CIO Brief

Credit Hedging - Defensible Isn't Durable

Rethinking Credit Hedging Under Real Stress

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Executive Framing – Why This Matters Now

Credit hedging is widely treated as prudent risk management.

In practice, many institutional credit hedges primarily manage reporting optics rather than economic loss. They reduce mark-to-market volatility, satisfy governance expectations, and provide comfort to committees – but often fail to protect portfolios when credit stress becomes real.

This brief examines why credit hedging frequently underperforms at precisely the moment it is expected to work, and why, for many long-horizon portfolios, hedging can worsen outcomes rather than improve them.

Most credit losses do not arise from gradual spread movements. They emerge through defaults, restructurings, prolonged impairments, and liquidity freezes that unfold over years. Yet most hedges are designed around spread behaviour, index correlation, and quarterly effectiveness testing.

This mismatch is not accidental. It is structural and persistent.

What Credit Risk Actually Is (and What Most Hedges Cover)

Credit risk is often treated as a single exposure. It is not.

In practice, credit risk combines several distinct components:

- **Default risk** – binary, low-frequency, high-impact
- **Recovery risk** – uncertain, path-dependent, slow to resolve
- **Liquidity risk** – the ability to exit or fund positions under stress
- **Spread risk** – mark-to-market volatility in normal markets

Most CDS-based hedges primarily address **spread risk**.

When portfolios suffer material losses, the drivers are usually different:

- **Defaults cluster** rather than arrive smoothly
- **Recoveries** disappoint expectations
- **Assets cannot be sold** without large discounts
- **Hedges cannot be monetised** when liquidity matters

Spread volatility is rarely the dominant source of permanent loss.

The result is a persistent gap between what portfolios believe they are hedging and what they are actually exposed to.

Why CDS Dominates Institutional Credit Hedging

CDS dominates institutional credit hedging because it is operationally convenient.

It is liquid in normal markets, familiar to consultants and committees, compatible with accounting and regulatory frameworks, and straightforward to document and report. These characteristics make CDS defensible within governance processes.

None of these features guarantee protection during stress.

CDS hedging often transfers **how risk is reported**, not **whether loss is avoided**.

For portfolios that mark-to-market daily or face redemption risk, this trade-off may be acceptable. Spread volatility can become economic loss if it triggers margin calls or forced selling.

For long-duration portfolios – insurance general accounts, infrastructure debt, private credit, and evergreen vehicles – the trade-off is very different. These portfolios rarely fail because spreads widened temporarily. They fail because liquidity vanished or capital became constrained while losses were still unresolved.

Defensibility and effectiveness are not the same thing.

The Hidden Failure Mode – Liquidity

Credit stress is ultimately a liquidity problem.

When credit deteriorates, markets do not remain orderly. Bond liquidity contracts, dealer balance sheets retreat, and bid-offer spreads widen sharply. Positions that appeared liquid become expensive or impossible to exit.

In theory, hedges should offset this stress.

In practice:

- index CDS carries significant basis to deteriorating credits
- single-name CDS suffers the same liquidity constraints as the bonds
- settlement timing often mismatches funding needs
- hedges may show gains on paper while being unusable in practice.

The most damaging outcomes do not occur because hedges "fail." They occur because hedges cannot be monetised when decisions must be made – forcing portfolios to sell other assets at poor levels or absorb losses the hedge was assumed to offset.

A hedge that cannot be converted into usable liquidity when required does not provide protection, regardless of accounting treatment.

The Real Decision – What Are You Trying to Prevent?

The relevant question is not:

"Should we hedge credit risk?"

It is:

"What specific outcome are we trying to prevent, and does this hedge actually change that outcome?"

Credit hedging can make sense when:

- exposures are concentrated and cannot be diversified
- leverage or redemptions turn mark-to-market losses into permanent loss
- regulatory or rating constraints are binding
- Credit hedging often destroys value when:
- portfolios are long-dated and hold-to-maturity
- losses unfold slowly through restructurings
- liquidity is the dominant risk
- hedge costs exceed expected loss absorption

In many cases, portfolio construction, diversification, structural seniority, liquidity buffers, and capital reserves provide more durable protection than derivative overlays.

The most fragile position is not being unhedged.

It is believing you are protected when you are not.

How This Brief Is Intended to Be Used

This brief is designed to frame a decision, not prescribe a solution.

It should be used:

- before approving or rolling a credit hedge
- to clarify what risk is actually being transferred

A detailed practitioner paper and a committee diagnostic are available for institutions reviewing existing credit hedge programmes.

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About Para Bellum Advisors

Para Bellum Advisors is an independent advisory firm specialising in derivatives, collateral, and balance-sheet efficiency for institutional investors.

Its focus is not product distribution or transaction volume, but structure: how hedges are designed, how capital is consumed, and how portfolios behave under stress.

Para Bellum Advisors' work is grounded in practitioner experience across trading, structuring, and portfolio management. The objective is not theoretical optimisation, but durable improvement in capital efficiency, liquidity resilience, and realised outcomes.

Further information is available at www.offers.parabellumadvisors.com

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