PARA BELLUM ADVISORS

EXECUTIVE BRIEF

Why “Successful” Rates Hedges Still Break

Hidden Liquidity, Governance, and Regime Risk in Long-Dated Hedging

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Executive Summary

Many rates hedging programmes fail even when interest rates behave broadly as expected. The issue is not forecasting accuracy or instrument choice. 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. 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 it’s 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. 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.

> *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.*

Rates Hedging Is Not One Problem

Institutional rates exposure 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 mistake is not choosing one objective over the other. It is 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 reallocate 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. For managing short-term exposure, they perform exactly as intended. Used structurally, they 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. 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.

> *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.

> *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: sustained negative carry, margin funding under volatility, collateral drag, and forced restructuring once governance tolerance is exhausted.

> *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. 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.*

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.

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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