CIO Brief

Why “Successful” Rates Hedges Still Break

Hidden liquidity, governance, and regime risks in long-dated hedging

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Executive Summary

This brief explains why many rates hedging programmes fail even when interest rates behave broadly as expected.

The issue is not forecasting accuracy or instrument choice in isolation. It is structural. Familiar hedges are often designed to optimise short-term optics while deferring the risks that dominate outcomes over time – liquidity strain, funding persistence, collateral dynamics, and governance intervention under stress.

The objective is not to prescribe instruments. It is to improve judgement before restructuring decisions are forced.

The consequence is that many institutions do not realise a hedge has become structurally fragile until it begins to constrain portfolio decisions. By that point, the question is no longer how to optimise the hedge, but how to manage its unwind without compounding damage.

The Problem Is Not Prediction

Post-mortems on hedging failures often begin with rate forecasts. That is rarely where the failure originates.

In many cases, hedges fail even though rates evolve broadly as expected. Duration is neutralised. Reported volatility remains contained. Hedge accounting holds. Governance processes are satisfied. By conventional measures, the hedge works.

The breakdown occurs later.

What ultimately fails is not the rate view, but the structure's ability to be lived with as conditions change. Risks that were not resolved at inception assert themselves gradually through cashflows, funding requirements, and governance pressure. By the time the problem is acknowledged, flexibility has usually been lost.

This is why rates hedging failures so often appear surprising in hindsight, despite having been structurally inevitable.

Rates Hedging Is Not One Problem

Institutional rates exposure is commonly treated as a single, homogeneous risk. In practice, it spans at least two distinct objectives.

The first is **short-term risk management**: reducing near-term volatility, smoothing reported outcomes, and avoiding drawdowns that attract scrutiny.

The second is **long-term economic certainty**: controlling financing costs, preserving liquidity across regimes, and avoiding forced decisions when conditions deteriorate.

These objectives are not additive. Structures that perform well against one often perform poorly against the other. The cost of that mismatch is rarely immediate, which is why it is tolerated for extended periods before becoming unavoidable.

Most frameworks default to the objective that is most visible and easiest to defend in governance processes. The trade-offs involved are real, but they are rarely made explicit.

The mistake is not choosing one objective over the other, but failing to recognise which one the hedge is actually serving.

Volatility Reduction Is Not Risk Elimination

Volatility is episodic. It is uncomfortable, but often survivable.

Economic exposure is persistent. It asserts itself through ongoing cashflows, collateral requirements, funding dependence, and balance-sheet pressure. These forces accumulate quietly and rarely trigger early warnings.

A hedge can materially reduce mark-to-market volatility while embedding risks that dominate outcomes over time. Governance processes are typically calibrated to monitor volatility, even though portfolios fail because of liquidity and funding constraints.

Reducing volatility does not mean risk has been removed. It means it has been displaced.

What Rates Hedges Actually Do

Rates hedges are often described in terms of what they remove: duration, sensitivity, exposure.

That framing is incomplete.

In practice, hedging reallocates risk. Some risks become smaller and more visible. Others are displaced into areas that are less observable, less frequently modelled, and more likely to bind under stress.

Over long horizons, outcomes are determined less by pricing precision and more by where risk ultimately resides. Structures that defer uncertainty into future regimes depend on favourable liquidity and governance conditions to remain viable. When those conditions change, the hedge's apparent success can reverse.

This divergence explains why hedges can appear robust for years before deteriorating rapidly.

Familiar Instruments and Deferred Decisions

Futures

Futures are effective tactical tools. They are liquid, transparent, and operationally efficient. For managing short-term exposure, they perform exactly as intended.

Used structurally, futures introduce a different set of dependencies. A futures hedge exists only if it is maintained. Maintaining it requires repeated roll decisions executed under whatever market conditions prevail at the time.

Over time, this transforms the hedge into an unacknowledged active strategy. The institution becomes dependent on continuous market access, acceptable roll economics, and ongoing governance tolerance. Many programmes only recognise this years later, when appetite or liquidity has shifted.

Over time, this changes how the hedge is perceived internally – from protection to something that must be actively "managed".

If a hedge must be rolled indefinitely to exist, it is not aligned with a long-dated exposure.

Swaps

Swaps are often described as instruments that "lock in" rates. In reality, they resolve only one decision at inception.

They leave unresolved the behaviour of floating cashflows, funding costs, margin requirements, and liquidity demands under stress. These exposures remain benign while conditions are stable and become binding once regimes shift.

Swaps tend to fail quietly. Duration remains neutralised. Reports stay clean. The problem emerges through persistent net cash outflows and growing liquidity strain once rates move and stay there.

The difficulty is not that these risks are unknown, but that they rarely dominate attention until they do.

This is not a forecasting error. It is a deferred decision revealing itself.

The Cheap Hedge Fallacy

Many rates hedges persist because they look cheap at inception.

Upfront pricing, tight spreads, and favourable carry dominate selection. Lifecycle cost rarely does. For long-dated hedges, the largest costs are incurred not at entry, but through time.

These costs include sustained negative carry, margin funding under volatility, collateral drag, and forced restructuring once governance tolerance is exhausted. Treasury involvement typically becomes visible only after flexibility has already narrowed.

Hedges that appear cheapest initially often push the largest costs into the future – precisely when the ability to respond is weakest.

Governance Is Not a Side Constraint

Governance does not sit outside hedging outcomes. It determines them.

Most institutions optimise for committee comfort, reversibility, and short-term optics. This is rational behaviour within existing incentive structures.

No CIO ever lost their job for suppressing volatility. Liquidity events, by contrast, are career-defining. As a result, hedges are designed to minimise visible discomfort rather than to maximise endurance.

A hedge that requires discretion to remain viable is fragile by design. Each future decision introduces timing risk, behavioural risk, and the possibility of forced action under stress.

When Rates Hedges Fail

Rates hedges rarely fail suddenly.

They deteriorate gradually. Cashflows persist. Margin requirements rise. Liquidity becomes visible. Governance tolerance tightens. Each step reinforces the next.

By the time the issue is acknowledged, the option to adjust the structure cheaply has usually passed. The outcome is often attributed to market shock, even though the real cause was embedded at inception.

Rates hedging failures are rarely the result of a single poor decision. They reflect small choices whose consequences only become visible once time has done its work.

What It Means for a Hedge to Behave

A rates hedge behaves only if it delivers its intended economic outcome across regimes without forcing action at the wrong moment.

That requires accepting a simple reality: uncertainty can either be resolved upfront or deferred into the future. It cannot be eliminated by clean reports, familiar instruments, or sensitivity metrics.

The hedges that survive are not the most flexible. They are the ones that leave the fewest decisions to be made when conditions deteriorate.

That is what it means for a rates hedge to behave.

How CIOs Use This Brief

This brief is designed to support judgement before action.

It helps distinguish between hedges that are structurally survivable and those that depend on continued favourable conditions. It is intended to surface hidden assumptions early, before restructuring decisions are forced by liquidity or governance constraints.

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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