



PARA BELLUM ADVISORS

EXECUTIVE BRIEF

The Rates Hedge That Looked Right – Until It Didn't

Spotting Structural Fragility Before It Binds

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Executive Summary

Most long-dated rates hedges do not fail because interest rates move in an unexpected direction. They fail because structures that look correct at inception quietly accumulate liquidity, funding, and governance risk over time. Duration is neutralised, risk reports remain clean, and execution is competent, yet outcomes deteriorate as cashflows persist, margin demands grow, and flexibility disappears.

By the time the problem becomes visible, the hedge itself has become the constraint. This brief examines why that pattern is so common, even in well-governed institutions, and why working hedges can still undermine portfolios years after they are put on.

When Correct Design Still Fails

Most long-dated rates hedges are approved for sensible reasons. They neutralise duration, use liquid and familiar instruments, satisfy accounting and policy requirements, and are easy to defend at inception.

What is rarely made explicit is the economic choice embedded in the structure. Every long-dated hedge either closes the economics of the exposure when it is executed or defers material risks into the future. Instruments that defer economics leave funding costs, liquidity dependence, and repeated decision-making exposed to conditions that will inevitably change. That distinction is rarely framed clearly in investment or risk committees. As a result, many portfolios inherit hedges that look correct on paper but depend on assumptions about future liquidity and governance discipline that quietly erode over time.

The hedge simply did what it was designed to do. It deferred economic exposure into floating cashflows, funding conditions, and repeated decisions under stress.

Why Intuition Misleads: Tenor Matching and Rolling

Tenor matching works when exposure is contractually durable and unlikely to change. In those cases, matching hedge maturity to cashflows can remove uncertainty almost entirely. Problems arise when tenor matching is applied to exposures whose persistence is aspirational rather than enforceable. When the hedge outlives the exposure's true commitment, termination risk is introduced by design. What was intended as protection becomes a rigid constraint.

Rolling structures create a different illusion. They preserve the appearance of flexibility by avoiding long commitments. In practice, they embed repeated repricing, funding dependence, and market access as permanent features of the hedge. Over long horizons, those dynamics dominate outcomes.

Flexibility that relies on continuous liquidity and calm governance is not free. It is borrowed from the future.

Collateral Is Where Reality Arrives

In modern markets, rates hedging is capital-intensive by design. Initial margin immobilises capital from day one. Variation margin introduces pro-cyclical cashflows that peak precisely when volatility rises and funding is most constrained. These dynamics matter far more over long horizons than entry pricing or short-term carry.

Most hedging decisions underweight this reality. Collateral is treated as operational plumbing rather than as a structural risk. When long-dated hedges fail in practice, it is rarely because mark-to-market losses become intolerable. It is because the hedge cannot be funded through stress without forcing asset sales or governance action elsewhere in the portfolio.

At that point, the hedge stops behaving as protection and starts dictating portfolio decisions.

What Emerging Markets Reveal

Emerging markets do not change the logic of rates hedging. They remove the buffers that allow poor structure to persist. Where liquidity is thin, instruments are constrained, and funding is fragile, hedges that defer economics fail quickly and visibly. In developed markets, deep liquidity allows the same structural weaknesses to survive longer. They do not eliminate them.

The disciplines enforced in emerging markets, closing economics where commitment is real, avoiding perpetual rolling, and accepting mark-to-market volatility in exchange for certainty, are the same disciplines long-dated hedging requires everywhere.

What CIOs Should Be Asking Before It Matters

Before approving or inheriting a long-dated rates hedge, there are four questions that should produce clear answers.

Which economics are truly closed today, and which are being deferred into future regimes?

Could this hedge survive prolonged stress without forcing action due to liquidity or funding constraints?

Does the structure rely on continuous market access to function?

Would the hedge remain acceptable if reviewed under a more conservative governance regime?

If those answers are unclear, fragility already exists, even if the hedge has performed well to date.

Closing Perspective

Long-dated rates hedging is not a technical optimisation exercise. It is a commitment decision made under uncertainty, whose consequences emerge years later under very different conditions. Uncertainty can be resolved at inception, or it can be deferred into future environments where liquidity is scarce, and governance tolerance is low.

Hedges behave only when economics are closed where commitment is real, and flexibility is used only where it can actually be exercised. The goal is to surface those realities early, while choices still exist.

About This Brief

This Executive Brief is a companion to the Para Bellum Advisors practitioner paper: Why Rates Hedges Don't Behave: A Practitioner's Guide to Long-Dated Rates Hedging.

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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