CIO Brief

FX Swaps vs Cross-Currency Swaps

Why treating them as substitutes quietly breaks long-dated hedging frameworks

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Executive Summary

There is a persistent mistake in how foreign-exchange risk is handled in long-dated portfolios. It shows up in insurers, funds, infrastructure vehicles, and family offices alike. It is rarely obvious in calm markets, rarely flagged by standard risk reports, and almost never framed correctly when performance disappoints.

The mistake is simple: **treating FX swaps and cross-currency swaps as interchangeable tools**.

They are not. They sit in different markets, solve different problems, and carry very different failure modes. When those distinctions are ignored, portfolios end up structurally fragile long before anyone realises the exposure.

This briefing explains why.

Start with the real objective, not the instrument

Foreign-exchange hedging is often discussed as if it were a trading decision – which instrument is cheaper, which dealer quoted tighter, which roll is easier to execute.

That framing is already wrong.

At the CIO level, FX hedging is not about price optimisation. It is about **economic transformation**. The question is not "how do I hedge FX today?" but rather:

What currency exposure do I want this asset or liability to behave like over its life?

Once that question is asked honestly, the instrument choice becomes much clearer – and much harder to shortcut.

What an FX swap actually delivers

An FX swap is a short-dated liquidity instrument. It consists of two transactions: a near-dated exchange of currencies and a far-dated reversal. Functionally, it is nothing more than a pair of FX forwards stitched together.

That simplicity is not a flaw. It is precisely why FX swaps are so useful for:

- managing near-term funding mismatches
- covering short-dated exposures
- smoothing liquidity over known horizons

But that same design imposes a hard limit. FX swaps are **short-term by nature**. Liquidity is deepest inside the first year, acceptable into the second, and drops away rapidly thereafter. There is no ongoing interest-rate exchange, no embedded alignment with long-dated assets, and no protection against the economics of repeated rolling.

An FX swap does not transform a balance sheet. It temporarily patches a currency gap.

What a cross-currency swap actually does

A cross-currency swap sits in a different market entirely. It exchanges not just principal, but also **interest cashflows**, for the full life of the transaction. Fixed can be swapped to fixed, fixed to floating, or floating to floating, depending on the structure required.

This matters because long-dated assets do not just generate FX exposure at maturity. They generate **ongoing cashflows**, funding requirements, and liquidity demands throughout their life. A CCS is designed to deal with that reality.

In major currency pairs, CCS markets extend ten, twenty, sometimes thirty years. They exist because global borrowers, insurers, and asset managers genuinely need to transform currency exposure over long horizons. That depth is not theoretical – it is structural.

A CCS does what FX swaps never attempt to do: it makes a foreign-currency asset behave, economically, like a domestic one.

Where frameworks quietly go wrong

The most common failure is not an aggressive risk decision. It is an apparently conservative one.

A long-dated asset – say ten years – is hedged using three- or six-month FX forwards or swaps, rolled repeatedly. On day one, the hedge ratio looks correct. The P&L impact looks modest. Governance boxes are ticked.

What is often ignored is what this actually entails.

A ten-year hedge implemented via three-month forwards requires around forty roll events. Forty resets of forward points. Forty spot fixings. Forty moments where liquidity, basis, and funding conditions determine the outcome.

Each roll is small. Collectively, they dominate the economics.

At that point, the hedge outcome is no longer driven by the asset. It is driven by **path dependency** – by how rates, basis, funding stress, and dealer balance sheets evolve over a decade.

That is not a hedge. It is a sequence of contingent bets that only look stable when viewed one roll at a time.

Why this matters most when markets are stressed

In calm conditions, rolling FX swaps feels benign. Forward points behave. Liquidity is there. Governance committees are comfortable.

Under stress, the weaknesses surface quickly. **Basis widens and funding costs spike**, just as liquidity at longer tenors evaporates and margin demands turn sharply pro-cyclical. What had looked like a routine roll becomes a timing and execution risk.

Specifically:

- liquidity evaporates at longer tenors
- margin demands become pro-cyclical
- roll execution becomes a timing risk

The hedge does not "fail" in a dramatic sense. It simply becomes expensive, unpredictable, and operationally fragile at exactly the wrong moment.

This is why many hedge reviews after periods of stress conclude that "FX hedging underperformed expectations" without ever identifying the real cause. The issue was not FX. It was **instrument mismatch**.

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Where cross-currency swaps earn their place

Cross-currency swaps are not exotic tools reserved for complex desks. They are practical instruments for anyone who genuinely needs predictability.

They are particularly effective for:

- insurers holding long-dated foreign bonds but reporting locally
- infrastructure and project-finance vehicles with long-horizon cashflows
- funds transforming funding currency without introducing rollover risk
- corporates seeking stable foreign-currency outgoings

In each case, the objective is not to optimise short-term pricing. It is to **eliminate structural uncertainty** over the life of the exposure.

A CCS does not remove all risk. Nothing does. But it removes the most dangerous one: dependence on future market liquidity to maintain today's hedge intent.

"Couldn't we just replicate it with forwards?"

In theory, yes – for short horizons.

In practice, beyond a year or two:

- execution complexity rises sharply
- operational burden increases
- liquidity costs compound
- funding and margin volatility dominate outcomes

What looks flexible at inception becomes brittle over time. At scale and duration, synthetic replication rarely beats a properly structured CCS once full lifecycle costs are accounted for.

The real CIO-level distinction

The key distinction is not technical. It is conceptual.

FX swaps are **liquidity tools**.
Cross-currency swaps are **balance-sheet tools**.

When a long-dated problem is solved with a short-dated instrument, the cost does not appear immediately. It accumulates quietly through carry leakage, roll friction, and governance surprises. By the time it is visible, the portfolio has already paid for the mismatch many times over.

That is why this issue persists. The damage is slow, dispersed, and easy to misattribute.

Closing perspective

If your portfolio holds assets measured in years and your FX framework is built on instruments measured in months, you are not hedging duration risk – you are deferring it.

That does not mean FX swaps are wrong. It means they are often asked to do a job they were never designed for.

Good hedging is not about cleverness. It is about alignment: between asset life, funding reality, and instrument structure.

Get that alignment right, and FX risk becomes boring – which is exactly what a CIO should want.

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Further Reading and Practitioner Resources

Para Bellum Advisors publishes practitioner papers and CIO Briefs: www.parabellumadvisors.com/insights.

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

The firm works with lean investment teams managing complex, long-dated portfolios across FX, rates, credit, equity, and volatility risk. Its focus is not on product distribution or transaction volume, but on structure: how hedges are designed, how capital is consumed, and how portfolios behave under stress.

Para Bellum Advisors is practitioner-led. Its work draws on decades of experience across trading, structuring, and portfolio management in banks, asset managers, and insurance balance sheets. The objective is not theoretical optimisation, but durable improvement in capital efficiency, liquidity resilience, and realised outcomes.

For more information, visit www.offers.parabellumadvisors.com

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