EXECUTIVE BRIEF

Credit Hedging

Defensible Isn’t Durable

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Executive Summary

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.

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

Credit risk is often treated as a single exposure. It is not. It combines default risk, which is binary, low-frequency, and high-impact; recovery risk, which is uncertain and path-dependent; liquidity risk, the ability to exit or fund positions under stress; and spread risk, which is 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, assets cannot be sold without large discounts, and 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 and Why That Is a Problem

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. 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 long-duration portfolios, including insurance general accounts, infrastructure debt, private credit, and evergreen vehicles, the trade-off is particularly poor. 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 practice, index CDS carries significant basis to deteriorating credits, single-name CDS suffers the same liquidity constraints as the bonds, settlement timing mismatches funding needs, and hedges may show gains on paper while being unusable in practice. The most damaging outcomes occur not because hedges fail but because they cannot be monetised when decisions must be made, forcing portfolios to sell other assets at poor levels.

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

The Real Decision

The relevant question is not whether to hedge credit risk. It is what specific outcome you are trying to prevent, and whether the hedge actually changes that outcome.

Credit hedging can make sense when exposures are concentrated and cannot be diversified, when leverage or redemptions turn mark-to-market losses into permanent loss, or when regulatory or rating constraints are binding. Credit hedging often destroys value when portfolios are long-dated and hold-to-maturity, when losses unfold slowly through restructurings, when liquidity is the dominant risk, or when 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.*

Closing Perspective

The most fragile position is not being unhedged. It is believing you are protected when you are not.

Before approving or rolling a credit hedge, the question to ask is whether this structure changes the outcome that actually matters, and whether the protection it provides will be available when it is needed most. Governance comfort and economic protection are different things. Conflating them is where most credit hedging programmes go wrong.

> *Defensible isn't durable. The distinction is worth making before the stress arrives, not after.*

About This Brief

This Executive Brief is a companion to the Para Bellum Advisors practitioner paper: The Credit Hedge Illusion: A Practitioner's Guide to What Actually Works.

Available at **www.parabellumadvisors.com/insights/**

About Para Bellum Advisors

Para Bellum Advisors is an independent advisory firm specialising in derivatives, structured finance, and balance sheet efficiency for institutional investors, family offices, and corporate treasury teams.

The firm focuses on hedge framework design, overlay mechanics, collateral efficiency, and portfolio resilience across FX, rates, credit, equity, and volatility exposures. Its work is practitioner-led, drawing on three decades of experience across trading, structuring, and portfolio management in APAC and globally.

Para Bellum Advisors is independent of product distribution and transaction mandates. Its objective is durable improvement in capital efficiency and liquidity resilience.

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