IC Brief

PARA BELLUM ADVISORS

Counterparty Credit Risk Reduction

Preventing forced liquidity actions from legacy derivative portfolios

Scenario Type: Infrastructure – Multi-Asset Portfolio (Operating Phase)
Asset Class: Diversified Infrastructure (Transport, Utilities, Renewables, Social)
Situation Type: Operating portfolio with long-dated derivatives accumulated across multiple acquisitions
Primary Issue: Portfolio-level counterparty concentration and downgrade-triggered collateral risk creating forced-action and liquidity exposure unrelated to hedge performance

1. Decision Context

The fund holds a large, long-dated derivative book built incrementally through asset acquisitions.

Each hedge was appropriate at the time of execution. At portfolio level, the aggregate structure has become fragile under credit stress.

The IC decision is **not** whether the portfolio is hedged correctly. It is whether the derivative book can absorb a counterparty credit event **without triggering forced liquidity actions, value leakage, or governance failure**.

This is a **control and resilience decision**, not a market view.

2. What Changed

The portfolio evolved organically. The control framework did not.

Over time:

- Derivatives accumulated transaction-by-transaction, not portfolio-designed
- Counterparty exposure drifted beyond policy limits without escalation
- Legacy CSAs remained in place under outdated assumptions
- Downgrade triggers and collateral mechanics were never stress-tested
- Board oversight focused on hedge presence, not hedge ecosystem behaviour

The portfolio entered a credit-sensitive regime without an operating playbook.

3. How the Risk Actually Manifests

The risk is not mark-to-market loss. It is **forced action under time pressure**.

When counterparty credit deteriorates:

- CSA thresholds step down
- Independent amounts activate
- Policy breaches trigger mandatory action
- Margin deadlines compress to days
- Pricing power shifts entirely to dealers

The hedge does not fail. Control fails.

4. What Surfaces on Review

Across the derivative book:

- Counterparty concentration materially exceeds policy intent
- Exposure aggregation exists on paper, not as a decision tool
- CSAs vary widely by vintage and counterparty
- Termination and novation economics are misunderstood ex-ante
- New counterparty onboarding introduces hidden collateral drag
- No sequencing framework exists to minimise forced-cost outcomes

The risk is structural and repeatable, not idiosyncratic.

5. Structural Assessment

This is **not**:

- A pricing issue
- A hedge effectiveness problem
- A bank-selection exercise

It **is**:

- A portfolio-level counterparty architecture failure
- A liquidity-under-stress problem
- A governance sequencing problem

Any response must preserve:

1. Liquidity control under downgrade scenarios
2. Policy compliance without donating value
3. Negotiating leverage with counterparties
4. Board-defensible execution logic

Brute-force termination or ad-hoc novation fails these tests **by crystallising stress**.

6. Structuring Logic

Effective responses focus on **sequencing and control**, not immediate reduction.

Typical structuring logic includes:

- Mapping counterparty exposure, CSA triggers, and collateral paths at portfolio level

- Identifying downgrade-sensitive points where forced action would occur
- Sequencing novations, compressions, or terminations to preserve pricing leverage
- Diversifying counterparties only where it improves liquidity resilience net of new collateral costs
- Standardising CSA mechanics to reduce asymmetric behaviour under stress

The objective is to **restore decision space before stress arrives**, not to optimise marks under pressure.

7. Intended Outcomes

When addressed correctly:

- Counterparty risk becomes governable rather than reactive
- Liquidity impact under downgrade scenarios is known and contained
- Forced action risk is materially reduced
- Negotiating leverage with dealers improves
- Policy compliance aligns with economic reality
- Board and IC oversight shifts from firefighting to control
- IC and board escalation becomes planned, not reactive

The portfolio remains hedged – but no longer fragile.

8. IC Takeaway

Counterparty credit events rarely create economic losses first. They create **decision clocks**.

Without a sequenced, portfolio-level plan, derivative books convert credit stress into forced liquidity events and avoidable value leakage.

This is a **governance and execution risk**, not a market risk.

Restoring control requires **rationalising the derivative ecosystem** – not just reducing notional.

Control is architectural, not transactional.

9. Applicability

Most relevant where:

- Derivative books were built across multiple acquisitions
- One or two counterparties dominate exposure
- Legacy CSAs contain downgrade triggers or step-downs
- Policy limits exist but lack operational enforcement
- Liquidity sensitivity matters at portfolio level

Less relevant where:

- Derivatives are short-dated and centrally managed
- CSAs are modern, standardised, and stress-tested
- Active compression and counterparty dashboards already exist

10. Engagement Path

Primary Offer: Derivatives Portfolio Review™ -Counterparty concentration, CSA trigger mapping, liquidity impact analysis, and downgrade-event playbook.

Secondary / Bespoke: Hedge Rebuild™, CSA renegotiation, downgrade-trigger remediation, novation and termination sequencing, counterparty diversification strategy.

A full structural narrative is available for readers who wish to review the underlying mechanics, trade-offs, and remediation sequencing in greater detail.

Disclaimer

Illustrative scenario for discussion purposes only. Not a transaction summary or client-specific case study.