s, \quad \chi_i = (Q^i_{\tau^\delta_i} - C^i_{\tau^\delta_i})^+, \]
  \[ \xi_i = (1 - R_i)\chi_i \text{ where } R_i \text{ denotes a related recovery rate} \]

- $R_i = 0$ modulo DVA / DVA2 issues
For $Z \subseteq N$, let $\tau_Z \in \mathbb{R}^+ \cup \{\infty\}$ denote the time of joint default of names in $Z$ and only in $Z$.

Joint defaults, which can be viewed as a form of “instantaneous contagion”, is the way we will model credit dependence between members.

**Lemma**

At each liquidation time $t = \tau^\delta_Z = \tau_Z + \delta$ such that $\tau_Z < \bar{T}$, the realized breach for the clearinghouse (residual cost after the margins of the defaulted members have been used) is given by

$$B_t = \sum_{i \in Z} \xi_i$$
Equity and Unfunded Default Fund

- **Equity (skin-in-the-game of the CCP)** \( E_{tY} = E_{tY}^* \) and, at each \( t = \tau_Z^\delta \) with \( \tau_Z < \bar{T} \),

\[
\Delta E_t = -(B_t \wedge E_{t-}).
\]

- As in a senior CDO tranche, the part of the realized breach left uncovered by the equity, \( (B_t - E_{t-})^+ \), is covered by the surviving members through the default fund, which they have to refill by the following rule, at each \( t = \tau_Z^\delta \) with \( \tau_Z < \bar{T} \):

\[
\epsilon^i_t = (B_t - E_{t-})^+ \frac{J^i_t DF^i_t}{\sum_{j \in N} J^j_t DF^j_t} \quad \text{proportional to their default fund margins}
\]

- or other keys of repartition such as initial margins, sizes of the positions, expected shortfall allocation (see Armenti, Crépey, Drapeau, and Papapantoleon (2015)), ...

\[
(B_t - E_{t-})^+ = \sum_{i; J^i_t=1} \epsilon^i_t
\]
Outline

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3. Bilateral Valuation Adjustment (BVA)
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We refer to the member 0 as “the member” henceforth, the other members being collectively referred to as “the clearinghouse”.

For notational simplicity, we remove any index 0 referring to the member.

For the member, the effective time horizon of the problem is

\[ \bar{T}^\delta = \mathbb{1}_{\tau < \bar{T}} \bar{T}^\delta + \mathbb{1}_{\tau \geq \bar{T}} \bar{T} \]

We assume that

- variation margins are remunerated at a flat OENIA rate \( r_t \)
- initial margins and default fund contributions are remunerated at the rate \( (r_t + c_t) \) with \( c_t < 0 \), e.g. \( c_t = -20 \) bp
- the member can invest (respectively get unsecured funding) at a rate \( (r_t + \lambda_t) \) (respectively \( (r_t + \bar{\lambda}_t) \))
Following Green, Kenyon, and Dennis (2014), we model the cost of the regulatory capital required for being part of the clearinghouse as $k_t K_t dt$

- $K_t$ is the CCP regulatory capital of the member,
- $k_t$ is a proportional hurdle rate
Marshall-Olkin Model of Default Times

- We model credit dependence between members through joint defaults
  - “Instantaneous contagion”
- Marshall-Olkin copula model of the default times $\tau_i, i \in N$
- Define a family $\mathcal{Y}$ of shocks, i.e. subsets $Y \subseteq N$ of obligors, usually consisting of the singletons $\{0\}, \{1\}, \ldots, \{n\}$ and a few common shocks representing simultaneous defaults
- Define, for $Y \in \mathcal{Y}$, independent $\gamma_Y$ exponential random variables $\epsilon_Y$
- Set, for each $i$,

$$\tau_i = \bigwedge_{Y \in \mathcal{Y}; Y \ni i} \eta_Y$$
Example: \( n = 5 \) and
\[
\mathcal{Y} = \{\{0\}, \{1\}, \{2\}, \{3\}, \{4\}, \{3, 4\}, \{1, 2, 3\}, \{0, 1\}\}.
\]

\[ \rightarrow \] Pre-default intensity of the member: 
\[
\gamma_\bullet = \sum_{\mathcal{Y} \in \mathcal{Y}_\bullet} \gamma_\mathcal{Y}, \text{ where } \mathcal{Y}_\bullet = \{ \mathcal{Y} \in \mathcal{Y}; 0 \in \mathcal{Y} \}. 
\]
Clearinghouse Setup
Central Clearing Valuation Adjustment (CCVA)
Bilateral Valuation Adjustment (BVA)
Numerical Results
References

CCVA Formula

Theorem

*First order, linearized CCVA at time 0:*

\[
\hat{\Theta}_0 = \mathbb{E}\left[ \sum_{0<\tau^\delta<\bar{\tau}} \beta_{\tau^\delta} \epsilon_{\tau^\delta} + \int_0^{\bar{\tau}} \beta_s \hat{f}_s(0) ds \right] = \mathbb{E} \sum_{0<\tau^\delta<\bar{\tau}} \beta_{\tau^\delta} \epsilon_{\tau^\delta} + \mathbb{E} \int_0^{\bar{\tau}} \beta_s dva_s ds
\]

\[
+ \mathbb{E} \int_0^{\bar{\tau}} \beta_s \left( -c_s (C_s - P_{\bar{s}-}) + \tilde{\lambda}_s (P_s - C_s)^- - \lambda_s (P_s - C_s)^+ \right) ds + \mathbb{E} \int_0^{\bar{\tau}} \beta_s k_s K_s ds,
\]

where

- \(dva = -\gamma \hat{\xi}\), where \(\hat{\xi}\) is a predictable process such that
  \(\hat{\xi}_\tau = \mathbb{E}(\beta_{\tau}^{-1} \beta_{\tau^\delta} \xi | G_{\tau-})\), with \(\xi = (1 - R)(Q_{\tau^\delta} - C_\tau)^+\), so that the DVA can be ignored by setting \(R = 1\).
- \(\tilde{\lambda} = \lambda - (1 - \bar{R}) \gamma\bullet\), in which the DVA2 can be ignored by setting \(\bar{R} = 1\).
For numerical purposes, we use the following randomized version of the theorem:

**Corollary**

*Given an independent $\mu$-exponential time $\zeta$,*

$$
\hat{\Theta}_0 = \mathbb{E}\left\{ \sum_{0 < \tau^{\delta}_Z < \bar{\tau}} \beta_{\tau^{\delta}_Z} e_{\tau^{\delta}_Z} + 1_{\{\zeta < \bar{\tau}\}} \frac{e^{\mu \zeta}}{\mu} \beta_{\zeta} \tilde{f}_{\zeta}(0) \right\}
$$

$$
= \mathbb{E}\left\{ \sum_{0 < \tau^{\delta}_Z < \bar{\tau}} \beta_{\tau^{\delta}_Z} e_{\tau^{\delta}_Z} + 1_{\{\zeta < \bar{\tau}\}} \frac{e^{\mu \zeta}}{\mu} \times \left[ - \beta_{\zeta} \gamma \cdot (1 - R)(Q_{\zeta^{\delta}} - C_{\zeta})^+ 
+ \beta_{\zeta} \left( - c_{\zeta}(C_{\zeta} - P_{\zeta_-}) + \lambda_{\zeta}(P_{\zeta} - C_{\zeta})^- - \lambda_{\zeta}(P_{\zeta} - C_{\zeta})^+ + k_{\zeta} K_{\zeta} \right) \right] \right\}.
$$
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Bilateral trading (CSA) setup between a bank, say the member, labeled 0, in the above CCVA setup, and a counterparty, say another member \( i \neq 0 \)
Let $VM$ denote the variation margin, where $VM \geq 0$ (resp. $\leq 0$) means collateral posted by the bank and received by the counterparty (resp. posted by the counterparty and received by the bank).

Let $IM^b \geq 0$ (resp. $IM^c \leq 0$) represent the initial margin posted by the bank (resp. the negative of the initial margin posted by the counterparty).

\[ C^b = VM + IM^b \quad \text{and} \quad C^c = VM + IM^c \]

represent respectively the collateral guarantee for the counterparty and the negative of the collateral guarantee for the bank.

Assuming all the margins re-hypothecable in the bilateral setup, the collateral funded by the bank is $C = VM + IM^b + IM^c$. 
### BVA Formula

**Theorem (Crépey and Song (2015))**

*First order, linearized BVA at time 0:*

\[
\tilde{\Theta}_0 = \mathbb{E} \left[ \int_0^{\tilde{\tau}} \beta_s \tilde{f}_s(0) \, ds \right] = \mathbb{E} \int_0^{\tilde{\tau}} \beta_s \text{cdva}_s \, ds + \text{CDVA} \\
+ \mathbb{E} \int_0^{\tilde{\tau}} \beta_s \left( -c_s(C_s - \tilde{P}_{s^-}) + \tilde{\lambda}_s (P_s - C_s)^- - \lambda_s (P_s - C_s)^+ \right) \, ds + \mathbb{E} \int_0^{\tilde{\tau}} \beta_s k_s K_s \, ds \text{ KVA}
\]

- \( P \) means the mark-to-market of the position of the member with the counterparty \( i \) (viewed from the perspective of the latter),
- the meaning of \( \beta, c, \lambda, \tilde{\lambda}, k \) and \( K \) is as in the CCVA setup, but “\( c = 0 \)” and the formula for the regulatory capital \( K \) is different,
- \( \tilde{\tau} = \tau_b \wedge \tau_c \) is the first-to-default time of the bank and its counterparty (as opposed to the default time of the member previously)
Clearinghouse Setup
Central Clearing Valuation Adjustment (CCVA)
Bilateral Valuation Adjustment (BVA)
Numerical Results
References

- $cdva = \gamma \hat{\xi}$, where $\hat{\xi}$ is a predictable process such that
  
  \[ \hat{\xi}_\tau = E(\beta_\tau^{-1} \beta_\tau \delta \xi \mid G_\tau^-), \]

  with

  \[ \xi = 1_{\{\tau_c \leq \tau_\delta\}}(1 - R_c)(Q_\tau - C^c_\tau)^- - 1_{\{\tau_b \leq \tau_\delta\}}(1 - R_b)(Q_\tau - C^b_\tau)^+, \]

  in which the recovery rates $R_c$ of the counterparty to the bank and $R_b$ of the bank to the counterparty are usually taken as 40%.

For numerical purposes, we use the following randomized version of this theorem, with $\mathcal{Y}_b = \{Y \in \mathcal{Y}; 0 \in \mathcal{Y}\}$, $\mathcal{Y}_c = \{Y \in \mathcal{Y}; i \in \mathcal{Y}\}$.

**Corollary**

Given an independent $\mu$-exponential time $\zeta$,

\[
\tilde{\Theta}_0 = E\left\{ 1_{\{\zeta < \bar{\tau}\}} \frac{e^{\mu \zeta}}{\mu} \beta_\zeta \bar{f}_\zeta(0) \right\} 
\]

\[
= E\left\{ 1_{\{\zeta < \bar{\tau}\}} \frac{e^{\mu \zeta}}{\mu} \left[ \beta_\zeta \delta \left( \sum_{Y \in \mathcal{Y}_c} \gamma_Y + 1_{\{\tau_c \leq \zeta \delta\}} \sum_{Y \in \mathcal{Y}_b \setminus \mathcal{Y}_c} \gamma_Y \right) (1 - R_c)(Q_\zeta - C^c_\zeta)^- 
  - \left( \sum_{Y \in \mathcal{Y}_b} \gamma_Y + 1_{\{\tau_b \leq \zeta \delta\}} \sum_{Y \in \mathcal{Y}_c \setminus \mathcal{Y}_b} \gamma_Y \right) (1 - R_b)(Q_\zeta - C^b_\zeta)^+ \right) 
  + \beta_\zeta \left( - c_\zeta (C_\zeta - P_\zeta^-) + \lambda_\zeta (P_\zeta - C_\zeta)^- - \lambda_\zeta (P_\zeta - C_\zeta)^+ + k_\zeta K_\zeta \right) \right]\right\}. 
\]
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3. Bilateral Valuation Adjustment (BVA)
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- Black-Scholes stock $S$ with historical drift $\mu$ and volatility $\sigma$,
- Asset swap with cash-flows $\frac{1}{4} (S_{T_{l-1}} - K)$ at increasing quarters $T_l$, $l = 1, \ldots, d$

- Notional for this swap such that the time-0 value of each leg of the swap is €1 (y axis in % above)
We consider a subset of nine representative members of the CDX index, with CDS spreads (average 3 year and 5 year bp spread) shown in increasing order in the first row of the following table.

(Top) Average 3 and 5 year CDS spreads for a representative subset of nine members of the CDX index as of 17 December 2007.
(Bottom) Coefficients $\alpha_i$ summing up to 0 used for determining the positions in the swap of the nine members.

<table>
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<tr>
<th>$\Sigma$</th>
<th>45</th>
<th>52</th>
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<th>61</th>
<th>73</th>
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<td>$\alpha$</td>
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</table>

The role of the reference member 0 will be played alternately by each of the nine members in the above table, for positions in the swap determined by the coefficients $\alpha_i$ summing up to zero through the rule $\omega_i = -\frac{\alpha_i}{\alpha_0}$.
We compare two trading setups:
- A bilateral CSA setup where the member 0 trades a long $\omega_i \in \mathbb{R}$ swap units position separately with each member $i \neq 0$
- A CCP setup where each member $i \in N$ trades a short $\omega_i \in \mathbb{R}$ swap units position through the CCP

In each considered case, the reference member 0 has an aggregated long one unit net position in the swap, and a gross position (compression factor)

$$\nu_0 = \sum_{i \neq 0} |\omega_i^{csa}| = \sum_{i \neq 0} \frac{|\alpha_i|}{|\alpha_0|} = \frac{\sum_{i \in N} |\alpha_i|}{|\alpha_0|} - 1,$$

so the smaller $|\alpha_0|$, the bigger the compression factor $\nu_0$. 
In the **CCP** setup, $IM^i$ (resp. $IM^i + DF^i$) set as the value at risk of level $a_{im}$ (resp. $a_m$) of the variation-marginned $P&L^i$.

In the **CSA** setup, initial margin $IM^i$ set as the value at risk of level $a'_{im} = a_m$ of the variation-marginned $P&L^i$.

In both setups a value at risk of level $a_{ead} > a'_{im} = a_m$ is used for computing the exposure at defaults in the regulatory capital formulas.
### Netting Benefit

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### References

- Numerical Results
- Clearinghouse Setup
- Central Clearing Valuation Adjustment (CCVA)
- Bilateral Valuation Adjustment (BVA)
## Impact of the Credit Spread of the Reference Member

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<td>176</td>
<td>367</td>
<td>1053</td>
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<td>3.27 (0.50)</td>
<td>3.05 (0.61)</td>
<td>3.17 (0.67)</td>
<td>2.84 (0.68)</td>
<td>3.26 (0.80)</td>
<td>2.82 (1.20)</td>
<td>3.23 (1.88)</td>
<td>2.37 (4.04)</td>
<td>1.33 (9.80)</td>
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<tr>
<td>9.64 (0.39)</td>
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<td>9.63</td>
<td>9.40</td>
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<td>10.25</td>
<td>11.22</td>
<td>12.59</td>
<td>17.01</td>
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<tr>
<td>8.67 (0.55)</td>
<td>8.24 (0.64)</td>
<td>8.29 (0.70)</td>
<td>8.84 (0.74)</td>
<td>7.38 (0.88)</td>
<td>7.12 (1.29)</td>
<td>5.18 (2.05)</td>
<td>5.02 (4.18)</td>
<td>2.48 (10.06)</td>
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<td>3.68</td>
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<td>4.50</td>
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<td>7.04</td>
<td>10.66</td>
<td>20.83</td>
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<td>0.19</td>
<td>0.19</td>
<td>0.18</td>
<td>0.14</td>
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<td>12.54</td>
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<td>12.88</td>
<td>13.54</td>
<td>12.73</td>
<td>14.34</td>
<td>16.03</td>
<td>26.02</td>
<td>49.37</td>
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</tbody>
</table>
### Impact of the liquidation period

<table>
<thead>
<tr>
<th>Member</th>
<th>61 bps, $\nu_0 = 53.00$</th>
<th>367 bps, $\nu_0 = 5.14$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\delta$</td>
<td>5d</td>
<td>15d</td>
</tr>
<tr>
<td>CVA / $\nu_0$</td>
<td>1.58</td>
<td>2.84</td>
</tr>
<tr>
<td>DVA / $\nu_0$</td>
<td>(0.38)</td>
<td>(0.68)</td>
</tr>
<tr>
<td>FVA / $\nu_0$</td>
<td>0.41</td>
<td>1.21</td>
</tr>
<tr>
<td>KVA / $\nu_0$</td>
<td>3.19</td>
<td>5.35</td>
</tr>
<tr>
<td>BVA / $\nu_0$</td>
<td>5.18</td>
<td>9.40</td>
</tr>
<tr>
<td>CVA</td>
<td>8.84</td>
<td>13.62</td>
</tr>
<tr>
<td>DVA</td>
<td>(0.74)</td>
<td>(1.28)</td>
</tr>
<tr>
<td>FVA</td>
<td>4.50</td>
<td>7.85</td>
</tr>
<tr>
<td>KVA</td>
<td>0.19</td>
<td>0.32</td>
</tr>
<tr>
<td>CCVA</td>
<td><strong>13.54</strong></td>
<td><strong>21.80</strong></td>
</tr>
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</table>
Impact of the level of the quantiles that are used for setting initial margins, default fund contributions and exposures at default (with $a_m = a_m'$ everywhere)

<table>
<thead>
<tr>
<th>Member</th>
<th>$\Sigma_0 = 61\text{bp}, \nu_0 = 53.00$</th>
<th>$\Sigma_0 = 367\text{bp}, \nu_0 = 5.14$</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>$a_{eqd} = 85%$</td>
<td>$a_{eqd} = 95%$</td>
</tr>
<tr>
<td></td>
<td>$a_{im}' = 80%$</td>
<td>$a_{im}' = 90%$</td>
</tr>
<tr>
<td><strong>CVA / $\nu_0$</strong></td>
<td>2.84</td>
<td>1.25</td>
</tr>
<tr>
<td><strong>DVA / $\nu_0$</strong></td>
<td>(0.68)</td>
<td>(0.30)</td>
</tr>
<tr>
<td><strong>FVA / $\nu_0$</strong></td>
<td>1.21</td>
<td>1.34</td>
</tr>
<tr>
<td><strong>KVA$^{ccr} / \nu_0$</strong></td>
<td>3.73</td>
<td>7.00</td>
</tr>
<tr>
<td><strong>KVA$^{cva} / \nu_0$</strong></td>
<td>1.62</td>
<td>3.03</td>
</tr>
<tr>
<td></td>
<td>$a_{im} = 70%$</td>
<td>$a_{im} = 80%$</td>
</tr>
<tr>
<td><strong>CVA</strong></td>
<td>8.84</td>
<td>5.52</td>
</tr>
<tr>
<td><strong>DVA</strong></td>
<td>(0.74)</td>
<td>(0.32)</td>
</tr>
<tr>
<td><strong>FVA</strong></td>
<td>4.50</td>
<td>6.74</td>
</tr>
<tr>
<td><strong>KVA</strong></td>
<td>0.19</td>
<td>0.36</td>
</tr>
<tr>
<td><strong>CCVA</strong></td>
<td>13.54</td>
<td>12.62</td>
</tr>
</tbody>
</table>
When higher quantile levels are used for the margins and exposures at default, we observe:

- The same qualitative patterns as before in terms of the comparison between the CSA and the CCP setup, which is mainly driven by the compression factor \( \nu_0 \).
- Inside each setup (CSA or CCP), an expected shift from CVA and DVA into KVA (resp. FVA) in the CSA (resp. CCP) setup.
- Ultimately, for very high quantiles, CVA and DVA would reach zero whereas KVA and FVA would keep increasing, meaning that excessive margins become useless and a pure cost to the system, in the CSA as in the CCP setup.
Conclusions

- We developed a rigorous theoretical comparison between bilateral and centrally cleared trading.
- This theoretical framework can be used by a clearinghouse to:
  - Analyze the benefit for a dealer to trade centrally as a member, rather than on a bilateral basis.
  - Find the right balance between initial margins and default fund in order to minimize this cost, hence become more competitive.
  - Help its members risk manage their CCVA.
- We illustrate the netting benefit of CCPs.
- Transfer of CVA and/or KVA into FVA when switching from a bilateral CSA to a CCP setup.
- Potentially important uncovered issues:
  - Fragmentation in case of several CCPs and/or markets.
  - Defaultability of the CCP.
  - Cost of more realistic liquidation procedures.
  - Market incompleteness.
  - Wrong way risk, ...

