We have seen that CVA is the present value of the default risk embedded in OTC derivatives. The role of the CVA desk is to manage that risk.

We have seen previously that hedging (or monetising) default risk has two related but differentiated components:

1. **Cash Hedging**: By this is meant the hedging of actual default events. That is, do something so that when one of our counterparties defaults, we do not suffer any loss, or at least losses are limited.

2. **Paper Hedging**: CVA is a price to a risk. As such, like any other price that is marked periodically, it will fluctuate and have a P&L. These fluctuations can be quite dramatic: during the credit crisis, two-thirds of the credit risk losses were balance sheet CVA related, as opposed to actual default losses [59].

In other words, when we hedge credit risk in OTC derivatives, we can hedge actual default events, and we can hedge the market price of potential future default events. These two things, being obviously highly related, are not the same.

### 11.1 The mechanics of a CVA desk

Let’s say that we are a standard desk in a derivatives dealer; by standard is meant a typical interest rate desk, an FX desk, an equity desk, etc., that sells and synthetically creates (i.e., hedges) OTC derivatives. In order to manage the counterparty risk in our book of derivatives, the dealer can set up a specialised desk. This (CVA) desk will provide a credit insurance to us, the standard desk, against losses from our counterparties defaulting. As a result, this desk is going to charge us for this insurance service. That charge is, precisely, the CVA. Once the CVA charge is received by the CVA desk, it will go out to the market and hedge out the credit risk it has absorbed from us. In this way, CVA should be seen as a “credit insurance fee”. This is illustrated in Figure 11.2.

In principle, the mandate of a CVA desk is to have a zero-flat P&L: it takes responsibility for the credit risk in the book of OTC derivatives in the organisation, and it hedges it out, so that any losses from CVA are profits from the hedges, and vice versa. However, as we will see in subsequent chapters, things are not as simple as that in reality, as a CVA desk can generate profit or loss coming from hedging friction costs and from risks that are not possible to hedge. Taking this one step further, a CVA desk may have a mandate to make money out of the credit risk it trades, hence being a profit centre for the institution.
If fact, the real problem that a CVA desk tries to handle is: how can we minimise the counterparty risk VaR in the book of OTC derivatives in the firm, given (i) the hedging constraint that the market offers and (ii) the limited amount of cash to spend on hedging that we have?

In less sophisticated firms, CVA hedging is done by the dealing desks directly. This is a good approach when the organisation does not have the capability to set up a group specialised in credit risk hedging, though it could easily be a suboptimal set-up given the high degree of complexity around CVA hedging.

In addition to all that has been said, a CVA desk has a key role in managing counterparty risk and, in fact, a centralised and well managed desk has the capability to generate profits via a number of mechanisms that include analysing, restructuring, or terminating trades that generate high credit risk or changing netting, or by suggesting changes in collateral agreements to decrease credit risk.